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A Dovish Hike

December 2018
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Fed officials raised the federal funds rate 25 basis points at their December meeting to a range of 2.25 - 2.50 percent. Despite recent market volatility and a growing chorus calling for policymakers not to raise rates, market-implied forecasts consistently predicted a 70 percent probability for a rate increase at yesterday's meeting since September. In his press conference, Fed Chair Powell cited strong economic growth and low unemployment but acknowledged that recent tightening in financial conditions motivated the committee to lower its 2019 forecast for inflation and real GDP growth by 10 and 20 basis points, respectively. Against that backdrop, the committee now forecasts just two rate increases next year.

Key Points:

- **Federal policymakers justified the rate increase citing strong labor market conditions**, household spending and steady business investment**.** Chair Powell reiterated the committee's view that the federal funds rate may be approaching the lower end of the neutral rate range but acknowledged the committees reaction function will be data-dependent. The Fed also announced a shift in communication policy and will now hold a press conference after each of the eight FOMC meetings beginning in 2019. In our view, this change gives the committee greater flexibility to raise rates at any meeting.

- **Policymakers are committed to careful consideration for future rate hikes and committed to reducing its balance sheet.** The committee views its balance sheet reduction program as a process on "autopilot" and views the federal funds rate as *the* mechanism to achieve its dual mandate of full employment and price stability. Although the changes in the federal funds rate are meaningful, the balance sheet reduction program has contributed to tighter monetary conditions abroad and bears monitoring. We expect the Fed to reduce the pace of balance sheet normalization if the effects of tighter financial conditions abroad begin to emerge domestically.

- **U.S. equities closed the trading session down 1.6 percent** on concerns that Fed policymakers may tighten policy too much. In our view, Chair Powell did his best to communicate a flexible, data-dependent path for future rate hikes but in the end it was not enough to inspire confidence in recent economic strength. While we continue to assess the potential impact of future Fed policy decisions on equity markets, we believe the dominant theme driving equities in 2019 will be a focus on global growth. In our view, the sideways economic growth trend in place since 2010 should continue but with increased asymmetric risks to the downside. We are suspect U.S. economic growth can decouple should those risks materialize.

- **The treasury curve flattened** as the 2-year/10-year spread fell 3.5 basis points to 12.5 basis points and the front end of the yield curve remained inverted. The shape of the yield curve is sending Fed policymakers a message that monetary conditions are too tight. Current levels are consistent with levels traditionally

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preceding slower economic growth and monetary accommodation. Looking ahead, policymakers will continue to monitor potential impacts from expected treasury supply issuance and wind down of the Federal Reserve's balance sheet – an event which has no precedent. If the market believes Fed policymakers are overtightening, as a function of higher short-term rates and balance sheet normalization, credit spreads will likely move higher and long duration interest rates will likely lower.

DiMeo Schneider & Associates, L.L.C. continues to believe that investors should be patient and adhere to a well-constructed, diversified investment portfolio anchored to your goals and time horizon. Despite elevated uncertainty, we do not find compelling reasons at this time that would justify overriding our asset allocation methodology.

For more information and assistance, please contact any professional at DiMeo Schneider & Associates, L.L.C.

About the Author:

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Steve provides investment consulting services to institutional clients and nonprofit organizations. He services clients by providing advice and expertise on asset allocation, portfolio design, investment policy statements, manager search process, fiduciary stewardship, and overall investment management. Prior to joining the firm in 2017, Steve was an Associate Client Investment Officer with Northern Trust Asset Management where he provided comprehensive investment management services to discretionary institutional client portfolios. Steve earned a BA in Economics and Finance from the University of Illinois Urbana-Champaign and a Masters of Analytics from the University of Chicago. He is a CFA® Charterholder and a member of the CFA Institute, CFA Society of Chicago, and The Chicago Council on Global Affairs. Steve enjoys outdoor activities and spending time with family.

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