Perspectives

DEC 2018

Fourth Rate Hike of 2018; More to Come?

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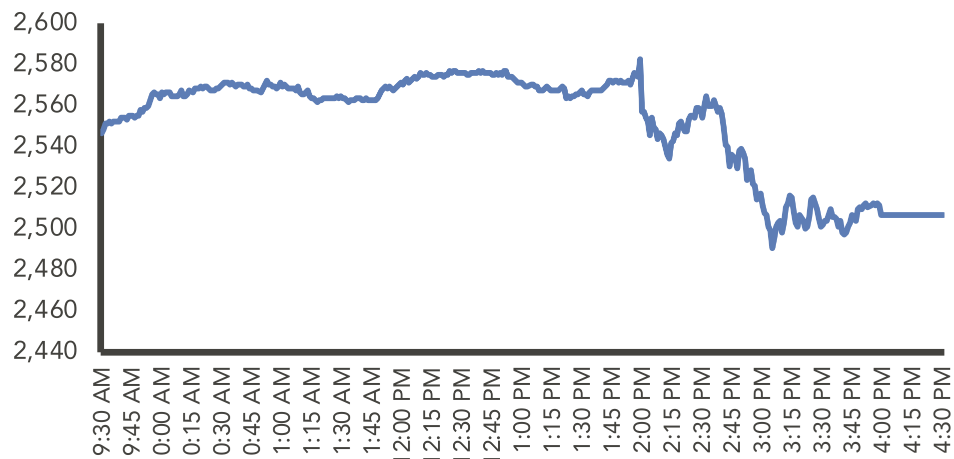
On Wednesday, December 19, the Federal Reserve executed its fourth rate hike of 2018. This 25-basis point hike, the ninth post-2008, takes the fed funds rate target range to 2.25%–2.50%. The market expected this hike and was focused on whether Fed Chair Powell, by going forth with the hike, might be showing his defiance against Trump's urge not to hike.

The S&P 500 was relatively stable, set for a rise prior to the announcement followed by a reversal, but off by only 1.5% for the day, as shown in Exhibit 1. This decline was attributed to the Fed's statement and Powell's press conference being not as dovish as was hoped.

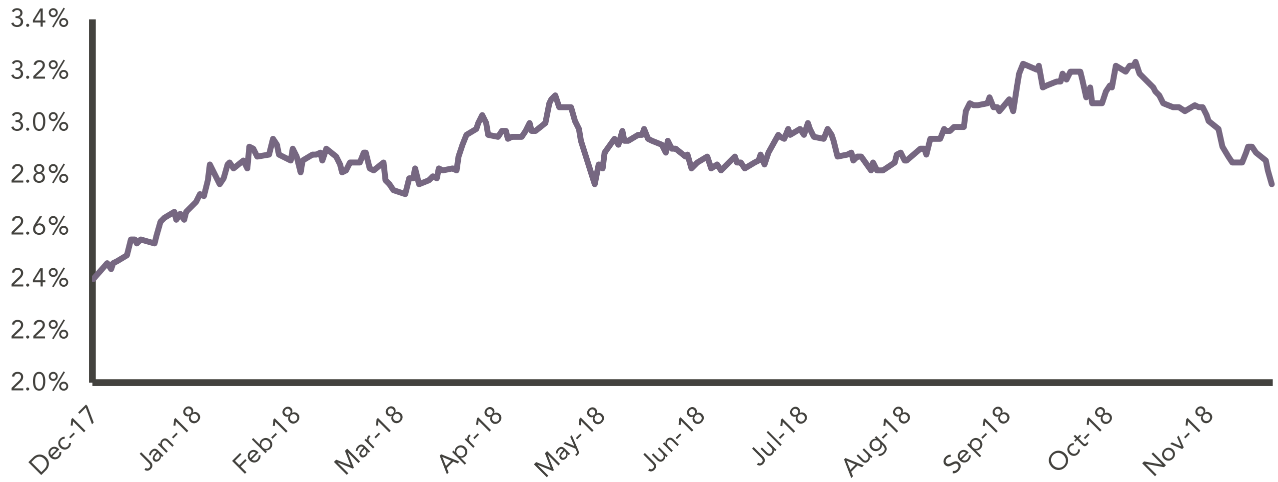
Exhibit 1: S&P 500 Index Intraday Price for December 19, 2018



Source: Bloomberg as of December 19, 2018

The 10-year Treasury yield fell by 5bp from 2.82% to 2.77% for the day, as shown in Exhibit 2. Investors extended the buying of Treasury bonds — thereby driving down yields — in an ongoing flight to safety that started with the recent October market correction.

