Registered Investment Advisor Firm

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Fed Rate Increase

Janet Yellen of the Federal Reserve (Fed) announced a quarter-point increase in its target range for overnight rates, from 0-.25% to .25%-.5%, a seven year period between adjustments. The question now becomes how fast they plan to reach their overall goal of 3.5%. I believe the Fed will gradually raise rates over the next 2-4 years. This is unusual as most times in the past, the Fed has raised at every Fed meeting until they reached their goal.

Weak economic growth, falling commodity prices, troubling overseas markets and an inflation rate well below their 2% target, kept the central bank from acting sooner. Today, the median projections of the policymakers are for four rate increases in 2016, but economic and financial market developments could change all that.

Low rates made it easier for investors to borrow and make stocks appear more attractive than bonds. That is now changing. In the past, stocks fell immediately after the Fed announcement, but held up better when the Fed proceeded more slowly, which I think will happen this time. The S&P500 was down an average of 2.7% over the 12 months following the first increase when the Fed moved rapidly.

When the Fed moved gradually, the index rose an average of 10.8% in the next 12 months. I think we could be well into 2017 before the Fed moves begin to squeeze the economy. The odds of a recession in 2016 are very, very low.

What does this mean for most of us? One result of the move is the increase in the prime rate, the base rate for a variety of loans including credit-card debt and mortgages. Borrowers will see higher rates soon, but savers won't see higher yields, yet. Most major banks announced they were not increasing the rates savers receive and did not give a timetable when they would.

Central Banks around the world reacted differently to the Fed's move. Many foreign banks moved in lock-step with

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the Fed, several raised less than the Fed and some bankers did nothing. Anticipation of higher interest rates and a stronger US growth rate have pushed up the value of the US dollar over the past year and should continue to strengthen the dollar.

Higher interest rates and consumer spending have a negative relationship, meaning that spending moves in the opposite direction of interest rates. As rates rise, consumer spending will fall.

Rising interest rates are the single biggest drag on the housing market as higher rates make homes less affordable.

Higher rates will push bond prices downward and move yields higher.

Low interest rates have been a blessing for stock prices since 2009. As the Fed took rates to zero, investors moved into stocks, as they chased higher returns for their money. They even borrowed at a record pace to invest in stocks.

Low rates also enabled public companies to borrow on the cheap to buy back their own stocks, thus reducing the amount of stock in the market and pushing stock prices higher. Higher rates will increase the interest expense of companies (affecting profitability), reduce the amount of money investors borrow to buy stocks (reduce demand) and increase the cost of public stock buyback programs.

Combine higher interest rates with a pull-back in consumer spending, falling demand for houses, a declining bond market and the continued contraction in earnings and revenue growth for S&P500 companies- I expect a more volatile movement for the US stock market in 2016.

After each step, the Fed will evaluate the consequences before deciding to make future changes. If the economy slows, if there are signs that inflation is falling below the Fed 2% target, it could delay the next move by months or even a year. That caution greatly reduces the danger of any serious economic decline.

The Fed announced no plans to sell the nearly$4.2 trillion worth of various Treasury bonds and mortgages that it owns. The bank is simply rolling over the portfolio, meaning it reinvests $21 billion a month as bonds mature. Most observers eventually expect the reinvestment to stop and the Fed top allow the bond holdings to mature and fall off of the balance sheet. The fact that this is not being done currently reflects the degree of caution among Fed policymakers.

Whether rates will be high or low a few years from now has little to do with what the Fed did in December 2015. It has a lot to do with what happens to forces inside the economy that are poorly understood and hard to forecast. But the rate rise should be reason for celebration, a sign that the recession and economic uncertainty is in our past.

FED Watch

The story continues.

Still on the edge of our seats.

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If you have questions or would like further information on this month's topics or any other financial or investment related subjects, including Social Security claiming strategies, please contact me by phone or through my email address at: Bob@DavisInvestmentGroup.biz

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