Investment note: Comment on Fed Rate Hike

Members of the Federal Open Market Committee (FOMC) voted for 25 basis points rate hike, raising the target range for the federal funds rate (Fed's benchmark rate) to "0.75% to 1%". Manulife Asset Management Chief Economist Megan Greene examines why economic data justified a rate hike and its implications for the economy.

Economic data justified a rate hike in March

According to Greene, the markets are currently in a good place to absorb a rate hike, not only because investors seem to know it is coming, but also because yields have come down moderately and the US dollar has weakened in recent weeks. Equities, meanwhile, have continued to soar. A weaker US dollar in particular gives the Fed room to hike now without risking pushing the US dollar up far enough to seriously threaten US growth

Economic data also justified a rate hike in March. ISM manufacturing data continues to suggest industrial production is expanding[1]. Survey data gauging confidence has been positive as well. Core Personal Consumption Expenditures (PCE)—the Fed's favorite metric for inflation—remained steady at 1.7% in January[2], below the Fed's target of 2%, but not dramatically so.

The data is not unambiguously rosy in the US, though. As Michael McDonough from Bloomberg Intelligence rightly points out, the Atlanta Fed's GDPNow forecast was just revised down to 1.8%, its lowest level since last summer[3]. Still, economic data has on balance continued the trajectory it had already been on, and Fed officials have shown that they do not need to see growth accelerate to hike rates; they just need to see it continue.

Economic and Market Impact

Greene is not expecting a significant hit to the US economy from a 25 basis points increase, in large part that is because the Fed's benchmark rate, at 1%, will remain below inflation and well

[1] Institute For Supply Management: Press Release, March 1, 2017.
[2] Bureau of Economic Analysis: Personal Income And Outlays (January), March 1, 2017
[3] Federal Reserve Bank of Atlanta, as of March 1, 2017.

below the Fed's estimate of the neutral rate (3.3%). That implies that the Federal Reserve have remained highly accommodative.

Instead, the concerns remain centered on the potential for a surge in the US dollar, which would hamper US manufacturing, act as financial tightening and have a deflationary impact. But given that the market is now almost fully-priced, a strong US dollar reaction seems unlikely.