

JEREMY SIEGEL ON THE FED RATE HIKE AND WHAT IT MEANS FOR 2016

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On Wednesday afternoon the [Federal Reserve \(Fed\)](#) raised rates by 25 [basis points \(bps\)](#), effectively raising its target band for the [Federal Funds Rate](#) to 25-50 bps. A widely anticipated move, it is an important and positive development for risk markets such as equities in that it removes a level of uncertainty. [Dovish Fed-Dot Plots Revised Downward](#) Following that decision, Fed chairman Janet Yellen's statement was generally dovish, placing a large emphasis on "gradual" rate hikes in the upcoming months. The dot plots that reflect projections from members of the Fed committee suggest that median estimates for Fed fund rates in 2016 lie between 1.25% and 1.50%. This implies there will likely be four rate hikes in 2016. There are two important factors that put this in context. First, although median forecasts of the dot plots imply four rate hikes, only three participants estimated that rates might actually be higher than the median, while seven members thought that rates would not get to that level. In contrast, at the September meeting, eight members thought the Fed would increase rates in excess of the median forecasts, indicating there has been a dovish tilt to these dots since then. Furthermore, these Fed forecasts of the Funds rate have been notoriously too [hawkish](#)—the Fed has systematically over-predicted the level for interest rates, and that may still be the case, given current market expectations. [Timing of Second Rate Hike](#) In my opinion, it is extremely unlikely that the Fed will raise rates at its first meeting in January 2016. Unless something extraordinary occurs, it will probably pass on this meeting and have a lively discussion at the March meeting, where a second rate hike is more likely. [Inflation—or Lack Thereof West Texas Intermediate \(WTI\)](#), which is used as a benchmark in oil pricing, fell to an 11-year low on Wednesday. Although [core inflation](#), which the Fed monitors, excludes food and energy, a dramatic price drop for goods and services in the manufacturing and services sector—resulting from lower oil prices—can ultimately put a lid on core inflation. [Will the Fed Turn Hawkish in 2016?](#) Wednesday's meeting ended with its committee members being in broad agreement of the decision—which is somewhat historic by itself, given that dissent has been a regular occurrence over the year. Many are expecting the Fed to tilt toward the hawkish end of the spectrum, what with one of its most dovish members, Narayana Kocherlakota, departing. I believe the Fed will be more balanced in its approach and will likely engage in a lively debate; we are nowhere close to having known hawks such as former Philadelphia Fed president Plosser or former Dallas Fed president Fisher as voting members next year. [Fed Funds Futures to Underestimate Rate Hikes](#) The Fed Funds futures market implies only two hikes in 2016. This likely underestimates where rates may end up, given the negative [beta](#) of these futures prices to the general market. This is because if growth collapses, the Fed will not hike rates—and these futures contracts will rise in price, working as a hedge against that event. As a result, these futures are often priced somewhat above their expected value, and, therefore, rates somewhat below their expected value. While the Fed dot plot has provided median guidance of four rate hikes for 2016, the Fed Funds market implies only two hikes. Given the negative bias, I think we'll likely see between two and three hikes instead of just two. [What Does It Mean to Target a 0.25%–0.50% Band?](#) When the Fed targeted a 0%–0.25% band, the mid-point was effectively 0.125%. With the new target band of 0.25%–0.50% (which

implies a mid-point of 0.375%), the Fed will likely target the lower end of the range to maintain full control over the Fed Funds Rate. Yellen herself mentioned at the press conference that the reverse repo facility will peg a rate of 25 bps, close to the floor of the new range. **The New Neutral: 2%** At the October Fed meeting, the Fed staff projected that the appropriate Fed Funds Rate level during a neutral period would be about a 0% real rate. With a target inflation rate of 1.5%-2%, the nominal Fed Funds Rate may get up to 1.5%-2%. This is largely in line with Bill Gross' concept of a new neutral of 2% for the Fed Funds Rate that I also support. I furthermore foresee that the interest curve will flatten somewhat, with 10-year rates increasing by half as much as [shorter-term rates](#). It is likely that the 10-year may creep up from its current level of 2.30% to 2.50%-2.75% by the end of 2016. [TIPS](#) yields may increase to 90-100 bps from their current level of 80 bps. **Fed not Fully Responsible for Ultra-Low Rates** While many ponder the unintended consequences of the Fed keeping rates low over the past seven years, academic research has shown that market forces have largely contributed to these low rates, namely outsized demand for "safe" liquid assets. To add fuel to the fire, record-low inflation, low economic growth, high risk aversion and an aging investor class are also partly responsible for this risk aversion. It was a combination of risk aversion and low growth that have kept rates this low for this long.

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DEFINITIONS

Federal Reserve: The Federal Reserve System is the central banking system of the United States.

Federal Funds Rate: The rate that banks that are members of the Federal Reserve system charge on overnight loans to one another. The Federal Open Market Committee sets this rate. Also referred to as the “policy rate” of the U.S. Federal Reserve.

Dovish: Description used when stimulation of economic growth is the primary concern in setting monetary policy decisions.

Dot Plot: a chart based on the economic projections of the Federal Reserve board members that illustrates their views on the appropriate pace of policy firming and provides a target range or target level for the federal funds rate.

Hawkish: Description used when worries about inflation are the primary concerns in setting monetary policy decisions.

Inflation: Characterized by rising price levels.

West Texas Intermediate (WTI): A grade of crude oil used as a benchmark in oil pricing.

Core inflation: Inflation excluding the impact of food and energy.

Beta: A measure of the volatility of a security or a portfolio in comparison to a benchmark. In general, a beta less than 1 indicates that the investment is less volatile than the benchmark, while a beta more than 1 indicates that the investment is more volatile than the benchmark.

Short-term rates: the rate of interest on a debt instrument maturing in two years or less.

Treasury Inflation-Protected Securities (TIPS): Bonds issued by the U.S. government. TIPS provide protection against inflation. The principal of a TIPS increases with inflation and decreases with deflation, as measured by the Consumer Price Index. When a TIPS matures, you are paid the adjusted principal or original principal, whichever is greater.