Less Loose

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When the Federal Reserve raises rates by another quarter percentage pointon Wednesday, you're going to see many stories about monetary policy getting tight and the potential threat that poses for the economy in general and the bull market in stocks in particular.

As usual, you should discount the conventional wisdom. What's really going on is the Fed is getting "less loose," not "tight" and there's ample room for the Fed to stay along this path without risking a recession or a bear market. The banking system is full of excess reserves from the Fed. Until the Fed eliminates those excess reserves or lifts the rates it pays banks on those reserves above the rates on loans, policy will remain loose.

We expect the Fed to stay on track for a third rate hike in 2017. The Fed's "dot plots" indicate the odds of this are much higher than the market consensus that another rate hike later this year is only a 50-50 proposition.

In addition, we expect both the Fed's statement as well as Fed Chief Yellen's press conference to keep it on course to start unwinding its bloated balance sheet later this year. Our best guess is another rate hike in September followed by six months of balance sheet reductions before rate hikes start again in March 2018. However, we wouldn't be surprised if the Fed embarked on balance sheet reductions a little earlier while moving a September rate hike to December. Either way, the Fed would be moving in the right direction.

Some critics, however, are saying inflation and wages aren't rising fast enough to justify rate hikes, which means the Fed should stand pat after Wednesday. But that reads too much into a few months' worth of data. Even if consumer prices dipped 0.1% in May, the CPI would be up 1.9% from a year ago, a sharp increase from a 1.0% gain in the year ending in May 2016 and no change in the year ending in March 2015. In other words, the trend is still up.

Although average hourly earnings are up only 2.5% from a year ago, that figure includes many highly productive Baby Boomers retiring while lower productivity Millennials enter the workforce. The Atlanta Fed adjusts for demographics and finds underlying wage growth closer to 3.5% instead.

We don't mind faster wage growth and don't think it causes inflation. But key policymakers at the Fed do, and in this case it will help lead them to the right policy, even if, in part, for the wrong reason.

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