

ECONOMIC UPDATE

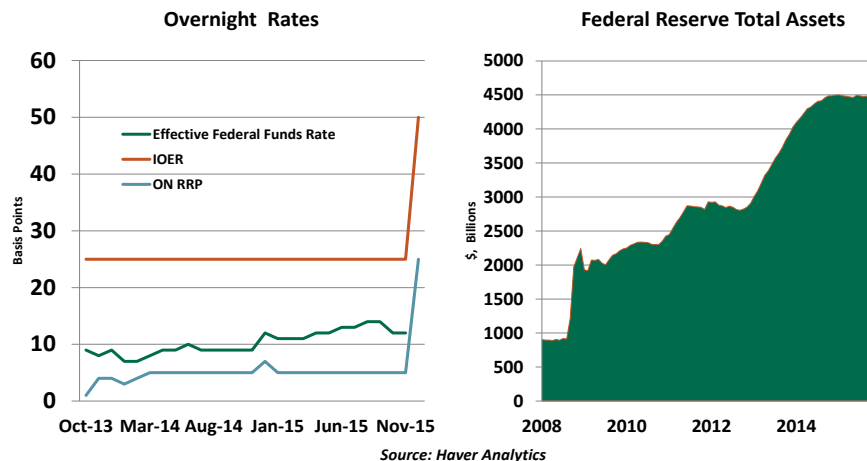
December 16, 2015

• One Small Step

My children are not fun to be with during road trips. Every 15 minutes, they'll ask, "Are we there yet?" "Are we there yet?" The GPS tools on their smart phones make it easy for them to answer this question. But they inquire anyway, to express their impatience.

I am certainly not comparing my partners and our clients to unruly children, but the inquiries I've gotten over the past two years about the first rate hike from the Federal Reserve have been tinged with impatience. Today's decision by the Fed finally answers those questions but raises a host of others.

Seven years to the day after bringing overnight interest rates to near zero, the Federal Open Market Committee (FOMC) ended what Chair Janet Yellen termed an "extraordinary period" by moving its targets up by 25 basis points. The Fed's balance sheet will remain at its current size; any maturities in the securities portfolio will be reinvested.

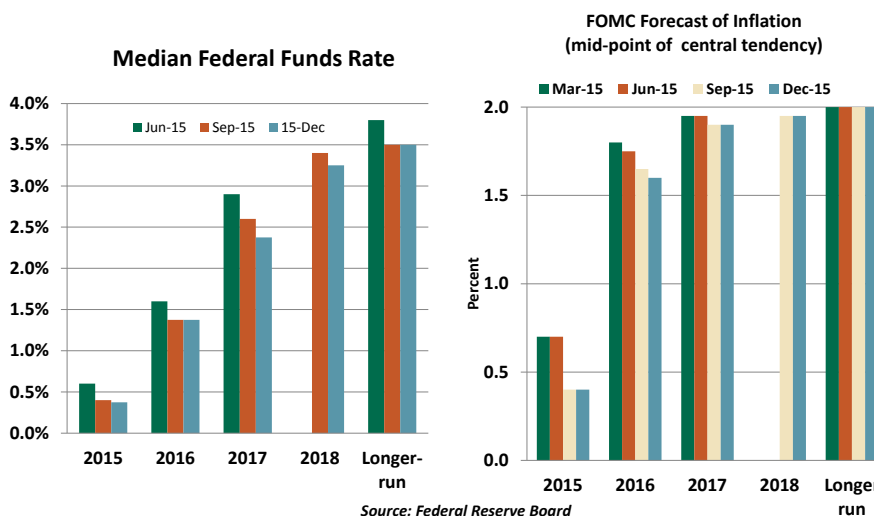


Here are some preliminary reflections on today's outcome.

1. The communication stressed the Fed's confidence that current economic momentum will be sustained. This is justified by recent data and is reflected in the Fed's own forecasts. This perspective should be valuable to equity markets.
2. Negative influences, especially from international sources, were seen as less threatening than they were in September. Overall, risks to the outlook were depicted as "balanced." Consumer conditions are improving as employment increases, wages grow and debt levels moderate. China is going through a challenging adjustment, but prospects for the eurozone seem much better than they were earlier this year.
3. Today's communication used the word "gradual" multiple times, providing reassurance that further increases would occur at a measured pace. That pace will continue to be calibrated based on the evolution of inflation and employment in the months ahead.

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4. The vote in support of today's action was unanimous. There were several FOMC members who expressed reservations about raising rates too early. But they were apparently ameliorated by the combination of a small hike and a somewhat dovish statement.
5. While the first interest-rate increase after such a long period of stability is important, U.S. monetary policy remains *tremendously* accommodative. Interest rates are far below what the FOMC consensus considers to be the long-term level (around 3.5%). Further, the Fed's balance sheet is almost five times larger than it was in 2008.



Policy normalization must begin before inflation reaches its target.

6. Inflation is much lower than desired, but today's communication expressed confidence that the 2% target could be reached in the medium term. The FOMC statement reminded us that it takes time for policy actions to affect future economic outcomes. Waiting too long risks having to tighten more abruptly, which could be very disruptive to market and economic progress.
7. Transitory factors such as low oil prices and the strong dollar were mentioned frequently as important restraints on inflation. As these dissipate, the price level should follow a more normal upward trajectory. Chair Yellen acknowledged that both survey- and market-based measures of inflation expectations have declined. But she blamed the latter on market distortions, as opposed to a fundamental shift in the outlook.

Taken together, the latter two points do an effective job of answering why rates were raised when inflation remains well below the targeted level.

Today's actions will work their way through the financial system over the coming weeks. The interest rate the Fed pays banks on excess reserves will be increased tomorrow, and the bank prime lending rate should follow shortly thereafter. Banks will give thought to how, and how much, to increase their deposit rates in response.

The lower end of the Fed's range will be enforced through increases in the size of the Fed's reverse repurchase program, which has been in a testing mode for many months. To this point,

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Today's action was well-
previewed and
therefore well-
received.

\$300 billion in transactions have been executed daily, but that limit will now be removed so that overnight rates can reach the desired destination. It could be some time before things are fully calibrated, especially given that market liquidity is thinning as we approach the end of the year.

Markets took today's news very well, with stock and bond prices little-changed this afternoon. That outcome is testimony to the effectiveness of the central bank's foreshadowing over the past several weeks. Criticized for poor communication for much of 2015, the Fed closed the year on a much stronger note.

Having passed one landmark, the next natural question for those on a journey is where to go from here. The median forecast for overnight interest rates at the end of 2016 is 100 basis points higher than today's level, implying four more moves next year, but there is considerable divergence around that level. Some participants favor two moves in the next twelve months, while more than half anticipate four or more.

We continue to be on the low side of those projecting the funds rate in 2016, given the size of the inflation deficit and lingering global uncertainty.

The next "live" meeting will take place next March. There could be a lot of twists and turns in the road before then. Seatbelts fastened: This will continue to be an interesting ride.

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