EQUITY RESEARCH

Federal Reserve hikes rates

COLLINS SARRI STATHAM
INVESTMENTS

Research Report

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US Federal Reserve hikes Fed Funds (16 December 2015)

In a widely expected move the US Federal Reserve lifted the federal funds rate by 0.25% increasing the rate band to 0.25%-0.5%. The Fed funds rate guides money market interest rates. The statement referred to "gradual tightening" over 2016.

The Federal Reserve signalled it expects the median projected target rate for Federal funds to be 1.375% for 2016 – implying a further 1% rise by end 2016.

There was unanimous support from Committee members for the hike in rates – a signal that market observers said marked a shift to a more "hawkish" approach.

The Board expects inflationary pressures to increase as energy deflation drops out of the measure and lower employment strengthens demand. It expects GDP growth of 2.4% in 2016 and unemployment to decline further.

The discount rate used by the Fed to lend to commercial banks lifted 0.25% to 1%.

The Federal Reserve will not start reducing its $4trn balance sheet yet. It will continue to re-invest payments from its bond portfolio into new agency and mortgage backed bonds. The balance sheet, already 25% of US GDP is a concern for markets as there is no plan for its winding down.

Implications of rate hike; US yield curve movement

T- Bill/ T-Bond	Yield to Maturity	Change (%)	COMMENT
3 months	0.25 (%)	-0.01	Move priced in
6 months	0.48 (%)	-0.03	-
2 YR	1.00 (%)	+0.03	Reflects "gradual" 2016
5 YR	1.75 (%)	+0.03	-
10 YR	2.30 (%)	+0.01	A very muted response
30 YR	3.01 (%)	unchanged	Mortgage impact muted

Source; www.google.com.finance

Prior to the move, US banks were urging customers fix their mortgage rates. Bank of America ran a large advert on its home page www.bankofamerica.com suggesting customers immediately fix. This is a tightening cycle but its pace is expected to be shallow. The gradual approach is designed to prevent abrupt changes in credit demand/ sharp drops in bond prices as in previous tightening cycles (ie 1994-5).

Post the announcement, US banks left their deposit rates unchanged but lifted their commercial lending rates – improving net interest margin. But the initial response, an unchanged 30 year bond yield suggests limited impact on floating mortgages.

Taking a linear approach to the rate cycle, bearing in mind the Fed's promise to be gradual- the rise in Fed funds rates should be a quarter point per quarter. This could strengthen the US dollar considerably in the context of negative ECB interest rates and a slowing China that is quietly devaluing the yuan.

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