HIGHLAND

MARKET BRIEF
DECEMBER 2016

FED HIKES RATES FOR 2ND TIME IN A DECADE

To the surprise of no one, the Federal Reserve ("Fed") raised interest rates 25 basis points to 0.50-0.75%. Prior to the meeting, the market had priced in a 100% probability of a rate increase. There was even an 8% probability of the Fed raising interest rates 50 basis points. What did come as a surprise was the Fed's Dot Plot, which now shows 3 rate increases in 2017, one higher than the previous Dot Plot illustrated. This estimate would take the Fed Funds target range to between 1.25% and 1.50% by year end 2017. Another surprise: The Fed increased its longer run rate for the first time in two years. The longer run rate had fallen from 4.25% in 2012 to 2.87% in September of 2016. This estimate increased to 3% in the latest Dot Plot.

In the press conference associated with the Fed's statement, Chairperson Yellen noted the labor market has continued to strengthen as job gains have been solid in recent months and the unemployment rate has declined. The unemployment gap, which is the unemployment rate minus the Congressional Budget Office's estimate of the natural rate of employment, is negative, implying the Fed is meeting its first mandate of full employment. The number of unemployed per job opening is 1.4, which is close to its lowest level since the spring of 2001. The decline in labor slack is one of the reasons the market was expecting the Fed to raise rates as inflationary pressures rise.

Yellen also discussed the economy, noting it has been resilient, with economic activity expanding at a moderate pace since mid-year. Corporate profits have rebounded with oil and commodity prices, and were positive for the first time in six quarters. In addition, real GDP rose to a 3.2% annualized rate in the 3rd quarter, which is the fastest pace in two years. Since President-Elect Trump's victory, confidence has surged in the U.S. among consumers and businesses. The CEO Confidence Index recently hit its 3rd highest point since 2007, while consumer confidence reached its highest level in nine years. According to a recent Duke University/CFO Business Outlook survey, nearly 20% of respondents have said expected business-friendly policy changes in 2017 have led to increased hiring and business spending plans for next year. This increase in confidence has trickled into the equity markets, where stocks have fared well since the election.

During the Q&A session, many of the journalists pressed Yellen about inflationary pressures rising and whether the Fed could get behind the curve. Although the Fed is projecting 3 rate increases in 2017, Yellen noted that most members did not include the effect of possible fiscal stimulus in their forecasts, which include:

- Corporate and personal income tax cut
- Higher infrastructure and defense spending
- Repeal of the Affordable Care Act

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If these were to go into effect, then the Fed could really find itself having to raise rates more quickly than expected. Even though Trump and the GOP have stated they want to enact these policies, it does not mean they will be able to push them through. However, with the unemployment rate falling and inflation rising from 0% a year ago to 1.7% as of the latest reading, the Fed may not be too far away from meeting its 2% inflation mandate.

After the Fed's statement release, bond yields increased, equities markets sold off, and the dollar rose. Since the election, the dollar has risen along with equities, while bond prices have fallen. If the dollar strengthens too much, then this could put pressure on corporate profits and multinational companies, thereby slowing down the equity market. At current levels, this is worth watching, but not to the point where it has become a significant detractor. Unlike the situation before last year's Fed hike when the dollar was strengthening, financial conditions have eased going into this rate hike.

It is no secret that President-Elect Trump and Yellen do not see eye-to-eye on monetary policy. The president is tasked with appointing members of the Federal Reserve Board of Governors who serve 14-year terms. Trump will fill two vacant spots in early 2017 and then will appoint a new chair and vice-chair in 2018, when Yellen and Stanley Fischer's terms end. These first two appointments merit attention as Trump could select two members he intends to elevate to the two spots in 2018. The end result of the pending appointments is that the Fed's favored Dot Plot could be eliminated and policy could move toward a more rule-based method. Either way, with the Fed coming closer to achieving its dual mandate, the trend is shifting toward tighter monetary policy.