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CAPITAL MANAGEMENT

Economic Insights

DECEMBER 2016

FED HIKES INTEREST RATES

On December 14th, the Federal Open Market Committee (FOMC) voted to raise the Federal Funds Rate from a range of 0.25-0.50% to a range of 0.50-0.75%, the first rate increase since December of 2015. Financial markets had anticipated a hike for months, with the Fed funds futures market pointing towards a 100% chance of the central bank raising rates at the December meeting.

The questions then become, why now, what will the pace of future increases be, and what is the outlook for U.S. Government bonds?

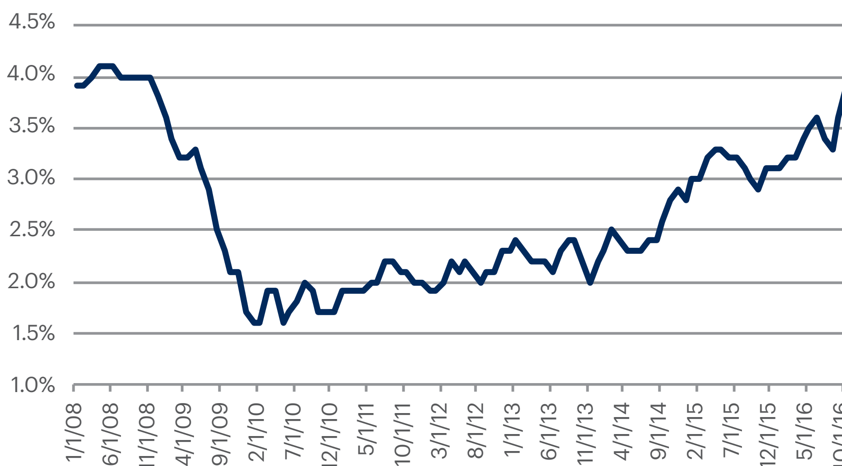
Why now?

The Fed had been reluctant to raise rates until continued signs of progress toward the Fed's unemployment and inflation targets materialized. While the unemployment rate has been trending lower since the end of the Financial Crisis, it has hovered at around 5 percent for much of this year.

According to data released by the Bureau of Labor Statistics earlier this month, the unemployment rate dropped to 4.6 percent, the lowest it has been since August 2007. A declining unemployment rate is indicative of a tightening labor market, and employers often must increase pay to attract workers which can result in an increase in inflation towards the Fed's 2% target. The Fed also pays close attention to changes in hourly wages as a leading indicator of potential inflationary conditions and, as shown in the chart below, hourly wages have recovered to pre-recession levels.

We estimate that the Fed funds rate will be between 1% and 1.5% at the end of 2017.

Change in Median Hourly Earnings—Back to the Old Normal?



Source: Federal Reserve Bank of Atlanta. Chart shows 12-month percentage change in calculated median hourly earnings of individuals using microdata from monthly current population survey.

Further indications of an economy continuing to rebound came from revised third quarter GDP figures which showed 3.2% growth—much of it from increased consumer spending—the biggest increase in quarterly GDP growth in two years. A strong U.S. dollar and less-than-stellar business investment held back GDP growth, but the Fed was likely influenced by continuing evidence of domestic economic strength and less concerned that rate hikes might derail the trajectory of recovery.

Pace of future rate increases

We expect that Fed tightening will remain gradual. We estimate that the Fed funds rate will be 1.0-1.50% at the end of 2017, which implies two to three increases in 2017.

But the pace and extent of future rate hikes is complicated by the make-up of the FOMC. Because rate hikes are implemented following Committee vote, the "hawk/dove" balance is monitored closely by Fed-watchers trying to divine the likely outcome of future votes. Upcoming changes to the composition of the voting members of the FOMC indicate that policy preferences among voting members may tilt more to the dovish side in 2017. As a result, not all FOMC members may be in agreement about the pace and timing of hikes, and future votes may be closer—and more contentious—than the poll taken on Wednesday.

Outlook

Our 2017 forecast for 10-year Treasury yields is a range of 2.0-2.75% and we expect that Treasury bond prices will face challenges across the curve for at least the next twelve months. We agree with the view of many bond market commentators that the bull market in U.S. Government bonds, particularly the 10-year Treasury, is nearing or at the end of a 35-year run.

Given the recent Presidential election and faster GDP growth, inflation may well be on the horizon. President-elect Trump's ambitious fiscal goals, including an infrastructure spending plan and proposed tax cuts, could provide a stimulus to the economy. But even with a GOP-controlled U.S. Congress, it is unclear how many of his ambitious plans will be implemented. Also unclear is whether the 60 basis point rise in 10-year Treasury yields since Election Day indicates that bond markets have fully priced in what may happen with Mr. Trump at the helm, or if further price weakness is to be expected.

In terms of asset allocation for our clients' portfolios, we do not expect to make any changes in our U.S. Treasury weighting given the rate hike and election results. We have been underweight government bonds for some time, seeing better opportunities in high-grade corporate debt, with no changes to these weightings expected.

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