Economic and Market Insights
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Will the Fed take a pass today?

The Federal Reserve will tell us today if they will or won't raise rates. ***We doubt they will raise them, but even if they do, the forward path of future hikes is likely to remain modest and not roil the markets.*** The Fed has a so-called "dual mandate" to help the country obtain as full an employment level as possible while keeping inflation at bay. Here is why we think they are still on hold.

Clearly the employment picture continues to improve with the unemployment rate now down to 5.1%, 0.2% lower than at the last Fed meeting. But with wages barely growing at more than a 2-plus percent pace, and energy prices falling, measured inflation rates remain muted and well below the Fed's 2% target. In fact both core (no food and energy) and top line inflation readings have fallen since the Fed's last meeting, arguing for a pass in the rate hike.

What else has changed in the last six weeks between meetings? The S&P 500 has fallen 6%. The Chinese stock market is in a freefall after having dropped another 19%. Risk measures have elevated with the VIX (a measure of stock market risk) about 50% higher now, and credit spreads have widened by 0.2%. **The Fed does not typically tighten unless inflation is accelerating, stock prices are rising and credit spreads are contracting. None are occurring.**

What does it mean for the markets?

In the short run the markets will likely breathe a sigh of relief as they begin to discount the notion that the Fed will postpone its rate-hiking agenda. But that doesn't mean the Fed is on the sidelines for the rest of the year. We believe the stock market correction is likely to be digested by late October and the typical positive stock market "seasonals" in November and December will help push stock prices back toward their recent highs. Credit spreads should begin to settle down as the equity market stabilizes. Economic growth is likely to continue at an above 2-plus percent pace and unemployment to move perhaps to the sub-five percent range. All of this should afford the Fed the ability to lift rates by the end of the year as our economy and markets prove that they can "decouple" from the negativity emanating from China.

So do we have to suffer through the wall of worry once again?

Yes and no. Yes the markets will get anxious before the rate hike. Yes there will be a few days of heightened volatility. But as the Fed begins to telegraph a very gentle slope of interest rate path in 2016, the markets will react positively. On average, if the Fed slowly hikes rates, stocks have been nearly 10% higher one year later. And while short-term interest rates rise, longer-term interest rates at 3% today are likely discounting most of the interest rate-hiking process. And amazingly, because the Fed can only raise rates into an improving economy, credit spreads stabilize and even contract a bit on average. And finally, as the dollar rises even a bit more, this should provide pockets of opportunity overseas, particularly in Europe and most likely in the emerging markets, which are much closer to Chinese slowdown than we are.

So hopefully, with a pass today and a gentle forecast for a rate liftoff late in the year, our markets have largely borne the brunt already of the rate-hiking process, and should be able to absorb this tightening of monetary policy as we exit 2015 and enter 2016.