TIAA

March FOMC reaction: The Fed Marches on

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The U.S. economy no longer requires emergency levels of support from its central bank.

Executive summary

- As expected, on March 15 the U.S. Federal Reserve raised its target federal funds rate by 0.25%, to a range of 0.75%-1.00%.
- A March rate hike was viewed by markets as unlikely until late February, when senior Fed policymakers began stating publicly their clear intentions to hike rates sooner than later.
- The stronger U.S. and global economic backdrop, free of major geopolitical turmoil or adverse financial market conditions, gave the Fed an opening to raise rates sooner than perhaps even it intended in 2017.
- Revised Fed forecasts indicate that despite tightening policy earlier than expected in 2017, most voting members still only anticipate raising rates by another 50 basis points (0.50%) over the balance of the year.
- In light of only moderate inflationary pressure and with the risk of a delayed fiscal stimulus from Congress, we also expect just two additional rate hikes this year.
- Markets interpreted the statement and the updated economic projections as dovish, causing interest rates along with the U.S. dollar to fall and equity prices to rise.

What happened?

Just three months after it increased the federal funds target rate for the second time in this cycle, the Federal Reserve has done it again, voting 9-1 on March 15 to raise the target range by 25 basis points (0.25%) to 0.75%-1.00%. While widely expected by markets and professional forecasters, the move was unanticipated as recently as last month before a series of public statements from senior Fed policymakers made it clear they intended to hike in March.

The post-meeting statement was little changed from the January edition. The March announcement noted that business fixed investment has “firmed somewhat” whereas it was described as “soft” in January. It also acknowledged the small uptick in headline inflation, which has come close to reaching the Fed’s medium-term 2% target.

New economic and policy forecasts from the Fed showed median expectations for both growth and inflation little-changed from the December projections. Similarly, Fed officials tend to only expect two further 25-basis-point rate increases over the balance of the year. The so-called “dot plot” of Fed policy forecasts shows the median committee member expects a 1.25%-1.50% range by year end. The median projection for 2018 shows three further rate increases. It seems the Fed chose to tighten policy because economic data has largely confirmed its prior forecasts, not because the economy has performed better than expected. In her post-meeting press conference, Chair Janet Yellen underscored the point that the committee’s assessment of both economic conditions and the likely path of monetary policy are essentially unchanged from three months ago.

Why does it matter?

To the relief of many—including, in all likelihood, the Fed itself—U.S. monetary policy has become less of a driving force in financial markets. Policy has become dependent on the health of the labor market and any pass-through from higher wages to broad-based inflation. Whether the Fed hikes two or three more times this year will probably not have a tremendous impact on equity prices, longer-term interest rates, or economic growth. Instead, policy tightening should serve as confirmation that the U.S. economy no longer requires emergency levels of support from its central bank.

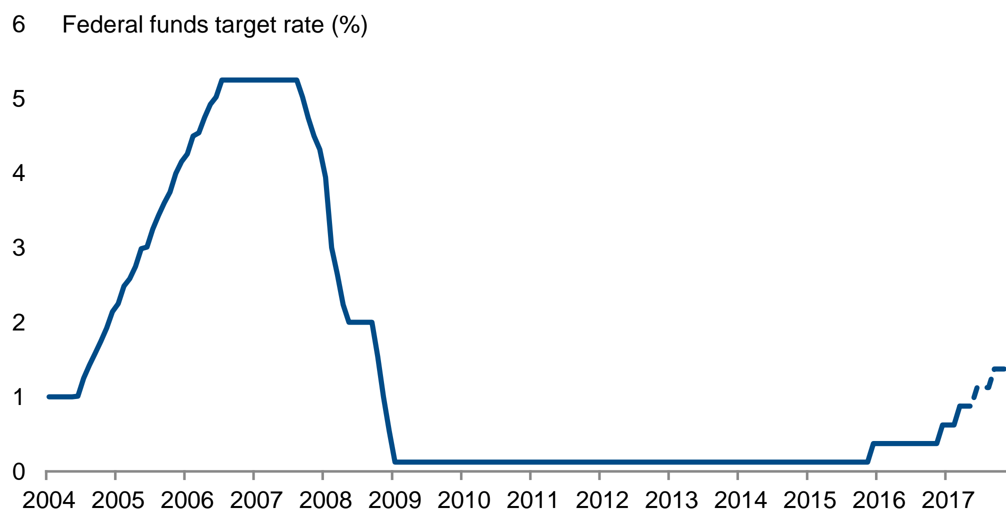
What was the market reaction?

Immediately following the release of the statement, longer-term U.S. interest rates fell along with the U.S. dollar. Markets may have been expecting a more hawkish policy outlook from the committee based on this earlier-than-expected hike, but that view was not evident in the updated economic projections or in the members' expectations for policy tightening in 2017 and beyond. The 10-year U.S. Treasury yield ended the day at 2.50%, down 10 basis points from yesterday's close. The euro rose 1.2% against the U.S. dollar, and the S&P 500 Index closed near 2385, rising 0.5% after the release of the statement and 0.8% for the session as a whole.

Equity markets have been undeterred by the prospect of a March rate hike.

As expectations for a March rate hike solidified over the past several weeks, markets reacted in a relatively orderly fashion. The U.S. dollar, already very strong against most major currencies, remains down modestly on the year, while the 10-year U.S. Treasury yield little-changed since mid-December. Equity markets have been undeterred by the prospect of higher rates, with the S&P 500 Index 4.5% higher in February and month-to-date in March and international stocks up by a similar amount in their local currencies.

Figure 1. A third hike, with more likely on the way



Source: Bloomberg, as of 3/15/2017. Dotted line indicates TIAA Investments forecast through 2017.

What is our outlook moving forward?

The Fed would like the size of its balance sheet to shrink down to a more normal level.

The earlier start for Fed rate hikes this year—we had originally expected the first move to come in June—does not change our expectation that the Fed will undertake three-25 basis-point increases in 2017. Our view is consistent with both the market's and the Fed's forecasts. It is now also possible that after raising rates in both June and September the Fed will then use its December meeting to announce a change to its practice of reinvesting maturing proceeds from its expansive portfolio of U.S. Treasuries and mortgage-backed securities.

Currently, the Fed rolls maturing assets into new ones to keep its portfolio—and the money supply—constant. Allowing proceeds to roll off (i.e., mature) without full replacement drains the money supply, a de facto tightening of monetary policy. The Fed would like to shrink its balance sheet to a more normal level as a percentage of GDP over time. It currently stands at just under 20% while it was closer to 6% prior to the financial crisis. By moving closer to the pre-crisis level, the Fed would be unwinding the three rounds of quantitative easing it conducted from 2009 to 2014.

More broadly, improving economic conditions along with further Fed tightening of shorter-term U.S. interest rates should push longer-term rates moderately higher over the balance of the year. Equity markets have historically been undisturbed by initial Fed hikes made in response to stronger economic conditions as opposed to unwelcome inflationary pressure. Similarly, the U.S. dollar's strength against the euro and other major currencies likely already incorporates the market's current expectation of two more rate increases this year. As such, we expect little change to the trade-weighted value of the dollar in the near term, with risks tilted to moderate weakening should growth continue to pick up outside the United States.

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