Musings From the Chief Economist

Fed Funds Rate Hike to 5.00%

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The Federal Open Market Committee (FMOC) as expected raised its target federal funds rate (FFR) by 25 basis points to 5.0% - its sixteenth consecutive rate hike. The FFR is now at its highest level since April of 2001. The FOMC also indicated that the FFR is now close to its neutral rate and that "the extent and timing" of future rate hikes depends on the prospects for both the economy and inflation. The FMOC also stated that, "inflation is contained" and that while economic growth has been strong, it is "expected to moderate."

The key question for the financial markets, "Is the Fed done?" Many market participants think so based on a single comment from Chairman Ben Bernanke's April 27th testimony before the Joint Economic Committee. During his prepared remarks, Bernanke said, " ... at some point in the future the Committee may decide to take no action at one or more meetings in the interest of allowing more time to receive information relevant to the outlook."

This makes sense. A pause to digest prior rate increases and to assess their economic impact is prudent monetary policy. Monetary policy works with a lag, and the FOMC has increased short-term rates substantially over the last few years. The full effect of those rate hikes has not yet been felt in the broad economy. With long rates now rising, the Fed needs to be wary of over-tightening. So it should not be unusual for the FMOC to pause and monitor such a pause. It does not imply one way or the other what future policy will be. As Bernanke himself said, "Of course, a decision to take no action at a particular meeting does not preclude actions at subsequent meetings."

Whether or not the FOMC will tighten further depends on the prospects for both growth and inflation; that is, the decision remains data dependent. If the Fed is done, it will because the economy has moved to a slower growth trajectory, which should provide a friendly financial market environment for both stocks and bonds. If the Fed raises rates further, it will be because economic growth is stronger than expected. In this scenario, corporate profits should continue to be surprisingly strong but bond yields will move higher. Either way, investors should continue to favor stocks over bonds.

It would not be surprising to see the economy slow given higher short rates, rising long rates, and higher oil prices. However, we have had these conditions for over a year and the economy continues to grow faster than expected. Healthy job creation, rising capital expenditures, strong global growth and low inventories are creating a favorable backdrop for continued growth. If this is the case, the Fed could pause in June and then raise rates again at its August 8th meeting, as resource utilization continues to tighten.

Sources: Oak Associates, Bloomberg, Federal Reserve Bank

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