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THE FED
SEPTEMBER FOMC MEETING

KEY TAKEAWAYS

- Unsurprisingly, the central bank raised rates by 25 basis points.
- Jerome Powell is very optimistic regarding the state of the economy.
- The Fed is projecting higher growth for 2018 than previously expected.
- It believes the labor market will remain tight and inflation under control.
- Finally, investors should not worry about a flatter yield curve.

On Wednesday, September 26th, the Federal Reserve took another step into the normalization of monetary policy. Even though widely expected, the 25-basis-point increase in the federal funds rate (approved unanimously) was significant at a symbolic level: rates – now set between 2% and 2.25% – were finally back to the level they had in April of 2008, before the economic crisis erupted.

This was the eighth interest-rate hike since December of 2015 (and the third with Jerome Powell as chairman), when the central bank – then headed by Janet Yellen – started raising rates for the first time since the crisis. Before that, they had remained close to zero. In August, the Fed had decided to leave rates unchanged. Even though the market widely expected what happened at the end of September, there are a few important takeaways that investors should not miss. In this paper, we briefly go over them.

1. Continuity

The Fed under Jerome Powell has basically stuck to what the central bank was doing before he became chairman. And his predecessor, Janet Yellen, was seen during her tenure as not deviating much from what Ben Bernanke had done during his time as chairman. With interest rates, this means that the stimulus will be withdrawn, but gradually. This will happen in spite of political pressure (mainly by President Trump) to keep rates low.

2. Caution

Another 0.25% hike is expected for December. The prudence shown by the Fed should not surprise anyone now. On the one hand, they do not want to rattle markets. On the other, they want to proceed judiciously according to current economic data. The Fed does not want an overheated economy, but it is also trying to avoid hurting growth and employment levels unnecessarily.

The internal survey that the Fed releases every quarter shows that board members are forecasting three more hikes in 2019, and one more in 2020, ending with a rate of 3.4% in 2021. The long-term rate would be 3%.

3. Optimism

Given that the outcome was all but guaranteed, the market was paying more attention to the language in the Fed's official statement, and to what Jerome Powell would say in his press conference. Besides the implication of one more raise in December, it was made clear that the Fed's economic outlook is strong, with solid growth, low unemployment, and controlled inflation.

Moreover, the Fed dropped the word "accommodative" regarding its policy, meaning it no longer views it as boosting economic growth. However, the current rate is estimated to be below the long-term neutral level (neutral relative to its effect on growth). The change in language is attributed to the central bank not knowing exactly what the latter rate is (i.e., the current rate might be close).

Investors need to realize that, as rates go up and the balance sheet shrinks, the central bank is getting back some essential tools that could be very useful in case of an economic downturn. Without these, and considering that fiscal policy is far from restrained right now (e.g., tax cuts), the traditional responses to economic decline would not be available.

In terms of forecasts, the Fed is estimating a GDP expansion of 3.1% for 2018, 30 basis points higher than the previous estimate. "This is a pretty good moment for the U.S. economy," said Mr. Powell after the meeting. For next year, projected growth is 2.5%. The effect of tax cuts and government spending will begin to wear off. On top of this, trade tensions will affect growth (for example, by disrupting supply chains and increasing the cost of materials). Growth is expected to be 2% in 2020, and 1.8% in 2021.

Finally, inflation is not expected to surpass 2.1% per year during the next few years. Hence, the Fed is not very concerned about it. Mr. Powell said the central bank did not see inflation picking up unexpectedly. Unemployment is expected to be 3.7% this year, dropping to 3.5% in 2019.

4. Side effects: yields

Yields in the U.S. have crept up with the federal funds rate. On October 4th, the 10-year Treasury yield reached its maximum level since 2011, going beyond 3.2% at some point (receding later below that level). Employment data released on the first week of October has led many analysts to believe that the unemployment rate (to be released October 5th) could end up being lower than expected. It stood at 3.9% last month. Private-sector job creation was higher than expected during September. Also, the services sector activity hit a 21-year high, according to a non-manufacturing activity index published by the Institute for Supply Management. Finally, the number of people claiming unemployment benefits reached a 49-year low. The good news at the end of Q3 make it even more likely that the Fed will follow through with another rate increase in December.

For those scared about the flatter yield curve, on Thursday 9/27, after the FOMC meeting, Jerome Powell explicitly addressed the issue, saying there was no reason to think the risk of a recession in the next year or two was elevated "at all."

Last revised: October 4th, 2018.

Update: on October 11th, the Consumer Price Index (CPI) figures for the month of September were released. Both the CPI and the core CPI – which excludes food and energy prices, making it a less volatile index – increased by 0.1%, half of what the market was expecting. The annual increase now stands at 2.3% for the headline CPI and 2.2% for the core CPI. Two notes about these numbers: first, they are in line with the Fed's outlook, supporting the assertion that prices will not start rising faster than expected as a consequence of the tight labor market. Secondly, the stock market welcomed the news, for it reduced fears that the Fed might tighten monetary policy faster than expected in order to quell inflationary pressures. On the other end, government yields took a minor hit, given their positive relation with short-term interest rates. Regardless of the new CPI readings, it is very unlikely that they will alter the Fed's interest-rate path. Another 25-basis-point increase in December is still the most likely scenario.

Important information

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