In the Spotlight

The Pace of Fed Tightening

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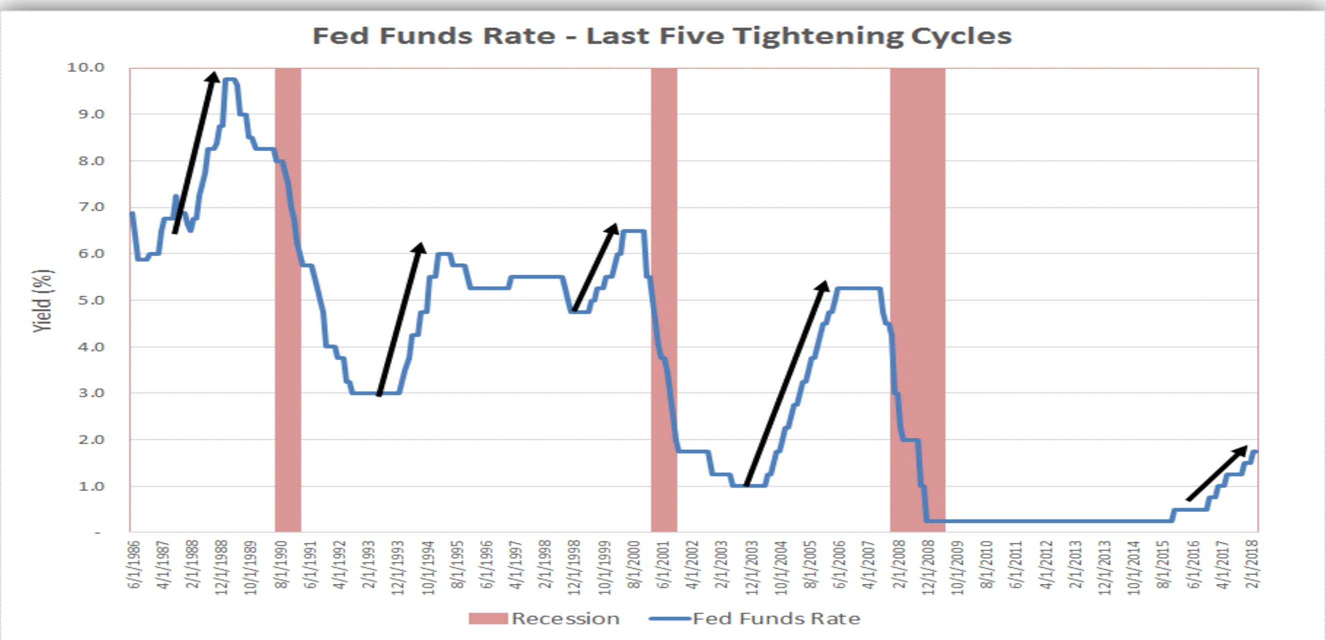

1st Hike	Last Hike	Start Rate	End Rate	Change	# of Months	Increase/Quarter
Feb-88	Feb-89	6.50	9.75	3.25	12	0.81
Jan-94	Feb-95	3.00	6.00	3.00	13	0.69
May-99	May-00	4.75	6.50	1.75	12	0.44
May-04	Jun-06	1.00	5.25	4.25	25	0.51
Nov-16		0.50	1.75	1.25	17	0.22

The challenge before the Fed is to normalize interest rates and contain inflation while not precipitating a recession. Rates remain low relative to inflation and nominal growth, and have been this way since the Great Recession. At current inflation and growth levels, a "normal" level for the Fed Funds rate is around 3.5% based on historical averages. The Fed currently sees a Funds rate of about 3% as neutral and expects to reach that level in 2019. Inflation, while on the rise, remains below the Fed's 2% target for personal consumption expenditures[1]. The Fed expects inflation to exceed its 2% target next year.

The current tightening pace is modest, at just 0.22% per quarter so far – half (or less) of the pace of the prior four cycles. In three of the prior four tightening cycles, the Fed caused an inverted yield curve which led to a recession. The 1994/95 cycle did not lead to recession as the Fed took a cue from falling bond yields: it stopped raising rates then began lowering them, thereby avoiding an inverted yield curve. Expect the Fed to behave similarly this cycle.

The Fed will take its cue from the bond market as it continues to raise rates. If it raises rates too far or too fast, the bond market will signal this with an inverted yield curve. Currently, the yield curve is positive with 10-year Treasury yields about 120 basis points above the Fed Funds rate. This is near the long-term average and gives the Fed ample room to continue to raise the Fed Funds rate according to its current plans. The Fed plans to raise rates 2-3 more times this year and 3 more times in 2019. At 25 basis points per hike, the Fed's rate hike plan will maintain the modest tightening pace and bring the Fed Funds rate up to 3% to 3.25% in 2019.

Email research@wealthcarecapital.com with questions, comments or requests. Sources: Bloomberg, Bureau of Economic Analysis.

[1] The Fed's preferred inflation measure is the Personal Consumption Expenditures price index, whereas a commonly reported measure is the Consumer Price Index (CPI).

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