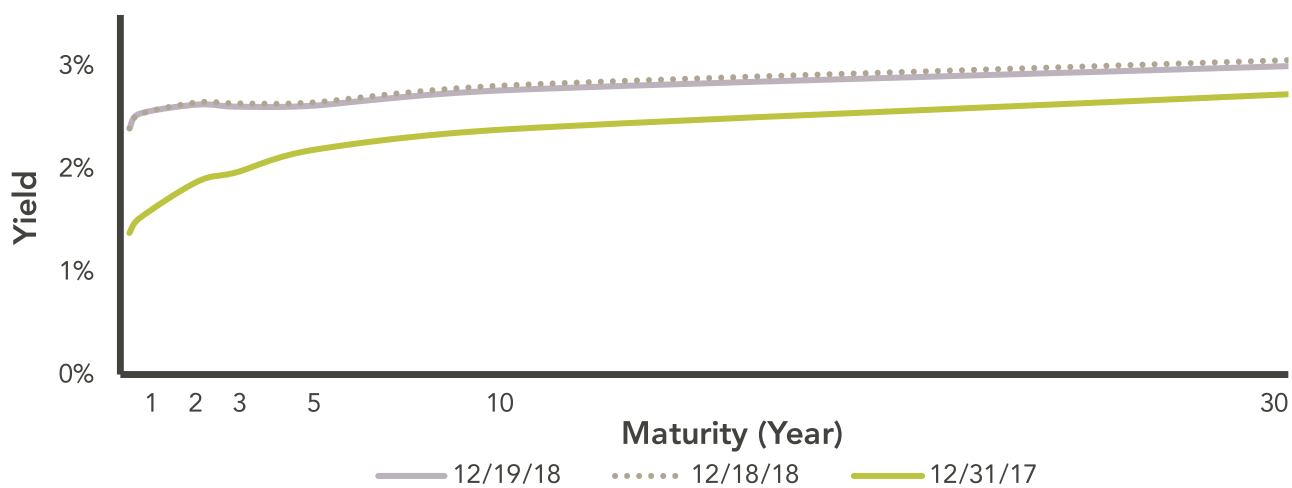
Exhibit 2: 10-Year Treasury Yield



Source: Bloomberg as of December 19, 2018

The yield curve flattened slightly for the day, falling on the long end corresponding to the flight to safety, as shown in Exhibit 3. The rise on the short end had already taken place prior to the hike based on anticipation for the hike. Through 2018, the curve has risen more on the short end corresponding to the rate hikes and less on the long end corresponding to more modest expectations of growth.

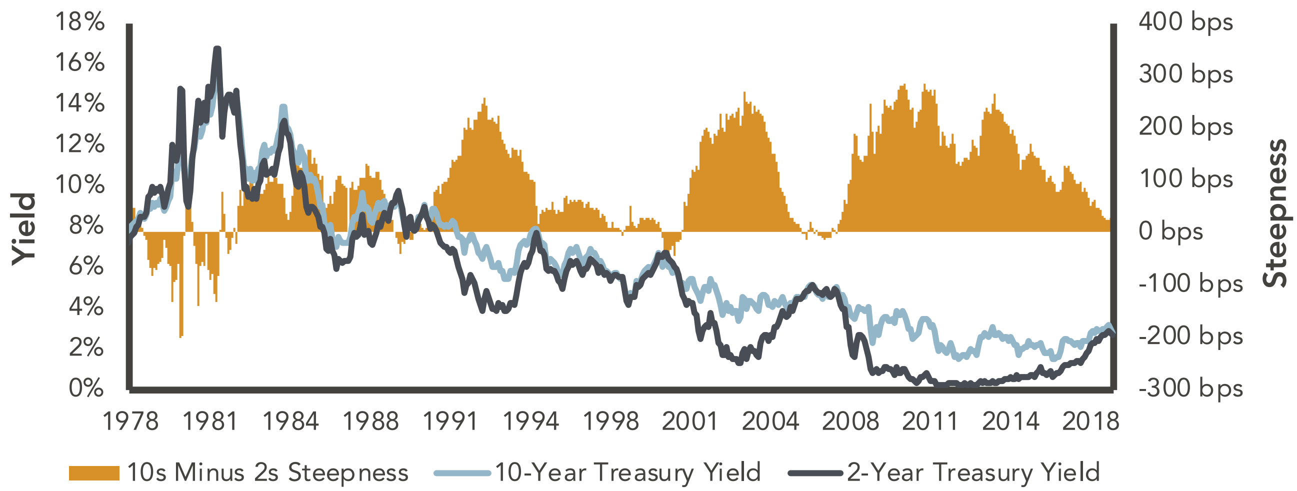
Exhibit 3: Treasury Yield Curve



Source: Bloomberg as of December 19, 2018

The steepness of the yield curve declined from 17bp between the 10-year and 2-year to 14bp over the course of the day, continuing its decline since 2010, as shown in Exhibit 4. Based on previous market cycles, an inverted yield curve has predicted a recession six months to two years after inversion. For now, while the 5s minus 2s did begin inverting on December 3, the 10s minus 2s is still upward sloping.

Exhibit 4: Yield Curve Steepness



Source: Bloomberg as of December 19, 2018

The U.S. Dollar Index, which tracks the strength of the dollar against a basket of major currencies and usually rises in tandem with increased U.S. interest rates, was unchanged for the day, but had been rising over the last three months in anticipation of the hike.

With escalating tariffs, an unemployment rate that may be higher than it shows (as the rate of underemployment is still high), and softening inflation, one could argue that the Fed does not need to raise rates further. However, the dot plot currently shows two more hikes are expected in 2019, one more in 2020, and none in 2021. Whether the Fed follows this same trajectory remains to be seen and will no doubt have an impact on capital markets in 2019.

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