Investment Insights

The Fed Delivers on Rate Hike

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David Rossmiller
Head of Fixed Income

Highlights

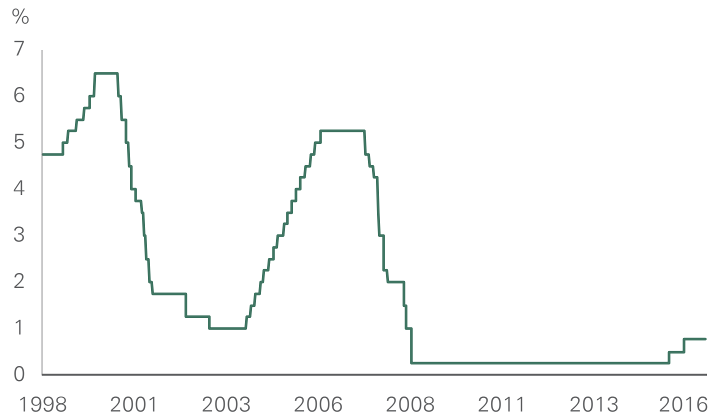
- After a one-year hiatus, the Federal Reserve's Federal Open Market Committee (FOMC) raised its policy rates by 0.25%, as widely expected.
- The "dot plot" forecasts of the fed funds policy rate were shifted slightly upward from the September meeting, indicating three rate hikes in 2017.
- The market's reaction to the Fed's action was muted because the Fed fully met market expectations.
- Our outlook for fixed income is mildly positive for 2017, with the balance of market risks likely to push yields moderately higher.

The Details

Today, the U.S. Federal Reserve decided — for the first time in a year — to raise its policy rates by 0.25%. This move lifts the federal funds rate from a range of 0.25%-0.50% to a new range of 0.50%-0.75% (Exhibit 1).

The Fed's forecast of its own policy rate — the so-called "dot plot" — shifted upward slightly, indicating three rate hikes in 2017 instead of the two predicted at the September FOMC meeting. The Fed's economic forecasts — of GDP, inflation, and unemployment — were little changed, although the FOMC's official statement noted a "moderate" pickup in economic growth (upgraded from "modest" at the November FOMC meeting). Also noted was that "market-based measures of inflation compensation have moved up considerably but still are low," and that "survey-based forecasts of longer-term inflation are little changed." (Exhibit 2)

Exhibit 1: Fed Funds Target Rate — Rising Slowly



As of December 14, 2016.
Source: Bloomberg, Federal Reserve

In her press conference, Chair Yellen downplayed the dot-plot shift, calling it "tiny" and emphasizing that it reflected the changes of only a few participants. As much as some commentators keep tallies of the voting members' preferences, in the end, the FOMC is not a democracy, and the chair has the strongest influence on policy results. Yellen, when asked, assiduously avoided commenting on the possibility — or effects — of potential fiscal stimulus measures by the Trump administration.

So, all in all, it was an unsurprising outcome, which is good news to market participants. The move has been widely anticipated for some time, so the immediate market reaction was modest, with 10-year Treasury yields up 7 basis points to 2.52%, the S&P 500 Index down 12 points to 2259, and the U.S. dollar almost 1% stronger against other major currencies.

Exhibit 2: Economic Projections of Federal Reserve Board Members and Federal Reserve Bank Presidents

	Median				
	2016	2017	2018	2019	Longer Run
Change in real GDP					
December 14, 2016	1.9%	2.1%	2.0%	1.9%	1.8%
September projection	1.8%	2.0%	2.0%	1.8%	1.8%
Unemployment rate					
December 14, 2016	4.7%	4.5%	4.5%	4.5%	4.8%
September projection	4.8%	4.6%	4.5%	4.6%	4.8%
Personal consumption expenditures inflation					
December 14, 2016	1.5%	1.9%	2.0%	2.0%	2.0%
September projection	1.3%	1.9%	2.0%	2.0%	2.0%
Core personal consumption expenditures inflation*					
December 14, 2016	1.7%	1.8%	2.0%	2.0%	n/a
September projection	1.7%	1.8%	2.0%	2.0%	n/a
Federal funds rate					
December 14, 2016	0.625%	1.375%	2.125%	2.875%	3.000%
September projection	0.625%	1.125%	1.875%	2.625%	2.875%

*Excludes food and energy prices.

