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Fed Ready to Raise and Acknowledges Lower Long-run Rates

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The FOMC Minutes released on Wednesday clearly indicated that “most” of the members believe that a rate increase would be appropriate in December if the economic and financial news remains benign. The minutes also indicated that future increases in rates are likely to be” gradual,” which I interpret to mean *at most* one increase of 25 bps per quarterly meeting. Supporting this interpretation, vice-chair Stan Fischer indicated he feels that the Fed has clearly communicated to the market its intentions and that barring unforeseen circumstances, can be expected to hike in December. Stocks reacted favorably to this news, recovering much of what was lost in the downdraft last week.

What would it take for the Fed to delay its increase? In my opinion, only another downdraft in commodity prices plus a very weak November jobs report. Fears of the latter were allayed by the improvement in the jobless claims last week after two consecutive higher-than-expected readings. The early read on the November payroll report is an increase of 180k and the unemployment remaining at 5.0%. I would say we would need a reading well below 100k and a tick up in unemployment before the FOMC entertains thoughts of a delay.

The data coming in this week were close to consensus. CPI inflation, in contrast to the PPI numbers reported last week, came in almost exactly on target. While housing starts were weak, most of the decline was concentrated in the more volatile multi-unit projects while permits held firm. And Thursday’s jobless claims, as noted above, relieved some anxiety about a weakening job picture.

Aside from elaborating on the intentions of the Fed to hike next month, a most surprising – and important -- part of the minutes was a special Fed staff presentation about “natural” or “neutral” real interest rates. Readers of this commentary know that I have been banging the drums for quite a while that the Fed must recognize that real rates are much lower both now and in the foreseeable future than they have been in most of the postwar period. The Fed staff agrees and is now on record saying that the short-term real rate, consistently with full employment is now zero. Slower real growth, a retiring workforce, lagging productivity and increased risk aversion are the cause. The Fed Staff projections match more closely with the Fed funds futures markets. It will be of interest to see if we see a significant lowering of the “long-run” Fed funds rate, as evinced by the “Dot Plot,” in the December 16 FOMC meeting. It we do, that too could boost stock prices.

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