United States

A bird in the hand is worth two in the bush

- **Promise made, promise kept: the Fed took a second step towards the normalisation of monetary policy with a 25bp rate hike.**
- **Interest rate projections suggest that there will be three key rate increases in 2017, although Janet Yellen reminded us that rates are not on a pre-set path.**
- **Economic projections were virtually identical with September's set, even though the past three months have seen some major changes. As if it is not hard enough to try to estimate the effects of a fiscal policy whose profile is very fuzzy at best, the markets have also reacted strongly.**
- **The Fed preferred to be reassuring, by taking predictable actions and delivering unsurprising messages, and qualified the rate increase as a "vote of confidence" in the economy.**

Even if less predictable than last year, this week Fed's decision was highly predictable. As expected, the Fed raised its key rates by 25 basis points (bp). As Janet Yellen explained, the decision was justified by the US economy, which has made "considerable progress" towards meeting the Fed's two objectives: maximum employment and price stability. In addition to the Fed's concrete monetary policy action, attention was focused on the new economic forecasts of the various FOMC members. Here, stability was the key word. There were only marginal revisions to the growth (up), inflation (up for headline, flat for core) and unemployment (down) forecasts. These revisions should be seen as a reflection of recently published economic data, rather than a new diagnosis. Specifically, they are clean of any effects from a possible fiscal stimulus.

Another projection also attracted attention: the Federal funds target rate. In September, the median projection suggested two rate increases (of 25bp each) in 2017, but the "central" scenario is now for three. Once again, this must be kept in perspective. During the press conference, Janet Yellen attributed this trend to the revised forecasts of just a "some" members. Instead of a change of perspective by the core FOMC, it should be seen as minor changes by a few members. Details show that the previously highly dovish members, the ones that were projecting a Fed fund target range of 0.50%-0.75% in end-2018 moved their projection up, factoring in the December 2016 hike and another 25 bp one next year. This moved the median forecast accordingly, a bit artificially, higher. And here again, these projections are still basically the same, while they are just that: projections. Janet Yellen reminded us once more that the rate policy was not on a pre-set course, which is unquestionable as shown by the recent past: in December 2015, that projection was for four rate hikes in 2016, which ended up with only one…

Based on what Janet Yellen said, the stability of the forecasts seems due to uncertainty more than to certainty. According to this reading, FOMC members would not attach a greater probability to their forecasts, much to the contrary. Given the uncertainty shrouding fiscal policy trends, they would have preferred to freeze their projections while awaiting more precise details.

The world has undeniably changed since the publication of September's forecasts. Oil prices picked up after oil producing countries (both within the OPEC and beyond) agreed to reduce output, and Donald Trump's election triggered a general re-pricing movement in the financial markets. The dollar appreciated again (and further with the Fed's recent announcements). Treasury yields have risen, and with them all long-term interest rates.

It is easy to draw a parallel with the "taper tantrum" of spring 2013, even though the two episodes are not completely identical: specifically while then equities and corporate bonds were hit, they are currently benefiting from the movement, with a bullish equity market and narrower corporate spreads. Still, the increase in long-term interest rates is impressive: since the day after Election Day, the 10-year Treasury yield is up almost 70 basis points, the yield on BAA-rated corporate bonds by around 40 bp, the 30-year mortgage interest rate by close to 80 bp and the nominal effective exchange rate by more than 3.5%.

These factors are clearly headwinds for households: the rebound in energy prices will strain purchasing power, while higher mortgage rates will undoubtedly curb the housing market. Yet promises of fiscal support could also boost disposable income. It goes without saying that the effects of campaign promises are impossible to estimate, at least not until they have been translated into concrete draft proposals. To complicate matters further, the effects will not be the same for different income brackets. The ones hit hardest by headwinds (oil prices) will also benefit the least from supports (tax cuts, higher returns on savings), while they tend to be the ones with the highest propensity to consume.

In this context, the Fed preferred to strike a reassuring tone. Asked about the impact the rate increase risks having on households, Janet Yellen said the decision was a clear signal of the Fed's optimism, and should be viewed as a "vote of confidence" in the economy. In this case, being reassuring meant being predictable. No one was expecting the *status quo*, so the Fed went ahead with a rate increase. At the press conference, it was pointed out that this was the second time the Fed had waited until a monetary tightening move was fully priced in before announcing it. Although Janet Yellen said that this kind of market consensus was by no means a necessary condition, she congratulated the Fed on its capacity to deliver a clear message. And the message was heard. The Fed does not intend to let the economy overheat, and the unemployment rate is only expected to fall briefly (and marginally) below the equilibrium rate. Janet Yellen does not think this is a good time to overheat the economy. From there, it is easy to jump to the conclusion that the time is no longer ripe for fiscal stimulus, which she did. She added that the challenge for the United States is to raise the economy's potential growth rate, indicating that education and training were certainly the best tools for achieving this.