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DECEMBER 16TH 2015 - FED HIKES RATES

NOW WHAT?

In their last meeting of 2015, the Federal Reserve decided to increase the policy rate 25 basis points (1/4 of 1%). With a glut of reserves already in the system they were forced to pay the higher rate themselves in the form of IOER, interest on excess reserves. At the same time they decided to increase the rate they will pay on RRPs (reverse repurchase agreements) from .05% to .25% and increase their RRP self-imposed daily maximum from $300 billion to $2 trillion!

This means the Fed could be on the hook for up to $18 Billion in interest payments paid directly to the nation's commercial banks, money market funds and other large financial institutions annually. This adds fuel to the economy, increases the potential for inflation, and discourages lending. The major banks didn't take long (about 30 minutes) to announce an increase in their Prime Rate. This caused every existing loan tied to Prime to get more expensive to service. The banks also wasted no time in announcing they were NOT going to increase customer deposit rates. So much for helping the savers. So far we have given more money to the banks and taken more money away from the people. And that was just the first day.

When explaining their actions the Fed said they were confident the current 5% unemployment rate was within their mandate and they were confident in their "belief" the inflation rate would move toward their 2% target in the medium term. They had to move now because if they waited for inflation to actually arrive, it might be too late and they risked falling behind the curve. The Fed said a small increase in interest rates now would increase confidence in our economy. This would encourage investors to invest, and consumers to consume. Let's see what happened.

On December 16th, 2015, the ten year Treasury bond paid 2.30%. Today it pays 2.05%. That's a big move in 1 month. Wasn't it supposed to move up?

On December 16th, 2015, the Dow Jones Industrial Average closed at 17,749. Today it is 1,800 points lower. So much for confidence.

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The Federal Reserve is attempting to influence interest rates in order to manage the economy. Increasing rates will not slow down the Private Sector unless it's the Private Sector paying the higher rates. If the Fed (Government) pays the higher rate it will have little effect on Private Sector behavior.

Fixed income investors are very interested in the direction of interest rates. Current rates are a function of supply and demand. Most will agree the supply of liquidity (money) in the financial system has rarely if ever been greater. So let's talk about the demand for short term safe investments. The Fed has announced that although they have ended Quantitative Easing, and will not be buying new bonds, they will continue to reinvest both principal and interest going forward. In order to maintain the current size of their balance sheet they will have to "buy" $215 billion in 2016. This increases to $375 billion in 2018 and will total over $1 trillion in less than 4 years. To put this in perspective the number was $3.5 billion in 2015 and $474 million in 2014.

My guess is the Fed will concentrate on short term as opposed to longer term bonds. Additional demand for short term Treasuries will also come from money market funds required to invest only in government guaranteed securities so they can maintain that comforting $1 net asset value investors love so much.

So where are interest rates headed! Both supply and demand seem to indicate lower.

Gregory E Cater

January 19th 2016