Weekly Market Summary

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The 25 bps Hike in US Short Term Rates Everyone is Expecting !!

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If you're looking for drama surrounding today's meeting of Federal Reserve officials, do not look for it in their post-meeting announcement/statement. Policy makers are almost universally expected to raise their benchmark lending rate - the US Fed funds rates - by 25 bps (from 0.375% to 0.625%) for the first and only time in 2016, in comparison to the four increases they had projected for 2016 at this time last year. That fabulously wrong rate guess comes in sharp contrast to the Fed's unemployment and inflation projections, which look mostly spot-on based on what recent economic releases have shown (although the Fed's growth projections have stayed too ambitious compared to the actual outcome).

So why did the Fed get their economic projections close to right, but their rate projections so wrong? Slower rate hikes may have helped the Fed achieve better growth as it left the economy more room to prosper. And surely policy makers held off on rate increases because of highly unpredictable events, from China-inspired market volatility early in the year, to Britain's vote in late-June to exit the European Union and recent heightened uncertainties surrounding the US presidential election. "*The Fed is keeping an eye on what is going on globally, and that prevented them from hiking rates as they signaled initially," said Thomas Costerg, senior U.S. economist at Standard Chartered Bank in New York …It boils down to the international picture*."

What no one knows for sure though is what the Fed may say about the likely pace of future rate increases or perhaps about the economy's prospects under the incoming Trump administration. Any answers - or at least hints - could come in the Fed's updated economic forecasts or in the news conference by Chair Janet Yellen.

Here are three (or possibly four) things to watch for after the Fed's meeting ends:

State of the US Economy

The Fed most recently raised its key policy rate in December 2015, after having left it at a record low near zero since the financial crisis erupted seven years earlier. In a statement, it will explain its rate decision and its view of the economy. So far, the Fed has expressed the belief that still-low inflation gives it leeway to raise rates at a very gradual pace. Investors will be watching to see if Fed officials modify that view.

An especially rosy view, with expectations of a steadily rising job market and inflation edging closer to the Fed's 2% could suggest a relatively fast pace of future rate increases. A more cautious outlook, by contrast, would signal that the central bank expects to further raise rates only incrementally ("measured" pace).

Forecast and Dot Plot

Each quarter, the 17 members of the Fed's policy committee - five board members (there are two vacancies) and 12 regional bank presidents - offer their own individual, but anonymous, forecasts for the economy's performance. Any significant upgrade Wednesday of those forecasts - for economic growth, the unemployment rate and inflation -

could mean the Fed is growing more confident that the economy has strengthened enough to withstand a faster pace of rate hikes. The current 4.6% unemployment rate, a nine-year low, is below the 4.8% that Fed officials in September had collectively pegged as full employment. And after an anemic first half of the year, economic growth has accelerated in the second half.

Another gauge to watch is where the 17 officials foresee the path of their benchmark rate, the Federal funds rate. Each official's expectation is represented as a dot on the rate chart. Fed officials stress that the chart is merely a projection of where rates might go and is not a pledge of any kind. A year ago, for example, the "dot plot" suggested that the Fed would raise rates four times in 2016. Yet a rate hike Wednesday would be the first this year. In September, the Fed officials projected one rate hike for 2016 and two each in 2017 and 2018. Some economists are now revising their own forecasts to show three or even four rate increases for next year if Trump succeeds in getting his economic program through Congress and the program begins to accelerate the economy. Once inaugurated, Trump will have the authority to immediately fill the two vacancies on the Fed's board. Those new officials could have a key role in influencing future rate decisions.

Yellen's Views

30 minutes after the Fed's announcement, Yellen will take questions from reporters, who will seek details about the Fed's discussions, its economic outlook and its thoughts on the Trump administration. If history is a guide, one should expect Chair Yellen to be exceedingly cautious in discussing how the Fed may or may not fine-tune its policymaking in response to Trump's plans to slash taxes, ease regulations, speed infrastructure spending - and possibly try to diminish the Fed's independence.