Source: Federal Reserve Board

Implications

Since today's result was rather predictable, the much more interesting question is what's to come? The economy continues to grow at a reasonably good clip, and since the rate hike was fully expected, there shouldn't be any lasting effect on markets or economic growth. Negative reactions, like jittery stock markets, don't usually start to show up until much later in a rate-hiking cycle.

In the aftermath of last month's surprise U.S. election result, markets reacted strongly to the pro-growth policies talked about by President-elect Trump, so we've seen a sharp stock market rally and a quick rise in interest rates. The bond market selloff is a reaction to a number of things:

1. Trump's proposed tax cuts, deregulation, and infrastructure spending programs have raised expectations of stronger economic growth.
2. Deficit spending will likely be necessary to fund these programs, causing more issuance of U.S. Treasury debt.
3. The U.S. economy is at full employment — with the unemployment rate at only 4.6% — so fiscal stimulus is likely to cause an uptick in inflation (Exhibit 3).
4. The composition of the FOMC — the Fed's policy-making committee — is likely to get more hawkish as new members are appointed by Trump.

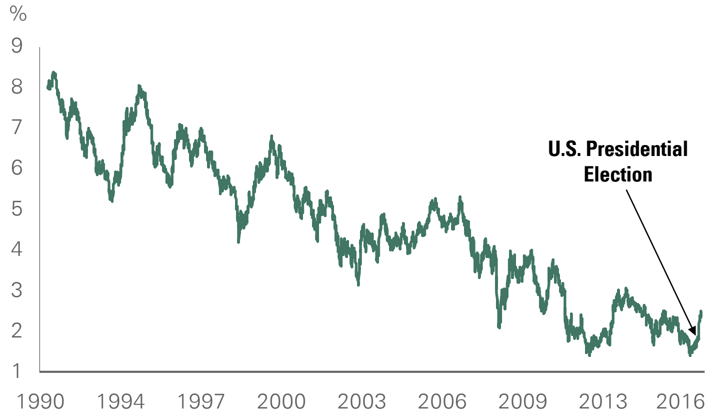
Exhibit 3: U.S. Economy is at Full Employment

U.S. Unemployment Rate

As of November 30, 2016.

Source: Bloomberg, U.S. Bureau of Labor Statistics

Exhibit 4: U.S. 10-Year Government Note Yield Has Risen



As of December 12, 2016.

Source: Bloomberg.

As a result of these risks, during the past month we reduced the interest-rate exposure, or duration, in our clients' bond portfolios, and we will keep alert for signals that our positioning might need to change again.

Looking ahead, we do expect yields to rise a bit further. That said, yield rises are likely to be slower as 2017 progresses than they were in the knee-jerk reaction immediately after the election (Exhibit 4).

While optimism for the economy is running very high right now as investors digest the implications of Trump's tax-cut and deregulation proposals, we also acknowledge that there are plenty of risks that could temper this optimism as the new year unfolds. To name a few, equity valuations are high, the U.S. economic expansion is long in the tooth, geopolitical risks related to the Trump presidency could cause volatility, geopolitical risks as European governments become more populist could cause another European existential crisis, talk of tax cuts could morph instead into tax reform, and potential conflicts over trade and currency valuation could impair economic growth and sentiment. This balance of pros and cons means bond yields and policy rates are likely to rise slowly in 2017.

Client Portfolios

A slow grind toward higher yields means conservative bond portfolios, like the ones we manage for our clients, are likely to generate a positive return and outperform cash. Portfolios are structured so, as the Fed continues slowly to raise its policy rates, the concentration of bonds and notes with maturities under three years will continue to roll down the curve and mature, allowing our portfolio managers to reinvest quickly, participating in progressively higher short-term yield levels. Yields of longer-maturity bonds usually do not rise by nearly as much — meaning longer bonds can perform reasonably well during a rate-hiking cycle — and their higher yields help maintain a portfolio's income stream. The net result, we believe, will be low-but-positive returns in our clients' bond portfolios in 2017.

In a broader portfolio context, we still consider bonds to be an important defensive component — helping to shield against equity-market volatility — when market attention shifts from promises to risks. So, despite the market's unabashed optimism over potential Trump policy changes, we believe it is best to keep a balanced perspective right now in order to protect our clients' capital.

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