LPL RESEARCH

WEEKLY ECONOMIC COMMENTARY

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FOMC FAQs

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KEY TAKEAWAYS

The Fed holds its eighth and final FOMC meeting of 2015 this Tuesday and Wednesday, December 15 – 16, 2015.

As of Monday, December 14, 2015, the fed funds futures market has priced in about an 80% chance of a 25 basis point (0.25%) rate hike at this week's meeting.

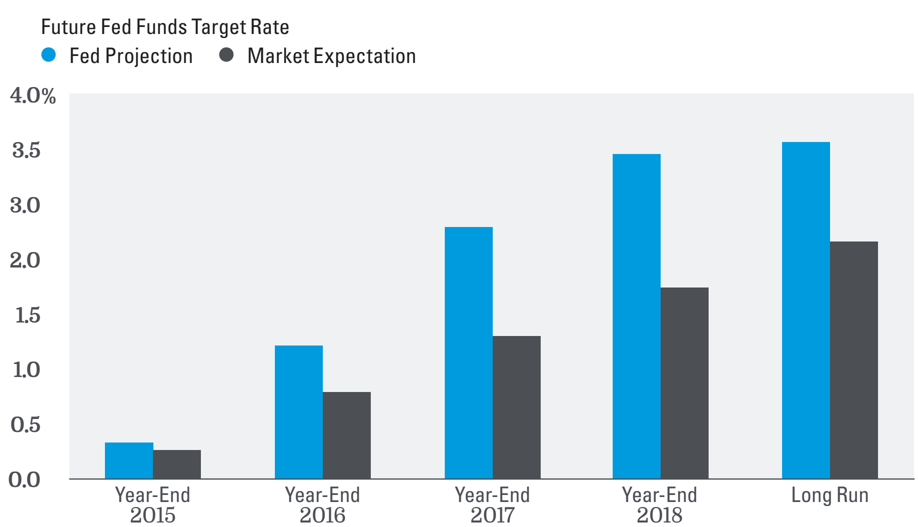
Our view remains that the timing of the first hike matters less than the pace of the hikes; the end point for the fed funds rate in this tightening cycle and the gap between the Fed's own view of rates and the market's view remain crucial.

As we noted in our *Outlook 2016: Embrace the Routine* publication, the start of a new Federal Reserve (Fed) rate hike cycle may grab investors' attention, but investors must distinguish where it is more likely to disrupt their accustomed routine (bonds) and where it is more likely to be just a distraction (stocks). In addition, the market and the Fed remain deeply divided over the timing and pace of Fed rate hikes, and how that gap is resolved will determine the extent of the effects on the markets. As a reminder, the start of Fed rate hikes does not signal the end of economic expansions. Indeed, since 1950, the start of Fed rate hikes meant that the economy was still in the first half of the expansion.

We believe a rate hike this week remains a strong possibility. Our view remains that when the Fed does raise rates, the timing of the first hike matters less than the pace of the hikes; the end point for the fed funds rate in this tightening cycle (the first since 2004) and the gap between the Fed's own view of rates and the market's view remain crucial.

The Federal Open Market Committee's (FOMC) latest forecast of its own actions (September 2015) puts the fed funds rate at 1.375% by the end of 2016. As of December 14, 2015, the market (as defined by the fed funds futures market) puts the fed funds rate 0.50 – 0.75% lower at around 0.77% by the end of 2016 [Figure 1]. How that gap closes — between what the market thinks the Fed will

1 ALTHOUGH THE GAP HAS NARROWED, FUTURES ALREADY REFLECT A SLOWER PACE OF RATE HIKES



Source: LPL Research, Chicago Board of Trade, Federal Reserve 12/14/15

Long run is defined as five years.

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do and what the Fed is implying it will do—against the backdrop of what the Fed actually does, will be a key source of distraction for markets in 2016. Our view is that by the end of 2016, the fed funds rate will be pushed into the 0.75–1.0% range.

WHAT IS THE SCHEDULE OF EVENTS FOR THE FED THIS WEEK?

The Fed holds its eighth and final FOMC meeting of 2015 this Tuesday and Wednesday, December 15–16, 2015. The meeting will be followed by an FOMC statement at 2:00 p.m. ET, along with the FOMC's latest economic forecasts for gross domestic product (GDP), the unemployment rate, inflation, and fed funds projections for year-end 2016, 2017, 2018, and beyond (aka the "dot plots"). Following the release, at 2:30 p.m. ET, Fed Chair Janet Yellen will hold her fourth and final press conference of 2015.

HAS THE "MARKET" PRICED IN A RATE HIKE AT THIS WEEK'S MEETING?

