First Trust
Monday Morning OUTLOOK

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Resist the Rate-Hike Huff

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In June 2013, then-Federal Reserve Chair Ben Bernanke hinted the time to "moderate" quantitative easing was approaching. The press called this "tapering". The Fed would end QE gradually, by slowly shrinking its asset purchases rather than going cold turkey.

What happened? Within a week, US equities had sold off about 5% and the 10-year Treasury yield shot up about 40 basis points, from 2.2% to 2.6%. It's known widely as the "taper tantrum" and that phrase is used by some pessimists to show how vulnerable the market is, or was.

Many believed the economic recovery couldn't possibly continue without the support of the Fed. Others went so far as to say emerging markets would collapse.

The Fed held off for a while, but started tapering in 2014, and appointed a new Chair, Janet Yellen, who finished tapering at the end of October 2014.

And what happened? The unemployment rate fell from 6.7% to 5.6%, the US created 3 million new jobs and real GDP expanded by 2.4% in 2014 (roughly equal to the 2.3% growth rate of the current recovery). Equity investors soon caught onto the economy's resilience, and the S&P 500, including dividends, rose 13.7% to an all-time high.

In an eerily similar pattern, some investors are in a "rate-hike huff" because the Fed is heading toward a modest first rate hike in June. We fully expect the Fed to begin the process this week by removing the word "patient" from its policy statement. Projecting further out, we expect rate hikes to be very gradual and modest for about the first year, with increases of about 25 basis points per calendar quarter, or only one full percentage point in the first year.

Like tapering, this will not hurt economic growth. Nominal GDP – real GDP growth plus inflation – has been expanding near a 4.0% annual rate for the past few years, which is easily good enough to justify higher short-term interest rates. Short-term rates would have to rise to 3.5% or above before we became concerned, and for any real worriers out there, the M2 money supply has accelerated recently suggesting that the Fed is not even close to tight.

In a repeat of last year, there will be another temporary slowdown in GDP growth and other data during the first quarter of this year. The good news is that we have seen this movie before and we know the ending.

Even though it seemed so obvious, many thought weather had little or nothing to do with the 2.1% annualized drop in real GDP in the first quarter of 2014. Some said they thought the weather was a Soviet-style lame excuse for weaker-than expected earnings or other data. Some argued the Fed would be forced to change course and do another round of QE.

Then came a sharp rebound in growth in the middle two quarters of 2014, showing it *was* the weather after all.

This year seems to be following a miniature version of that same pattern. The National Oceanic and Atmospheric Administration (NOAA) – no, they can't part the seas – uses a measure called Heating Degree Days (HDDs) to measure temperature.

What this data shows is that February 2015 was the coldest February, for the most people, since 1979. Add in a port strike on the West Coast, and we're now anticipating a tepid growth rate of just 1% for the first quarter, with a bounce back in the middle of the year, just like last year.

And just as last year's data slowdown in Q1 didn't stop the Fed from tapering, this year's volatility and weak data won't stop the Fed from raising rates by mid-year.

The best news is that equities rebounded in 2014, despite continued tapering. We expect the same this year as the Fed launches its first rate-hike-cycle since 2004. And weakness now is a head-fake caused by a "hike-huff."

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
3-16 / 7:30 am	Empire State Mfg Survey - Mar	8.0	**5.5**	6.9	7.8
8:15 am	Industrial Production – Feb	+0.2%	**+0.2%**	+0.1%	+0.2%
8:15 am	Capacity Utilization – Feb	79.5%	**79.4%**	78.9%	79.4%
3-17 / 7:30 am	Housing Starts – Feb	1.040 Mil	**1.026 Mil**		1.065 Mil
3-19 / 7:30 am	Initial Claims – Mar 14	294K	**299K**		289K
9:00 am	Leading Indicators – Feb	+0.2%	**+0.3%**		+0.2%
9:00 am	Philly Fed Survey – Mar	7.0	**6.6**		5.2