Despite a Wimpy Fed, September Hike on the Table

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Mark your calendars for a rate hike on September 21st. Today's statement was much more hawkish than the June statement and Esther George, the Kansas City Fed Bank President, hopped back on the dissent train in favor of hiking rates by 25 basis points at today's meeting.

The Fed tilted towards tightening in three areas of today's statement. First, they said "the labor market strengthened," and that "on balance, payrolls and other labor market indicators point to some increase in labor utilization in recent months." This comes in contrast to last month, when the one off weakness of the May employment report led to a knee-jerk overreaction by the Fed as they fretted about slower improvement in the labor market. Second, the Fed noted that "economic activity has been expanding at a moderate rate," meaning the economy continues to grow. Third, it was clear last month in Fed Chief Janet Yellen's post-meeting press conference that the Fed was worried about outside forces effecting economic growth in the U.S. (think Brexit). Today, the Fed added in extra text stating that "near-term risks to the economic outlook have diminished."

Taken together, we believe the Federal Reserve is starting to signal that it intends to raise rates by 25 basis points at the next meeting, consistent with the projections it made in June that it would still raise rates twice in 2016. This suggests one hike next meeting and then one at the end of the year after the election. But this is by no means guaranteed. Today's statement stopped short of adding specific language suggesting a rate hike is imminent, like it did in October 2015, when it referred to the "next meeting" and then followed through, raising rates that December.

In our view, economic fundamentals warrant a rate hike as soon as possible (we would have liked at least once already in 2016). The economy can handle higher short-term rates. The unemployment rate is already very close to the Fed's long-term projection of 4.8% and nominal GDP – real GDP growth plus inflation – has grown at a 3.6% annual rate in the past two years. Moreover, we are starting to see early signs of accelerating inflation. "Core" consumer prices are up 2.3% versus a year ago, tied with the largest increase since 2008.

Slightly higher short-term rates are not going to derail US growth, but will help avoid the misallocation of capital that's inevitable if short-term rates remain artificially low.