Since Trump's victory, stock markets have rallied, sending stocks to record highs, while bonds have absorbed losses (in excess of 70 bps jump!) on expectations of higher inflation and interest rates. Investors appear to be betting that the economy will strengthen along with corporate profits. A faster-growing economy could mean more rapid rate hikes from the Fed Yellen, though, will likely tread carefully in her assessment of the Trump agenda's likely impact on the economy, in part because the president-elect's agenda could undergo significant revision in its path through Congress.

The Fed chair may be less hesitant to reject Republican proposals in Congress to rein in the Fed's authority and independence. These efforts include a proposal to authorize Congress's auditing arm to review the Fed's rate decisions and require it to establish a formula to use in setting its policies. Yellen has criticized all those proposals, arguing that restricting the Fed's political independence would be a serious error, with possibly dangerous consequences for the economy.

Or maybe, you would want to keep an eye, instead, on President-elect Donald Trump's Twitter feed!!

Trump has been a harsh critic of Fed Chair Janet Yellen during the election campaign, and how the nation's incoming chief executive reacts to the expected hike on Wednesday may reveal much about whether and to what extent Trump will try to pressure the central bank through the remainder of her current term, which expires in February 2018.

Investors have already pushed up bond yields since Trump's surprise November 8th election win in anticipation of higher inflation. They are also likely to take note of any White House "bullying" of the Fed, which is expected to continue raising rates next year, albeit at a very gradual pace. "*It's an important thing to keep an eye on*," said Donald Kohn, a former Fed vice chair who is now a senior fellow at the Brookings Institution in Washington. "*It helps policy making, and the public perception of policy making, if the administration is not publicly commenting. It reinforces the idea of a monetary authority independent from short-term political pressure. Eroding that would be moving in the wrong direction.*"

While the Fed has faced more severe pressure from past presidents than a Twitter tantrum, the last three administrations under Bill Clinton, George W. Bush and Barack Obama have refrained from publicly commenting on policy decisions. That could change under Trump, who slammed the Fed during his election campaign and has demonstrated repeatedly his willingness to defy the conventions and sensibilities of establishment Washington.

Fed Meeting Actual Outcome

As widely expected, The Federal Open market Committee ("FOMC") raised the target range for the Federal funds rate by 25bp to 0.50% -0.75% (median 0.625%), the second rate increase this cycle (following the December 2015,25 bps hike). In justifying the move, the Committee highlighted cumulative progress toward the dual mandate (employment & inflation).

The main point of uncertainty remains the degree to which members did adjust their forecasts based on the expectation of expansionary fiscal policy (the Trump reflation trade). The Summary of Economic Projections ("SEP") show little to no change from September and Chair Yellen, in her press conference, suggested that it is "far too early" to judge the effects of fiscal policy on the Fed's policy stance, and added that the her team is operating under a cloud of uncertainty at the moment, and hence there is ample time to "wait and see".

The main change in the SEP was in the projected appropriate policy path where members now see a median of three rate hikes in 2017 versus only two at their September meeting (projections for 3 additional rate hikes in 2018 were left unchanged). In the press conference, Chair Yellen downplayed the change, saying the firming in the median rate path in 2017 was modest and only represented a small shift in the thinking of several committee members.

Market Reaction

Market Instrument	*Prior to the Fed announcement*	*Current*
US 2-year bond yield	*1.16%*	*1.27%*
US 5-year bond yield	*1.89%*	*2.05%*
EUR/USD	*1.0650*	*1.0490*
GBP/USD	*1.2700*	*1.2550*
USD/JPY	*115.20*	*117.55*
Gold (Spot)	*1162*	*1141*
Oil (February WTI)	*52.90*	*52.00*
Dow Jones Industrial Avg.	*19925*	*19792 (Wednesday's market closing)*
S&P 500	*2272*	*2253 (Wednesday's market closing)*

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