FED WATCH: SPRING FORWARD

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Much like our clocks this past weekend, the Federal Reserve (Fed) decided to "spring forward" with its monetary policy decisions. In what had become only recently a highly telegraphed move, the voting members implemented another 25 basis points (bps) increase in the target range for the Federal Funds Rate at their March policy convocation. However, prior to this action, the markets had been operating under the assumption that the first rate hike for 2017 would happen in June, not three months earlier. So, the natural questions are: what was the reasoning behind this latest rate hike, and where does that leave potential policy decisions going forward?

As recently as Chair Janet Yellen's Semiannual Monetary Policy report to Congress in mid-February, the Fed did not seem to be expressing any urgency or guidance that a rate increase could be imminent at its March meeting. It was only over the last two weeks that a change in the policymakers' tenor became apparent. From an economic perspective, what apparently tilted the vote in favor of another tightening move was the fact that data had become available suggesting the Fed was very close to achieving its dual mandate: maximum employment and price stability. More than likely, the inflation part of this mandate helped to tilt the scales, as the latest reading for the Fed's preferred gauge, the personal consumption expenditures price index, had risen to +1.9%, or just shy of the Fed's 2% stated threshold. In addition, financial conditions, another apparent "Fed fan favorite," and global economic activity moved in a direction the policymakers felt more comfortable with.

Thus, to prepare the markets for a move at its March meeting, the Fed needed to provide guidance, specifically from what we like to refer to as "the Big 3": Yellen, Vice Chair Stanley Fischer and N.Y. Fed President William C. Dudley. The latter got the ball rolling on February 28 in an unscheduled interview in which he said that the case for a rate hike had become "a lot more compelling" and that it should happen "fairly soon." Fischer followed suit a few days later, and Yellen seemed to put her final stamp on the matter at her March 3 speech in Chicago.

Given the financial markets somewhat placid response to these appearances, the Fed used this green light and, no doubt, continued on its quest to move the Federal Funds target range as far away from zero as it possibly can. In our opinion, the Fed wishes to have as much cushion as possible to use traditional easing methods in the future and potentially lower interest rates when the next economic landscape calls for such a move.

In addition, the Fed also appears to have a different mindset compared to last year. In other words, the "economic data bar" has been lowered so that upcoming reports do not necessarily need to justify a rate hike, but they just don't need to be weak enough to prevent such a move. The policymakers also seem to have a different eurozone election outlook as well, as last year's Brexit vote affected their decision-making process, but apparently this year, the upcoming Dutch and French elections did not prevent a March rate hike. It is also interesting to note that while inflation and employment data may have argued for a rate hike, there is a disconnect with other economic data, namely GDP. To be sure, fourth-quarter growth was pegged at a subpar rate of +1.9% while forecasts for first-quarter real GDP seem to be lining up for a potential reading of +1%, if not lower.

Conclusion

With the rate hike timetable being moved up by three months, at least from the markets' perspective, one has to wonder: is the Fed is going to be more aggressive going forward, and will the policymakers' prior forecast for three rate hikes in

2017 turn into four actual increases? Also, could the timetable to begin addressing the Fed's balance sheet get pushed up as well? Certainly, these are all good questions, but we have a lot of uncertainties (U.S. fiscal policy, eurozone elections, etc.) and future economic data to contend with first. However, what seems to be clear is that the Fed wishes to continue on its path of removing accommodation; against this backdrop, investors should consider solutions for a rising rate environment.

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DEFINITIONS

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Monetary policy : Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

Basis point : 1/100th of 1 percent.

Federal Funds Rate : The rate that banks that are members of the Federal Reserve system charge on overnight loans to one another. The Federal Open Market Committee sets this rate. Also referred to as the “policy rate” of the U.S. Federal Reserve.

Rate Hike : refers to an increase in the policy rate set by a central bank. In the U.S., this generally refers to the Federal Funds Target Rate.

Fed tightening : Refers to the Federal Reserve enacting monetary policies that have the overall impact of reducing the availability of credit, which is widely thought to have the potential to slow economic growth.

Inflation : Characterized by rising price levels.

Personal Consumption Expenditure (PCE) Price Index : measure of price changes in consumer goods and services in the U.S. economy.

Brexit : an abbreviation of “British exit” that mirrors the term Grexit. It refers to the possibility that Britain will withdraw from the European Unio.

Gross domestic product (GDP) : The sum total of all goods and services produced across an economy.

Fiscal Policy : Government spending policies that influence macroeconomic conditions. These policies affect tax rates, interest rates and government spending, in an effort to control the economy.

Eurozone (EZ) : Consists of the following 18 countries that have adopted the euro as their currency: Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia and Spain (source: European Central Bank, 2014).