Fed Hikes Again, Sets Plan to Re-Normalize Balance Sheet

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The Federal Reserve did what almost everyone expected today, raising the target range for the federal funds rate by 25 basis points to 1.00% - 1.25%.

Here are the key takeaways from today's statement from the Fed, its updated forecasts, its plan on reducing the balance sheet, as well as Fed Chief Yellen's press conference.

First, although the market consensus is that the Fed isn't going to raise rates again until 2018, the Fed thinks we still have one more hike in 2017, with the odds of two hikes equal to the odds of none at all.

Second, the Fed has a concrete plan to start reducing the size of its bloated balance sheet, a plan it is likely to start later this year. Once implemented, for the first three months, the Fed will reduce its balance sheet by $10 billion per month ($6 billion in Treasury securities, $4 billion in mortgage-related securities). Then, every three months, the amount of monthly balance sheet reduction will rise by $10 billion (w/ the same 60/40 proportion between Treasury securities and mortgage-related securities). That escalation will continue until the Fed is cutting its balance sheet by $50 billion per month.

Third, compared to three months ago, the Fed is expecting a little more economic growth this year, less unemployment, and less inflation. However, projections for economic growth and inflation remain unchanged beyond this year. The only significant change in the forecast was that the Fed now thinks the jobless rate will average 4.2% in 2018-19 instead of 4.5%. In addition, the Fed thinks the long run average rate for unemployment is 4.6% versus a prior estimate of 4.7%.

Fourth, the Fed is not impressed by the recent softness in inflation and does not think that softness is a reason to change the projected path of monetary policy. Although the Fed acknowledges inflation has receded back below its 2% target and is "monitoring inflation developments closely," it thinks inflation will head back to 2% in the medium term.
Fifth, the Fed is no longer as concerned about the potential negative influence of foreign events, having removed language saying it was closely monitoring "global economic and financial developments."

We still think the most likely path is that the Fed makes no policy changes in July but then uses the September meeting to make its last interest rate hike of the year while also announcing balance sheet reductions will start October 1. This is our interpretation of Yellen saying the balance sheet reductions would start "relatively soon." A less loose monetary policy than the market consensus believes is, in part, why we think long-term Treasury yields will be moving up significantly later this year, with a 3.00% target for the 10-year Treasury Note by the end of the year.

The most disheartening part of the today's Fed releases was that the plan for reducing the balance sheet noted that the Fed stands ready to use quantitative easing again in the future when the economy gets weak. We don't think QE helped the economy and had been hoping the Fed had learned that lesson. Apparently not.

Overall, however, we are pleased the Fed raised rates today and look forward to another rate hike and the beginning of balance sheet reductions later in 2017. Neither of these will hurt the economy and will help prevent future problems that could.
