December 14, 2016

The Second Rate Hike is Here, Now What?

Eric Lascelles, Chief Economist, RBC Global Asset Management

For those who have been watching monetary policy closely over the last several years, the U.S. Federal Reserve's (Fed's) decision to hike the federal funds rate by 0.25% on December 14, 2016 might feel like déjà vu. In a move that was widely predicted, this hike brings the fed funds rate into a range of 0.50%-0.75%.

The surprising – though not shocking – part of the announcement was the Fed's updated expectations around future rate hikes, which pointed to three anticipated rate hikes in 2017 versus the two hikes previously anticipated. This extra hike is hardly written in stone given the Fed's past track record of excessive optimism, but it is certainly plausible and it's the reason markets have reacted to an announcement that was already universally expected.

Why did the Fed hike rates?

In Fed Chairwoman Janet Yellen's speech, she indicated that this hike is "a vote of confidence in the economy" and the progress that has been made. Yellen reiterated that confidence by stating that the U.S. "economy has proven to be remarkably resilient," economic slack in the U.S. has diminished, labour markets remain strong, and inflation expectations are rising towards their target rate of 2%.

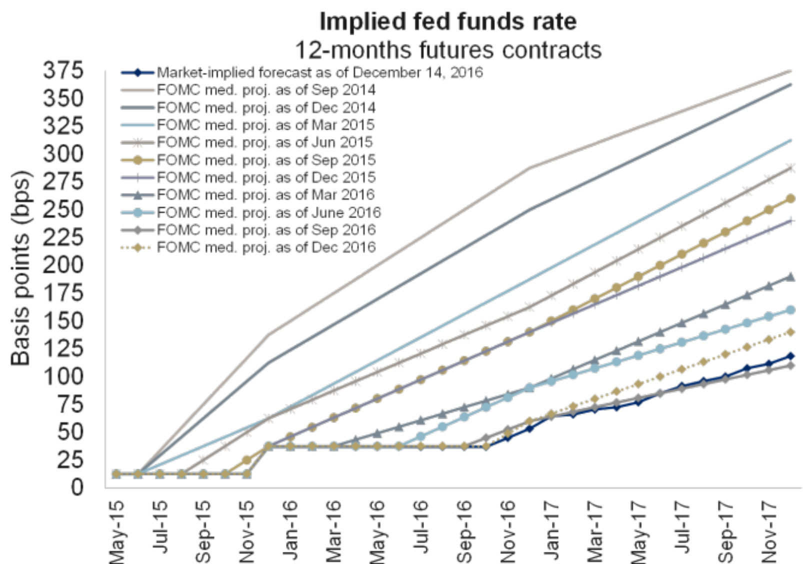
How does the recent U.S. election weigh into this?

The big question on investors' minds before the meeting was whether the election of Donald Trump and his proposed fiscal stimulus would warrant more tightening than intended before. At the margin, there are reasons to support this. On his campaign trail, Trump made mention that rates were too low. Furthermore, Republicans seem to favour a more rules-based approach to monetary policy, with the most prominent of these – the Taylor Rule – arguing that monetary policy should be a little tighter.

To the surprise of many, the Fed's statement did not mention fiscal stimulus. However, Yellen did acknowledge that it factored into members' forecasts. She also seemed to suggest that fiscal stimulus – a notable subject given an impending package from Trump – isn't particularly necessary now that the economy has strengthened.

What is the outlook for Fed tightening as we move forward?

Following the announcement, the median expectation by Fed participants is for three further hikes in 2017. As Yellen alluded to in the press conference, this shift is a "very modest adjustment" to existing monetary policy. Interestingly, it marks the first time expectations have risen since prior to the Financial Crisis. While a faster pace of rate hikes is plausible, the extra hike is hardly written in stone given the Fed's past track record of excessive optimism.



Source: Bloomberg, U.S. Federal Reserve, RBC GAM

What does this mean for investors?

The hike and hawkish tone constitutes yet another force pushing yields higher, and a continuation of the move we've seen since the U.S. election. We think there is a limit to how much further this trend can run. It's undeniable that monetary policy, inflation expectations and debt expectations represent upward pressures for yields. Fortunately, the U.S. economy ends up slightly ahead as opposed to behind when weighing potential fiscal policy and stimulus against some of these drags.

