First Trust
Monday Morning OUTLOOK
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Why Not 50?

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Asking if the Federal Reserve will lift the federal funds rate on June 13 is like asking if Las Vegas Golden Knights goalie Marc-Andre Fleury, who has stopped 94.7% of the shots against him in the 2018 Stanley Cup playoffs, will stop the next one. It's a virtual lock.

And everyone knows the rate hike is almost guaranteed to be the very same 25 basis point (bp) increment the Fed has used six times in the current rate hiking cycle, starting in December 2015. In fact, that's the same 25 bp increment the Fed used consistently between June 2004 and June 2006, totaling seventeen drip-drip-drip rate hikes in all. That campaign lifted rate 425 bps total, every one of which was telegraphed. Rates moved from a starting point of 1% to a peak of 5.25%.

We need to go all the way back to May 2000 to find a meeting at which the Fed raised rates by 50 bps – the final rate hike of that cycle – after a series of 25 bp hikes that started in mid-1999. In other words, the Fed has become comfortable and predictable with 25 bp moves, which seems to be all about not getting blamed for any kind of short-term market turmoil.

So why not raise by 50 bps?

Everyone knows the Fed will lift rates by at least another 50 bps this cycle. The federal funds futures market puts the odds of the Fed raising rates by less than 50 bps *this year* at 6.6%. We're sure the odds would be even lower if we included 2019. That's as close to a sure thing as Marc-Andre Fleury.

So, if the Fed is going there anyhow, why not get there sooner? Why not get to a neutral monetary policy more quickly? Why be so predictable?

Raising rates by 50 bps this early in the cycle isn't going to make monetary policy tight. Right now, nominal GDP (real GDP growth plus inflation) is up 4.8% in the past year and up at a 4.4% annual rate in the past two years, well above the current federal funds target of 1.625%. The 10-year Treasury yield is about 145 bps above the funds rate. Meanwhile, the banking system is chock full of excess reserves and a record amount of capital. Congress and executive agencies are moving to undo some of the excess regulations on the banking system, there are no major bubbles in the financial system, and corporate balance sheets are in fantastic shape.

Add in an unemployment rate of 3.9%, well below the Fed's consensus view that its long-term average will be 4.5%. Plus, the PCE deflator, the Fed's favorite inflation measure, is already up 2% from a year ago and, given the recent rise in oil prices, should hover persistently above 2% for the rest of the year.

One of the key problems with "forward guidance" and gradually lifting interest rates on a predictable schedule is that it's *too predictable*. It's like clockwork. At present, everyone thinks they can predict the movement of future short-term rates with little to no risk. Which is exactly what happened in the previous decade. By telegraphing every move, the financial system could use simple spreadsheets to build a strategy for taking advantage of 25 bp moves at every meeting. This led to a complacency and a willingness by many players to take on excessive risk. In many ways, this is the same thing President Trump complained about with our military – always telling the world exactly what we would do and when we would do it.

To be precise, we'd like to see the Fed raise rates by 50 bps in June. Then, using its dot plot and press conference, the Fed could signal more rate hikes to come while also, by going 50 bps at this meeting, signal that timing is always on the table. In other words, the Fed would probably raise rates by a total of 100 bp this year, but the average level of short-term rates in 2018 would be slightly higher than if it moved only 25 bps at a time. This would move long-term rates higher sooner as well.

Surprising the market would not be the end of the world. Back in September, the Bank of Canada surprised with a rate hike and lived to tell the tale. Canadian equities are up since then. And the Canadian dollar is up, as well.

Once again: we're not holding our breath waiting for the Fed to surprise the market. The most likely outcome on June 13 is yet another 25 bp rate hike. But if the Fed really wants to prevent the kinds of imbalances that built up before the last recession, it should consider introducing some upside uncertainty into the path of short term rates.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
5-23 / 9:00 am	New Home Sales – Apr	0.679 Mil	**0.666 Mil**		0.694 Mil
5-24 / 7:30 am	Initial Claims May 19	220K	**217K**		222K
9:00 am	Existing Home Sales – Apr	5.550 Mil	**5.480 Mil**		5.600 Mil
5-25 / 7:30 am	Durable Goods – Apr	-1.3%	**-1.2%**		+2.6%
7:30 am	Durable Goods (Ex-Trans) – Apr	+0.5%	**+0.7%**		+0.1%
9:00 am	U. Mich Consumer Sentiment- May	98.8	**98.8**		98.8