Economic Commentary

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The Fed on Course to Raise Rates by Another Quarter to 2.75%

The US Federal Reserve's Federal Open Market Committee (FMOC) is concluding its meeting today and is widely expected to announce an other quarter point hike in its fed funds rate, Canada's equivalent to the overnight rate. This is going to be the seventh consecutive rise in rates since the Fed embarked on a rate tightening cycle last June and will bring the fed funds rate to 2.75%. Today's rate hike is fully anticipated and priced in the market. Where there is some speculation is whether the Fed will alter the wording of its previous announcements by omitting the word "measured" which is seen as signaling the current course of measured quarter point hikes at each meeting. My expectation is that the Fed will not alter the wording significantly since inflation is still under control and it is still seen as being on course to keep raising rates until the end of the summer.

How high should short-term rates rise in the short-term? Nobody can tell exactly at which level the Fed will find comfort in the present environment. Besides, a lot depends on the future course of economic developments like how the inflation rate, the growth rate and the employment rate of growth will unfold. But we can say that at the very least the Fed is going to keep hiking rates by 25 basis points in each of the next two meetings (May 3rd and June 30th) which means a 3.25% rate by June 30th , at the very least. At most, based on the present state of inflation expectations and the current 4.5% rate in the 10-year bond market, the Fed would not want to raise rates any higher than that because it would imply a flat yield curve and therefore like putting the breaks on the economic expansion, something that the Fed has no reason to do unless provoked by an unexpected run-up in inflation or other factors.

Therefore, based on the current state of economic expectations, the Fed should raise rates to 3.5% by the August 9th meeting or 3.75% by the September 20th meeting which leaves a modest but firm 75 – 100 basis point differential between long and short rates in the USA. Following this course of action the Fed can say that it has removed the expansionary stimulus from money markets while still maintaining a neutral course, one that accommodates the expansion. One must also bear in mind that Fed Chairman Alan Greenspan is about to retire later this year after an 18-year tenure as head of the Fed and other things being equal he would like to see monetary policy return to a normal setting.

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