The Fed Raised Rates 0.25% Yesterday, OMG!

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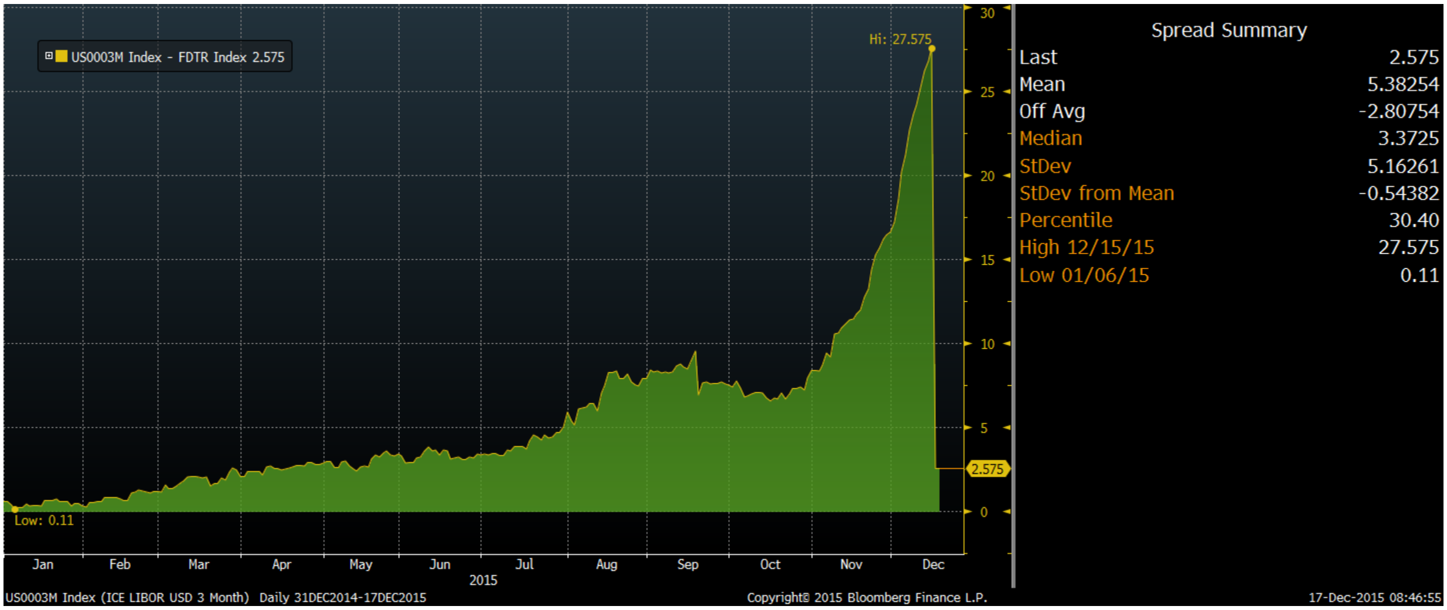
What's the Surprise?

Pardon the sarcasm, but this has to be the most anticipated Federal Reserve rate increase in history. How much so? We have been debating this all year and when it became clear it was likely, the markets priced it in before it actually happened. The best way to visualize this is to look at the spread between the Fed Funds Target Rate and 3-month LIBOR – the London Interbank Offered Rate. This is a benchmark rate that banks reference when making short-term loans to each other. Here is a Bloomberg chart of the spread since the beginning of the year:



You can see on this chart that the LIBOR interest rate market fully anticipated the rate hike in advance of it actually happening. The scale on this chart is in "basis points." One basis point is equal to one one-hundredth of one percent, or 0.01%. So we entered the year with LIBOR and the Fed Funds Rate at essentially the same level – a mere difference of 0.0011% (See the "Low: 0.11" basis points on the bottom-left of the chart). The day before the rate hike, the spread was 0.27% (See the "Hi: 27.575" basis points on the top-right of the chart), fully reflecting the anticipated rate hike of 0.25%. After the rate hike, the spread is back near zero, just 0.026% (the 2.575 basis points on the bottom-right of the chart). A take away here is that another rate hike is not expected by the market in the next three months.

In other markets:

- Yesterday's rate hike, while noteworthy, was pretty much a non-event to the 10-year Treasury market – the 10-year Treasury yield hit 2.33% right before the announcement, then the yield fell. Today it is trading around 2.25%. We have averaged about 2.2% over the past six months.
- It was pretty much a non-event for stocks too. Yes, they rallied after announcement into the close, but have given most of that back so far today. The pattern is similar whether you look at the U.S., developed international, or emerging markets based on ETFs that were trading at the time.
- The dollar rose and continues to do so today. This is as it should be. The pressure on the dollar to rise increases as U.S. interest rates rise relative to foreign rates. Note, the European Central Bank (ECB) just lowered its Deposit Facility Rate to -0.3% on December 3rd. Yes, that was a minus. The ECB is charging banks to keep money on deposit at the central bank.

What’s the Impact?

In terms of the impact on one’s personal finances, for now, there is not much:

- 0.25% on a $100,000 bank deposit will earn you $250 over the course of the year before taxes, if you get it. Chances are you won’t as banks are slow to raise deposit rates. Deposit rates tend to lag rate hikes in terms of both magnitude and timing.
- On the other hand, banks tend to raise lending rates more quickly. So, if you are taking out a new short-term loan today, it will probably be at a rate 0.25% higher than it was yesterday, and your variable rate mortgage loan will likely reset to a marginally higher rate. Three cheers to the enlightened self-interest of your friendly neighborhood banker.
- Still, compare the $250 per $100,000 in borrowing to the savings we have all experienced from the collapse in gas prices alone. If you consume 600 gallons a year driving, that is a savings of $900 per year in *after-tax* income since gas prices fell from the $3.50 range a year ago to about $2.00 per gallon today. You can thank the discord in OPEC, and Saudi Arabia especially, for the holiday gift of sustained low oil prices.

In terms of the impact on the overall economy, also not much from a numbers perspective. It was just a 0.25% hike from a low level. The current level is still stimulative to the economy. What is more important is the impact of the “policy change” on expectations and marginal borrowers.

The Fed’s expected path for the Fed Funds rate is as follows:

- 2016: 1.4%
- 2017: 2.4%
- 2018: 3.4%

This is a modest path to rate normalization and it may not happen. The Fed is intent to “contain” inflation to its target of 2% for the core personal consumption expenditures index, but it is currently running at just 1.3%. Based on current measures, they are shadow boxing with a non-existent inflation opponent. Further, they do not expect core inflation to hit 2% until 2018. If they do not get the inflation increases they are expecting/targeting and the economy falters at all, then expect them to lag the forecasted rate increases. It is unlikely that the economy will surprise to the upside with the higher dollar undermining our competitiveness from a trade perspective. The Fed also needs to manage the risks from marginal borrowers metastasizing to the broader economy. Based on the Credit Suisse U.S. Liquid High Yield Index, that market has already priced in more than a 60% increase in the expected default rate, primarily as a result of lower oil prices on low credit quality energy-related companies. The annual default rate implied by the market is in the 7% to 7.5% range. It was 4.5% as recent as June. This may be shaping up for a buying opportunity in high yield.

So, the Fed Rate hike was expected and was the right action for the moment – not too hot, not too cold, but just right as Goldilocks would say. The Fed is beginning the process of moving short term interest rates to a more normal level, and is doing so in a measured and responsible way. So long as the economy maintains momentum, the Fed will stay on their expected path of rate increases, which ultimately means better fixed income returns in the long run.

Data sources include Bloomberg, The Federal Reserve, Credit Suisse and Wealthcare.

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