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Who's Afraid of the Big Bad Fed? Not Stocks (Yet).

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Janet Yellen has weighed in this afternoon, stating that increases in the funds rate may be appropriate in the near future. Although this doesn't mean it will happen in the June instead of the July FOMC meeting, it definitely indicates that unless the economic data turn sharply lower, a Fed rate increase is in the cards over the next two months and, in my opinion, more likely in June.

Despite the drumbeat of Fed warnings of an increase, stocks rallied sharply this week. As we noted last Friday, the Fed's intentions can be interpreted as being optimistic about the prospects in the economy, an outcome that would be favorable for stocks. Remember, with the equity risk premium about 5%, and increase of 25 bps in the funds rate only increases the discount rate by 5%. If the economy gets stronger, earnings can increase at least that amount if not more.

In any case, the August Fed funds futures is now trading at 55.5 bps, which indicates a 72% probability of either a June or July increase, and that is a significant underestimate of the unbiased probabilities which are closer to 90%. Treasury bonds have been taking this Fed shift fairly well, as the ten year has moved up 15 bps over the past two weeks, and the dollar has exhibited strength, increasing about 4% over the same period. Gold has sold off $90 after a long bull run and higher short rates are probably pressuring oil somewhat.

The news on the economy is moderately upbeat. Although the manufacturing indexes are still lagging, housing looks like it is on fire as new home sales soared. The revision of Q1 GDP growth was moderately upward as expected, but there was slightly more inventory build. Q2 growth estimates are still running about 2.5%.

Next week we will receive the last monthly payroll report and the PCE inflation before the next Fed meeting. Early estimates are for payroll growth to be at 150k, with core PCE year-over year inflation running steady at 1.6%. If the numbers come in at these levels, a June increase is even more certain.

One should remember that last December's rate hike was also viewed benignly by the markets at first, yet after a few weeks, oil and the equity market collapsed and the dollar soared. I do not think this will happen again, but one should keep in mind that initial reactions are not always the same as the longer-term impact.