The economic implications of this move should be fairly limited for several reasons. First, this isn't the start of a new tightening cycle (the first hike occurred last December). In addition, the market was fully anticipating this hike, and the Fed indicated they will be moving slowly through this tightening cycle. Theoretically, a 25 bps rate hike has only a slight deleterious effect on the subsequent economic growth rate. But in our judgement, this is not a policy error, and as such should be viewed as a constructive outcome, not a damaging one for the economy.

This report has been provided by RBC Global Asset Management (RBC GAM) for informational purposes only and may not be reproduced, distributed or published without the written consent of RBC Global Asset Management Inc. (RBC GAM Inc.). In Canada, this report is provided by RBC GAM Inc. (including Philips, Hager & North Investment Management). In the United States, this report is provided by RBC Global Asset Management (U.S.) Inc., a federally registered investment adviser. In Europe and the Middle East, this report is provided by RBC Global Asset Management (UK) Limited, which is authorised and regulated by the UK Financial Conduct Authority. In Asia, this document is provided by RBC Investment Management (Asia) Limited, which is registered with the Securities and Futures Commission (SFC) in Hong Kong.

RBC GAM is the asset management division of Royal Bank of Canada (RBC) which includes RBC GAM Inc., RBC Global Asset Management (U.S.) Inc., RBC Global Asset Management (UK) Limited, RBC Alternative Asset Management Inc., the asset management division of RBC Investment Management (Asia) Limited, and BlueBay Asset Management LLP, which are separate, but affiliated subsidiaries of RBC.

This report has not been reviewed by, and is not registered with any securities or other regulatory authority, and may, where appropriate, be distributed by the above-listed entities in their respective jurisdictions. Additional information about RBC GAM may be found at www.rbcgam.com.

This report is not intended to provide legal, accounting, tax, investment, financial or other advice and such information should not be relied upon for providing such advice. The investment process as described in this report may change over time. The characteristics set forth in this report are intended as a general illustration of some of the criteria considered in selecting securities for client portfolios. Not all investments in a client portfolio will meet such criteria. RBC GAM takes reasonable steps to provide up-to-date, accurate and reliable information, and believes the information to be so when printed. Due to the possibility of human and mechanical error as well as other factors, including but not limited to technical or other inaccuracies or typographical errors or omissions, RBC GAM is not responsible for any errors or omissions contained herein. RBC GAM reserves the right at any time and without notice to change, amend or cease publication of the information.

Any investment and economic outlook information contained in this report has been compiled by RBC GAM from various sources. Information obtained from third parties is believed to be reliable, but no representation or warranty, express or implied, is made by RBC GAM, its affiliates or any other person as to its accuracy, completeness or correctness. RBC GAM and its affiliates assume no responsibility for any errors or omissions.

All opinions and estimates contained in this report constitute RBC GAM's judgment as of the indicated date of the information, are subject to change without notice and are provided in good faith but without legal responsibility. To the full extent permitted by law, neither RBC GAM nor any of its affiliates nor any other person accepts any liability whatsoever for any direct or consequential loss arising from any use of the outlook information contained herein. Interest rates and market conditions are subject to change.
Return estimates are for illustrative purposes only and are not a prediction of returns. Actual returns may be higher or lower than those shown and may vary substantially over shorter time periods. It is not possible to invest directly in an unmanaged index.

A note on forward-looking statements
This report may contain forward-looking statements about future performance, strategies or prospects, and possible future action. The words "may," "could," "should," "would," "suspect," "outlook," "believe," "plan," "anticipate," "estimate," "expect," "intend," "forecast," "objective" and similar expressions are intended to identify forward-looking statements. Forward-looking statements are not guarantees of future performance. Forward-looking statements involve inherent risks and uncertainties about general economic factors, so it is possible that predictions, forecasts, projections and other forward-looking statements will not be achieved. We caution you not to place undue reliance on these statements as a number of important factors could cause actual events or results to differ materially from those expressed or implied in any forward-looking statement made. These factors include, but are not limited to, general economic, political and market factors in Canada, the United States and internationally, interest and foreign exchange rates, global equity and capital markets, business competition, technological changes, changes in laws and regulations, judicial or regulatory judgments, legal proceedings and catastrophic events. The above list of important factors that may affect future results is not exhaustive. Before making any investment decisions, we encourage you to consider these and other factors carefully. All opinions contained in forward-looking statements are subject to change without notice and are provided in good faith but without legal responsibility.
® / TM Trademark(s) of Royal Bank of Canada. Used under licence. © RBC Global Asset Management Inc., 2016