We Have Rate Lift Off! A New Tightening Cycle Begins

After seven long years of zero-interest-rate policy, the ten voting members of the Federal Open Market Committee (FOMC) unanimously decided to raise its key federal funds rate by ¼ point to a new target range of 0.25% – 0.50%. The committee's policy statement emphasized that "future rate normalization (increases) will occur gradually" next year. The U.S. Federal Reserve's official new forecasts call for its key interest rate to end 2016 at 1.375%, implying four additional ¼-point rate increases in 2016 from today's new target range. Notably, the policy statement phrase "the timing and the size of future (rate) adjustments" means that the Fed retains flexibility for increases greater than ¼-point, if warranted. The Fed also raised the interest it pays on excess reserves that banks hold at the Fed from 0.25% to 0.5%. Likewise, key banks raised the Prime Rate from 3.25% to 3.5%.

Today's Federal Reserve action begins reducing its still historically-low accommodative interest rate policy. The FOMC embarked on its last tightening cycle in June 2004, with its last increase occurring in June 2006. Following the financial crisis, policymakers steadily lowered rates and moved to a near-zero (0% - 0.25%) rate stance in December 2008.

Policymakers gave a largely positive assessment of the economy, saying that growth has continued at a "moderate pace," and job market indicators confirm that "underutilization of labor resources have diminished appreciably since early this year." Regarding the closely watched "dot plot," showing Fed members various future rate outlooks, changes were few, with the most dovish member having a 2016 fed funds outlook of 0.75% – 1%, while the most hawkish view projects rates could rise to 2% – 2.25% next year.

We identify four main takeaways surrounding the December FOMC policy statement and updated economic forecasts:

- The Fed believes economic activity continues to expand at a moderate pace.
- The Fed's gross domestic product (GDP) growth outlook remains at 2.1% for 2015, while revised higher for 2016 to 2.4% from 2.3%. For 2017 and 2018, the Fed continues to project GDP growth of 2.2% and 2%, respectively.
- In her press conference, regarding the $3 trillion worth of quantitative-easing (QE) monthly-acquired bond holdings, Fed Chair Janet Yellen said the Fed will keep its balances high until normalization is long under way.
- The Fed believes future rate hikes will be "gradual" and dictated by economic outlook changes and incoming data, as inflation rises toward its 2% target.

We believe the Federal Reserve's description of gradual future rate increases will be on the light side and stay lower for longer. Notably, we observe the implied odds for an additional hike in January are just 6% and a 41% chance for March. Fed funds futures do not price in at least 70% odds for an additional rate hike until July 2016. We also highlight that rate policies remain highly accommodative overseas, with particular opportunity emphasis in Europe and Japan. We also expect market volatility to continue at elevated levels, as weak domestic manufacturing and greatly-diminished crude oil prices pose deflationary risks. We continue to recommend an allocation to equities in line with long-term investment objectives, and we maintain a somewhat defensive position in fixed income, with an overweight to credit sensitive bonds and a shorter duration. However, with the expectation that interest rates may remain lower for longer, it is possible that there will be fewer headwinds for bonds in the near-term. If that is the case, it may be prudent to start reducing the defensive positioning.

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