In December, Wait for Falling Snow and Rising Rates

Reading between the Lines

Last Wednesday, the Federal Reserve (Fed) released their most recent meeting statement outlining their current plan to leave their policy rate unchanged at 0%. This in itself was not a surprise to most. However, the comments within the statement did surprise some.

The Fed removed references about the global economy and China as hindrances to our domestic growth.[1] They also changed their previously open-ended language regarding progress toward their goal of maximum employment and 2.0% inflation and how it would affect their rate decision.[2]

Collectively, it now appears that if these goals are achieved by the end of the year and the international landscape remains status quo, they will likely raise rates during their December meeting.

Why December Makes Sense

The Fed has kept short-term rates near zero for over 6 years. During that period, the U.S. economy has slowly healed suggests by the following data.

- The unemployment rate has fallen from over 10% to 5.0% and may go lower.[3]
- Nominal GDP (real GDP + inflation) is around 4.0%.[4]
- The manufacturing and services sectors have been in expansionary mode for many quarters and remain there today.[5]
- The housing market keeps grinding along and appears to be healing.[6] Data from JP Morgan suggests that there is an underwhelming amount of supply on the market and housing affordability remains at multi-decade lows.[6]

Assuming nothing major changes between now and December, these factors should help the Fed decide to raise short-term rates.

Consistency is Key

Looking ahead, once the Fed decides start raising rates, it's likely that they will continue raising them on a consistent basis going forward. After its first hike, the Fed has historically raised rates by 25 basis points (1.0% = 100 basis points) during each of its subsequent meetings until a new policy rate is reached.[7] However, many pundits have suggested that this time may be different due to the extremely dovish policy stance of this Federal Reserve. Once the first rate hike ensues, it would not be a complete surprise to see rates left unchanged between multiple meetings. One thing is for certain, the Fed does not want to prematurely raise rates and cause the economy to fall into a recession.

What will this mean for stocks and bonds?

If history is any sort of guide for the future, a rise in interest rates is not necessarily a bad thing for stocks and some bonds. Research provided by JP Morgan shows that stocks tend to rise during the early stages of rising rate environments.[8] This is because rising rates tend to occur when the economy and corporate earnings are strong, and thus conducive for stocks.

Bonds are more of a mixed bag. Corporate bonds tend to perform better than other bonds during periods of rising rates. These bonds tend to be less interest rate sensitive and are instead influenced by a company's individual financial performance. On the other hand, treasuries and other sovereign government bonds tend to underperform when rates rise due to their rate-sensitive nature.

Conclusion

The Fed has held rates artificially low for over 6 years. The domestic economy appears to be reasonably healthy and the data supports this argument. Low unemployment, strong manufacturing, and a recovering housing market all point towards the Fed raising rates in the near term. This is not a necessarily a negative for stocks and bonds and instead should be seen as a positive sign for the U.S. economy. Assuming the data remains intact between now and the end of the year, expect short-term rates to move higher in December.

As always, please feel free to contact us with any questions you may have.

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Source:

1. FirstTrust
2. Ibid
3. Bloomberg.com
4. Ibid
5. Ibid
6. JP Morgan
7. New York Federal Reserve
8. JP Morgan

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