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ECONOMIC RESEARCH REPORT

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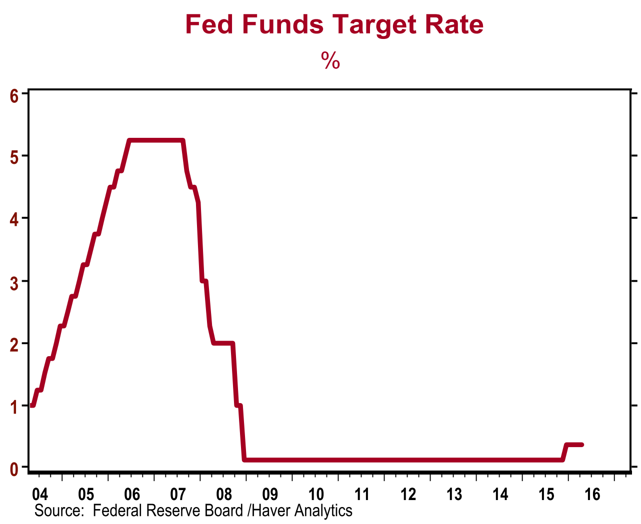
Fed Nudges Toward a June Rate Hike

As we said back in March, mark your calendars for a rate hike on June 15. Today's statement from the Federal Reserve signals that it intends to raise rates by 25 basis points at the next meeting, consistent with the projections it made in March that it would raise rates twice in 2016.

Here's why we think the Fed is headed toward a June rate hike.

First, the Fed re-ordered the list of economic indicators it discusses in the first paragraph of its statement, making the labor market first and noting its continued improvement. That's important because many key decision-makers at the Fed have said a tighter labor market will eventually lead to higher inflation.



Second, although the Fed mentioned more moderate growth in consumer spending, it also noted "solid" growth in household income and "high" consumer sentiment. In other words, the Fed expects growth in consumer spending to accelerate.

Third, the Fed completely removed the language about "risks" due to "global economic and financial developments." Remember that it was exactly these risks that stopped the Fed from raising rates earlier this year. We interpret the removal of this language to mean the Fed sees the risks to its March economic outlook as balanced, which means it's also comfortable with its March projection of two rate hikes.

In addition, like in March, the one dissent came from Kansas City Fed Bank President Esther George, who voted in favor of hiking rates by 25 basis points at *today's* meeting.

In our view, George was right and everyone else wrong. Economic fundamentals warrant a rate hike. The economy can handle higher short-term rates. The unemployment rate is already very close to the Fed's long-term projection of 4.8% and nominal GDP growth – real GDP growth plus inflation – is up at a 3.5% annual rate in the past two years.

Slightly higher short-term interest rates are not going to derail the US expansion, but will help avoid the misallocation of capital that's inevitable if short-term rates remain artificially low.

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Text of the Federal Reserve's Statement:

Information received since the Federal Open Market Committee met in March indicates that labor market conditions have improved further even as growth in economic activity appears to have slowed. Growth in household spending has moderated, although households' real income has risen at a solid rate and consumer sentiment remains high. Since the beginning of the year, the housing sector has improved further but business fixed investment and net exports have been soft. A range of recent indicators, including strong job gains, points to additional strengthening of the labor market. Inflation has continued to run below the Committee's 2 percent longer-run objective, partly reflecting earlier declines in energy prices and falling prices of non-energy imports. Market-based measures of inflation compensation remain low; survey-based measures of longer-term inflation expectations are little changed, on balance, in recent months.

Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. The Committee currently expects that, with gradual adjustments in the stance of monetary policy, economic activity will expand at a moderate pace and labor market indicators will continue to strengthen. Inflation is expected to remain low in the near term, in part because of earlier declines in energy prices, but to rise to 2 percent over the medium term as the transitory effects of declines in energy and import prices dissipate and the labor market strengthens further. The Committee continues to closely monitor inflation indicators and global economic and financial developments.

Against this backdrop, the Committee decided to maintain the target range for the federal funds rate at 1/4 to 1/2 percent. The stance of monetary policy remains accommodative, thereby supporting further improvement in labor market conditions and a return to 2 percent inflation.

In determining the timing and size of future adjustments to the target range for the federal funds rate, the Committee will assess realized and expected economic conditions relative to its objectives of maximum employment and 2 percent inflation. This assessment will take into account a wide range of information, including measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial and international developments. In light of the current shortfall of inflation from 2 percent, the Committee will carefully monitor actual and expected progress toward its inflation goal. The Committee expects that economic conditions will evolve in a manner that will warrant only gradual increases in the federal funds rate; the federal funds rate is likely to remain, for some time, below levels that are expected to prevail in the longer run. However, the actual path of the federal funds rate will depend on the economic outlook as informed by incoming data.

The Committee is maintaining its existing policy of reinvesting principal payments from its holdings of agency debt and agency mortgage-backed securities in agency mortgage-backed securities and of rolling over maturing Treasury securities at auction, and it anticipates doing so until normalization of the level of the federal funds rate is well under way. This policy, by keeping the Committee's holdings of longer-term securities at sizable levels, should help maintain accommodative financial conditions.

Voting for the FOMC monetary policy action were: Janet L. Yellen, Chair; William C. Dudley, Vice Chairman; Lael Brainard; James Bullard; Stanley Fischer; Loretta J. Mester; Jerome H. Powell; Eric Rosengren; and Daniel K. Tarullo. Voting against the action was Esther L. George, who preferred at this meeting to raise the target range for the federal funds rate to 1/2 to 3/4 percent.