Economic and Market Insights
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It Could Take the Federal Reserve Two More Years to Fully "Normalize" Interest Rates

The Federal Reserve Open Market Committee (FOMC) will meet this week and almost assuredly will raise short term interest rates by a quarter of a percent or 25 basis points. This will be their third rate hike over their last 15 meetings since they began to upwardly adjust rates in December of 2015.

How does this compare to previous tightening cycles and what will it likely mean for the forward path of interest rates?

As most everyone on the planet by now knows, this has been a very gradual rate hiking process so far, particularly compared to past rate hiking cycles. As you can see from the chart below, (based on the last three rate hiking time frames) the Fed typically raises rates at nearly every meeting once it decides to start moving and gets its interest rate-hiking process over within a one to two year time frame. On average, they raised rates 2.25% with rates peaking about 18 months into their past rate hike cycles.

Based on this "average" history, had the Fed stuck to their previous playbook, we might have seen short term interest rates rise toward a 2.5% to 3% range by June of this year. Yet here we are with short term rates almost assuredly very close to one percent, give or take an eighth of a percent by midyear.

The FOMC though, has continuously signaled that they expect to raise rates much more gradually than in the past, and of course they have done so. The markets expectation is finally beginning to move up a bit and converge towards the Fed's eventual forecast of about 3% by 2019.

We think that a 2.5% to 3% terminus rate is just about right. But the market might be surprised that given the strength of the U.S. economy we can get there a bit sooner than even the FOMC thinks. Unemployment rates have continued to drift lower (4.7%) and inflation rates have moved up (2%) to the Feds long term targets. Importantly, overseas markets are well behaved, the stimulus from negative European rates has helped and even the emerging market economies are cyclically rebounding.

The recent Trump stock market bump (approach 21,000 on the Dow Jones Industrial Average) has been a near-term stimulative shot in the arm, and the market is now discounting some additional rate-hiking activity next year given the administration's proposed pro-growth reflationary policies.

We believe the Fed will likely raise rates twice more this year, somewhere near mid-year, and once again at the end of the year, barring a recession or financial market reversal. And this will continue on a steady state basis likely concluding sometime next year, sooner than the market expects. And while it feels a bit too soon right now, we will eventually be talking about reducing rates again. It's interesting to note that on average two years into a rate hiking cycle the Fed is actually starting to lower rates. It won't be that soon this time around because of the gradual upward process, but no one has yet to "repeal and replace" the business cycle, no matter how pro growth the new administrative policies are perceived or will eventually become.

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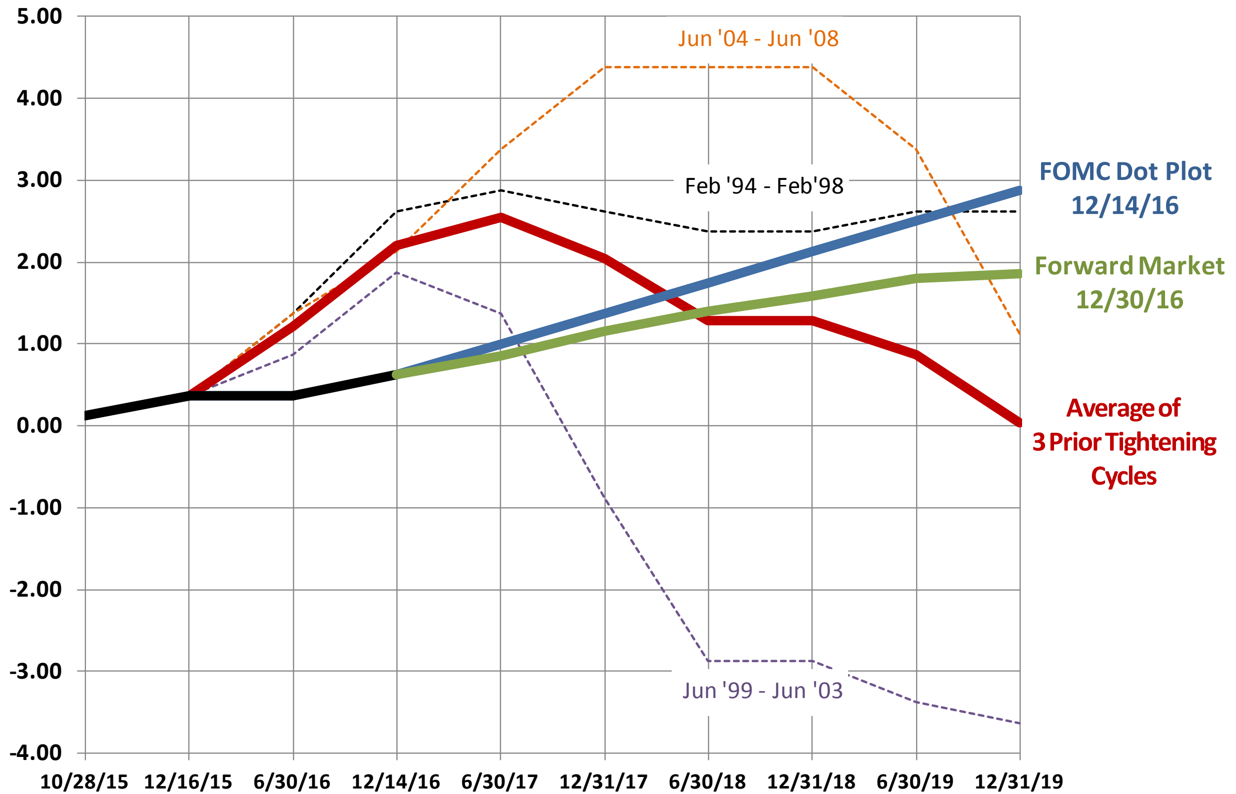

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