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DECEMBER 17, 2015 BY FINANCIAL MANAGERS SOCIETY

FOMC hikes rates, signaling that its path will be gradual

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As expected, the Federal Reserve raised interest rates for the first time in a decade while signaling that the pace of subsequent increases will be gradual. The FOMC unanimously voted to set the new target range for the federal funds rate at 0.25% to 0.50%, up from zero to 0.25%. Policy makers separately forecast an appropriate rate of 1.375% at the end of 2016, implying four quarter-point increases next year.

“The committee judges that there has been considerable improvement in labor market conditions this year, and it is reasonably confident that inflation will rise, over the medium term, to its 2% objective,” the FOMC said following a two-day meeting. The Fed said it raised rates “given the economic outlook, and recognizing the time it takes for policy actions to affect future economic outcomes.”

“The committee expects that economic conditions will evolve in a manner that will warrant only gradual increases in the federal funds rate,” the FOMC said. “The actual path of the federal funds rate will depend on the economic outlook as informed by incoming data.” The FOMC said it expects to maintain the size of its balance sheet until normalization of the level of the federal funds rate is well under way.

“The economic recovery has clearly come a long way, although it is not yet complete,” Fed Chair Yellen said at a press conference following the meeting. “Americans should realize that the Fed’s decision today reflects our confidence in the U.S. economy,” she added. “While things may be uneven across regions of the country and different industrial sectors, we see an economy that is on a path of sustainable improvement.”

As of this writing, the market was pricing in a 44% probability of a March 2016 rate hike, up from 9% just one month ago. There is virtually no chance of a move at the Jan. 27 meeting. According to a Bloomberg survey of economists, the FOMC will raise rates once in the first quarter of 2016,

while bringing overnight borrowing costs to 1.13% by the end of 2016.

Ironically, U.S. government bonds held firm at the conclusion of the meeting. The yield on the benchmark 10-year Treasury note closed at 2.29%, compared with 2.32% as recently as December 3. Based on trading in futures markets, the yield will rise to 2.50% by the end of 2016 and 2.63% by December of 2017.

The news media are reporting that borrowing rates of all kinds, including credit cards, auto loans and home mortgages will soon become much more expensive. If history is any guide, however, borrowers may have little reason to panic. Each time the Fed has hiked rates over the past 40 years, longer-term securities actually outperformed short-term debt as higher rates stemmed inflation and kept economic growth from overheating, according to data compiled by Bloomberg.

Back in 2001, for example, the Fed lowered the benchmark rate following the NASDAQ crash, eventually reaching 1%. Then in 2004, it began raising it by a quarter percent. At the time of the first increase, the 30-year mortgage rate was 6.3%. During the next four months, it dropped to 5.7%.

As the Fed continued to tighten, mortgage rates drifted lower, falling to 5.5% in June 2005. By the time of its last increase in the summer 2006, the 30-year fixed-rate mortgage was at 6.6%. The mortgage rate only increased about one-quarter percent during the Fed's entire tightening campaign even though overnight borrowing costs climbed 400 basis points.

With subdued inflation, a mixed global outlook and sub-par domestic economic expansion, there aren't many reasons for the Fed to move aggressively. That supports surveys which tend to show that investors are bullish on Treasuries, despite the Fed's actions on the short-end.
Market observers believe that uncertainty in the global economy will continue to put downward pressure on long-term rates. Fannie Mae, for example, is predicting the 30-year fixed mortgage rate will be around 4.1% at the end of 2016, little changed from today.

"You have many global investors parking their money in U.S. Treasury securities and that is keeping our longer term rates lower than they otherwise would be," according to Michael Fratantoni, chief economist with the Mortgage Bankers Association (MBA). He adds that most of the fundamentals are pointing to a very strong housing market.

In fact the MBA is forecasting an increase in both new and existing home sales next year. Total existing home sales are seen running at a 5.6 million annual pace by the fourth quarter of 2016, up from 5.4 million currently. New home sales are expected to jump about 20% to 623,000. This activity bodes well for new housing starts, which are approaching an eight-year high.

The multi-family market is likely to continue its hot streak as well. Freddie Mac said recently that favorable demographic trends will support strong multi-family growth for at least the next several years. New supply will continue to enter the market at "elevated levels," it said, reaching the highest number of completions since the 1980s.

If the prognostications are accurate, then real estate lenders should find plenty of opportunity, in both residential and commercial markets. On the investment front, financial institutions sitting on cash may want to add some assets right away, rather than waiting for rates to rise further. The incremental returns from investing may well offset potential market value adjustments. Putting money out on the curve should provide higher levels of income in the coming year, a primary goal for most bankers.

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