As of Monday, December 14, 2015, the fed funds futures market has priced in about an 80% chance of a 25 basis point (0.25%) rate hike at this week's meeting. The short end (as measured by the yield on the 2-year Treasury note) of the Treasury market has also been pricing in a hike in recent months, with the yield on the 2-year note moving from 0.55% in mid-October 2015, to 0.91% as of December 14. It is more difficult to discern whether other markets (equity, currency, fixed income, etc.) have priced in a hike or not, but the Fed's rhetoric in recent weeks and months along with the move in the fed funds futures markets have not gone unnoticed by investors in other markets. Still, because the Fed has not started a tightening cycle in more than 11 years (June 2004), there is likely to be some volatility in financial markets around the first hike.

WHY DO THE "DOT PLOTS" MATTER?

As noted earlier, the FOMC's latest (September 2015) forecast of its own actions puts the fed funds rate at 1.375% by the end of 2016. As of December 14, the market (as defined by the fed funds futures market) puts the fed funds rate 0.50–0.75% lower at around 0.77% by the end of 2016. How the relationship between these views evolves is crucial. Most market participants expect the FOMC to lower its year-end 2016, 2017, and 2018 fed funds target by at least 25 basis points (0.25%), and reduce the dot for the "longer run" (or neutral) fed funds rate by 25 basis points to 3.25%. This will help to close, but not completely eliminate, the gap between the market's expectation of what the Fed will do and the Fed's projection of its own actions. We still think the Fed will maintain its insistence that any future rate hikes are "data dependent" and that every FOMC meeting in 2016 is a "live meeting."

WILL THE ROTATION TO NEW FOMC MEMBERS IN 2016 IMPACT FED POLICY?

It is not too soon to look ahead to the voting lineup of the FOMC starting with the January 26–27, 2016, FOMC meeting. The FOMC consists of 19 members: 12 voting members and 7 nonvoting members. The 19 members are the presidents of each of the 12 regional Federal Reserve Banks (Boston, New York, Philadelphia, Richmond, etc.) and the 7 members of the Board of Governors of the Fed. The 7 board members include Fed Chair Yellen and Vice Chair Stanley Fischer.

According the Fed's website:

"The (voting members of the) Federal Open Market Committee (FOMC) consists of twelve members—the seven members of the Board of Governors of the Federal Reserve System; the president of the Federal Reserve Bank of New York; and four of the remaining eleven Reserve

Bank presidents, who serve one-year terms on a rotating basis. The rotating seats are filled from the following four groups of Banks, one Bank president from each group: Boston, Philadelphia, and Richmond; Cleveland and Chicago; Atlanta, St. Louis, and Dallas; and Minneapolis, Kansas City, and San Francisco. Nonvoting Reserve Bank presidents attend the meetings of the Committee, participate in the discussions, and contribute to the Committee's assessment of the economy and policy options."

In 2016, the Boston Fed's Eric Rosengren, a policy dove, will replace Richmond's Jeffrey Lacker, a hawk (please see Figure 2 for a description of hawks and doves). Cleveland's Loretta Mester replaces Chicago's Charles Evans in a hawk-for-dove swap. The president of the St. Louis Fed, James Bullard, a hawk, will replace dove Dennis Lockhart (Atlanta), and Kansas City's Esther George, who is also a hawk, will replace the dovish John Williams of the San Francisco Fed [Figure 2].

While the regional bank presidents rotating onto the FOMC as voters are, in aggregate, likely to be more hawkish than the regional bank presidents leaving the committee as voters, the returning voting members of the Fed Board of Governors are likely to continue to vote with the chairman and vice chairman on monetary policy. Thus, even the net addition of perhaps two additional hawks to the FOMC in 2016 is not likely to substantially alter the course of monetary policy next year.

DOES THE FED CHANGE MONETARY POLICY IN AN ELECTION YEAR?

The short answer is yes. While the Fed often pauses in the month or so prior to the November election, the Fed has changed policy (either raised or lowered rates or stopped or started quantitative easing [QE]) in every election year since at least 1968, and we don't expect anything different in 2016.

2 FOMC VOTING MEMBERS IN 2016

IN	OUT
Name and Title	**Name and Title**
Eric Rosengren President of the Federal Reserve Bank of Boston	Jeffrey Lacker President of the Federal Reserve Bank of Richmond
Loretta Mester President of the Federal Reserve Bank of Cleveland	Dennis Lockhart President of the Federal Reserve Bank of Atlanta
James Bullard President of the Federal Reserve Bank of St. Louis	Charles Evans President of the Federal Reserve Bank of Chicago
Esther George President of the Federal Reserve Bank of Kansas City	John Williams President of the Federal Reserve Bank of San Francisco

Source: LPL Research, Federal Reserve Board of Governors 12/14/15

Hawks: Fed officials who favor the low inflation side of the Fed's dual mandate of low inflation and full employment.

Doves: Fed officials who favor the full employment side of the Fed's dual mandate.

