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No surprise: FOMC makes long-anticipated rate move, hints at more to come

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As expected, the Federal Reserve raised its benchmark short-term interest rate for the first time in a year, pushing up the federal funds rate by a quarter percentage point to between 0.50% and 0.75%. Fed officials said an improving economy was ready for higher borrowing costs, pointing to "solid" job gains, as well as rising inflation and consumer spending.

"The stance of monetary policy remains accommodative, thereby supporting some further strengthening in labor market conditions and a return to 2% inflation," the Federal Open Market Committee said in a statement. In new language in its statement, the Fed said the rate increase came "in view of realized and expected labor market conditions and inflation," a sign officials see the labor market as close to, or at, full employment.

In a press conference following the announcement, Fed Chair Janet Yellen said the decision to raise rates "is a vote of confidence in the economy," noting that she doesn't see the central bank as behind the curve. She added that policy continues to be supportive to a moderate degree and inflation is still operating below the Fed's 2% objective.

The Fed's economic projections for the coming years were generally rosier than the last batch in September, with inflation expected to rise from 1.5% in 2016 to 1.9% in 2017 and to its target of 2% by 2018. Officials also see the jobless rate falling to 4.5% next year and remaining there through 2019, while expecting the economy to expand at a median annual pace of 1.9% this year and 2.1% in 2017, a slight improvement from the September outlook.

The Fed continues to expect "gradual" rate increases, the statement said, although forecasts suggest it sees rates rising faster next year than previously thought. Officials anticipate the median fed funds rate to be 1.4% by the end of 2017, according to the projection of 17 officials. By their estimates, the fed funds rate would reach 2.1% at the end of 2018 and 2.9% in 2019. That implies three quarter-percentage-point interest rate increases over each of the next three years – a faster pace than officials projected in September, when they only saw two rate increases next year.

The market forecast is calling for two hikes for the next two years and one in 2019, which would bring the overnight rate to 1.12% for December 2017, 1.62% at year-end 2018 and 1.87% for 2019. Further out on the curve, the benchmark 10-year Treasury note traded recently at 2.5%, compared with 2.3% at the end of last year; similar figures for the 5-year note are 2.0% and 1.8%, respectively.

In this environment, many bank treasurers are contemplating the optimal strategy for deploying assets, whether to put on longer-term fixed-rate investments which pay a higher coupon or add floating-rate instruments which would benefit if rates rise. They are also thinking about the cheapest way to borrow over the long haul.

For example, an investment officer may be considering two investment options: a five-year fixed-rate note yielding 2.5% or a similar term floating-rate bond priced at 90-Day LIBOR (0.96%) plus 60 basis points, for a current yield of 1.56%. If the market forecast is correct, the yield for the floating-rate bond will increase 50 basis points over the next two years, and by 25 basis points the following year, reaching 2.81% by December 2018. By contrast, the fixed-rate option will have yielded a constant 2.5% for the same time frame. Assuming an investment of $1 million, the fixed-rate bond provides interest income of $75,000 over the three-year time horizon, compared with $64,300 for the "floater."

A similar analysis can be used for wholesale borrowings. Short-term funding (one week) from typical wholesale sources was recently quoted at 70 basis points. Again assuming the market forecast, this rate would edge up in 25-basis-point increments every December, while the cost for fixed-rate five-year funding from these same sources is about 2.2%. Therefore, the expense for borrowing $1 million on a short-term basis for the next three years would be as follows: $9,950 for 2017, $14,950 for 2018 and $18,700 for 2019. The amount of interest expense totals $43,600, compared with $66,000 for the fixed-rate advance, for a savings of $22,400.

Most institutions still need to generate interest income, and a large allocation to floating-rate assets could impact earnings. Even though the yield curve has flattened, fixed-rate assets should still provide higher levels of current income than floating-rate alternatives for the foreseeable future. On the other side of the balance sheet, locking in term funding appears expensive at this time, especially when every dollar of net interest income is precious. Of course, every institution should consider its asset-liability position when making these decisions and bank treasurers should continue to maintain robust risk management practices, making efforts to keep interest rate risk exposure at reasonable levels.

Disclaimer: The views and opinions expressed in this article are those of the author and do not necessarily reflect the official policy or position of the Financial Managers Society.

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