First Trust
Monday Morning OUTLOOK
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Fed Teeing Up Rate Hike

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Just a couple of weeks ago the odds of the Federal Reserve raising rates in June were slim to none. The federal funds futures market put the odds of a rate hike around 4%.

Then, last week, we got the minutes from the Fed meeting back in April, which showed that as long as the economy continued to make progress the Fed was very comfortable with a June rate hike. Now, the futures market is putting the odds of a 0.625 percent interest rate on fed funds at about 30%.

We think those odds will move higher over the next few weeks and a rate hike in June is more likely than not, say about 60%. Not definite, not 100%, just much higher than most investors now expect.

But none of this should concern equity investors. Monetary policy will still be loose and remain that way for an extended period of time. Consumer prices are up 1.1% in the past year while "core" consumer prices are up 2.1%. So, either way, the federal funds rate will remain well below inflation, meaning the "real" (inflation-adjusted) federal funds rate stays negative.

Meanwhile, the banking system is still chock full of $2.3 trillion in excess reserves (reserves in excess of what banks are legally required to hold to meet reserve requirements). Raising rates is not going to change that. It will, however, mean the Fed pays banks more to hold these reserves, a plus for financial firms and, in turn, money growth. M2 has grown 9.4% at an annual rate in the past three months, while commercial and industrial loans have grown 16.1%.

Raising rates should help the Fed get in a position where it can eventually start drawing down those excess reserves. But, until it does, the chance of sharply accelerating money growth exists. This will bring more inflation. Normally, higher short-term rates tend to flatten the yield curve, with long-term rates moving up, too, but not as much as short-term rates.

But this time really is completely and totally different. Raising rates makes money growth accelerate because of all the excess reserves out there.

One reason some analysts and investors still think the Fed won't raise rates in June is that it hasn't clearly telegraphed that it wants to raise rates. But we think the absence of a clear signal is because the Fed is rethinking its position on transparency.

Time and again over the last several years, the Fed has indicated a shift in policy was imminent only to reverse course when short-term gyrations in financial markets scared the snot out of everyone. People still talk about the taper tantrum. We always said this was an over-reaction on everyone's part.

In the end, the Fed eventually tapered, ended quantitative easing and then raised rates as well, without negative economic consequences. So the Fed may now think that if the economy deserves slightly higher rates, the best thing to do is <u>not</u> make it clear it will raise rates beforehand (because markets might throw a fit), and just pull the trigger. Tapering, ending QE, and raising rates in December didn't hurt growth, so why not raise rates again without generating any hysteria before the action takes place?

There is still time for the data to get worse before the Fed makes its decision in mid-June. We just don't think that's going to happen. Instead, look for reports on durable goods, consumer spending, inflation, and the job market to give the Fed the confidence it needs to get back on track toward a more normal monetary policy.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
5-24 / 9:00 am	New Home Sales – Apr	0.522 Mil	**0.519 Mil**		0.511 Mil
5-26 / 7:30 am	Initial Claims May 21	275K	**273K**		278K
7:30 am	Durable Goods – Apr	+0.5%	**+1.0%**		+1.3%
7:30 am	Durable Goods (Ex-Trans) – Apr	+0.3%	**+0.1%**		-0.2%
5-27 / 7:30 am	Q1 GDP Preliminary Report	0.9%	**0.8%**		0.5%
7:30 am	Q1 GDP Chain Price Index	0.7%	**0.7%**		0.7%
9:00 am	U. Mich Consumer Sentiment- May	95.4	**95.8**		95.8