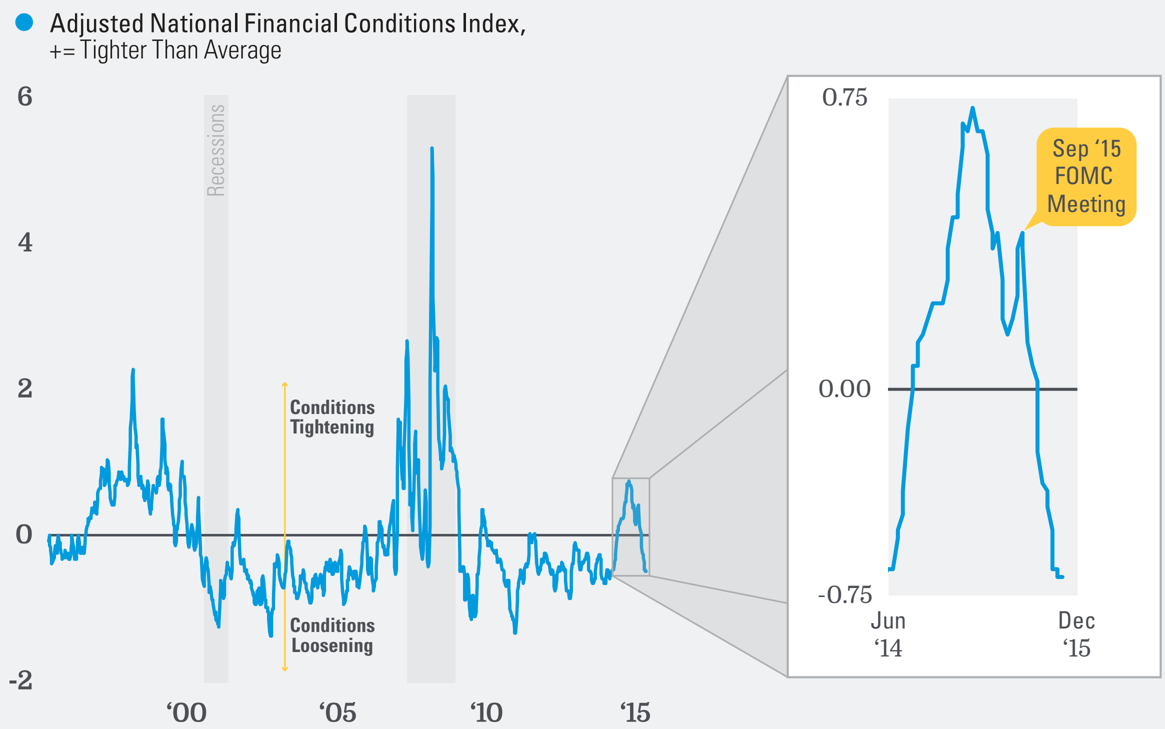
WILL THE RECENT EQUITY MARKET PULLBACK DETER THE FOMC FROM ACTING AT THIS MEETING?

As of December 11, the S&P 500 has declined by nearly 5% since early December 2015, leading some market participants to suggest the Fed may not move ahead with a rate hike this week. Fed Chair Yellen cited tightening financial conditions as one of the reasons the FOMC chose not to begin raising rates at the September 16–17, 2015, FOMC meeting. Figure 3 shows financial conditions—as measured by the Federal Reserve Bank of Chicago's Financial Conditions Index—have eased since the September 2015 FOMC meeting, after tightening over the spring and summer of 2015. Note that despite tightening financial conditions between mid-2014 and mid-2015—and again, briefly in August and September 2015—they never even got close to where they were during the 2007–2009 financial crisis.

WHAT ABOUT THE FED'S BALANCE SHEET?

We expect the FOMC to continue to mention its balance sheet as a monetary policy tool in the FOMC statement, but most market participants (ourselves included) believe that the Fed will wait until after the fed funds rate has moved well off the "zero bound" before allowing its balance sheet to contract.

3 FINANCIAL CONDITIONS HAVE EASED SINCE THE SEPTEMBER 2015 FOMC MEETING



Source: LPL Research, Federal Reserve Bank of Chicago, Haver Analytics 12/11/15

WHAT IMPACT WILL A 0.25% RATE HIKE HAVE ON THE U.S. ECONOMY?

There are several ways to address this issue. By itself, a 25 basis point (0.25%) rate increase — which is largely priced in by financial markets — should not have a large impact on the U.S. economy. Yes, it may cost more for businesses and consumers to borrow, but the removal of the uncertainty around the timing of the first Fed rate hike of the cycle — often cited by businesses and forecasters as an impediment to consumer and business spending in the past several years — should be a plus for both business and consumer spending. But ultimately, how fast and how far the Fed raises rates will determine the impact on the U.S. and global economies. ■

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DEFINITIONS

Quantitative easing (QE) refers to the Federal Reserve's (Fed) current and/or past programs whereby the Fed purchases a set amount of Treasury and/or mortgage-backed securities each month from banks. This inserts more money in the economy (known as easing), which is intended to encourage economic growth.

The Chicago Fed's National Financial Conditions Index provides a comprehensive weekly update on U.S. financial conditions in money markets, debt and equity markets, and the traditional and "shadow" banking systems.

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