Monetary Policy Normalization Underway

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The Federal Reserve’s Open Market Committee (FOMC) announced yesterday, as expected, that it would increase the inter-bank overnight rate, known as the Fed Funds rate, to a range of 0.75-1.00%, which will result in Funds trading near the mid-point of 0.88%. This is a 0.25% increase from previous trading around 0.63%, with the Fed using this mechanism that banks employ to settle required reserve accounts as a policy tool to drive other short-term money market rates. Unlike most of last year, during which the Fed was largely frustrated by an uncooperative economic environment in its objective to raise the Funds rate, economic activity and optimism are on the upswing since the November elections, giving the Fed sufficient cover to raise rates. Yesterday's move was thoroughly telegraphed and carefully choreographed by a succession of FOMC members guiding the markets to expect it.

Our view is that the markets have largely discounted not only Wednesday's rate increase but another two increases this year and more next year. The 10-year U.S. Treasury bond yields 2.53% today, close to where it traded after the Fed's last rate increase to 0.63% last December. The 2-year U.S. Treasury is anchored to expectations for future money market rates that can be rolled to achieve an alternative 2-year return. A projected progression of yields on 90-day T-bills, rising in orderly fashion to 2.00% in December 2018 results in a compound annual return of 1.38% over the 2-year period, which is about where the 2-year U.S. Treasury yield trades today. Our view since the Fed first lifted off from zero in December 2015 has been that the Fed's likely objective is to raise the Funds rate to a level roughly equal to the 12-month rate of change in the core inflation measure preferred by the FOMC, the Personal Consumption Expenditure Deflator, ex Food and Energy, currently at 1.7%. After a sharp rise in interest rates last fall, the bond market appears to have accommodated our view that the Fed Funds rate and the core inflation rate will converge around 2% by the end of next year.

A 2% Fed Funds rate coinciding with a 2% inflation rate means that the “real”, inflation-adjusted Funds rate would be zero. This would constitute a successful transition from the extraordinarily easy monetary policy in recent years, which saw the real Funds rate as low as -2%, to something approaching normal. Our assessment is that the equilibrium Fed Funds rate that balances supply and demand for liquidity, in inflation-adjusted terms, is probably around zero today. Thus getting the Funds rate to an equilibrium rate constitutes a return to normal, the likely scenario that is presently priced into the bond market. The equilibrium rate is a moving target however, and if the economy continues to improve and stronger employment conditions continue to drive the labor participation rate higher, further increases in the Funds rate may be necessary. For context, when the economy was peaking in the last cycle in 2006, the Fed Funds rate topped out at
5.25% and the core inflation rate peaked around 2.5%, thus the real Funds rate had risen to almost 3%. If the economy continues to improve in the year ahead and wage pressures begin to rise, the real equilibrium Funds rate may rise from zero and the Fed will be pressured to follow it up with additional rate increases that are not now discounted in longer-term yields. That’s a big if though, dependent on many factors, economic, political and global; including the complexities of an aggressive policy reform agenda in Washington. The point is that the bond market has come a long way to accommodate the view that the Fed is on the path to monetary policy normalization and expected to achieve that result by the end of next year.

The probability that the Fed will be able to successfully transition to more normal monetary policy has increased dramatically as a result of last fall’s elections, with reference to President Trump’s economic and fiscal policy proposals and the Republican majorities in Congress to help effect them. The fiscal policy outlook remains uncertain, however with the main priorities including no entitlement reform, increased defense spending, a big infrastructure spend, corporate and personal tax reform; and no consensus on how to pay for all that, bigger federal deficit projections are a reasonable conclusion. Interest rates may well have to rise further in that environment. This is exactly the prescription the Fed has been pushing for years: less monetary accommodation and more expansive fiscal policies to spur the economy forward. Rising interest rates restore rewards to savers, incentives to efficiency, promote capital formation and discourage leverage. A better balance between savings, investment and consumption would be beneficial to our economic stability and outlook. We just need to remember that normal in the U.S. includes worrying about the federal budget deficit and our alarming accumulation of public debt.

If you would like to discuss any part of this, please contact your banker, trust officer, portfolio manager, or call a Capital One Wealth and Asset Management representative at 866.442.3764.
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