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There will be a December Rate Hike; Debate Looms Large

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Barring a big negative shock to the financial markets or the economy in the next 2 ½ months, the Fed will raise interest rates by 25 bps in its December meeting. According to the Dot Plot (which indicates the funds rate that the Fed thinks is appropriate in the future), all but 3 of the 17 FOMC members indicated that they thought that at least one rate hike was warranted by year end. Indeed 3 members dissented, wanting an immediate increase, a number that has only been seen 3 times before and which most Fed watchers believe is the practical maximum dissent that the Chair could endure and still go forward as a policy (Technically, policy is decided by majority vote with no veto power by the Chair). Indeed, during Yellen's news conference she noted that by December most members felt the economy should be ready to absorb another rate increase. (The next Fed meeting is actually 6 days before the presidential election, but virtually no one expects a move at that time).

The major reason why Yellen said the Fed could afford to wait until December was the welcome rise in the participation rate this year. I have long stressed the importance of this underappreciated indicator for monetary policy and believe too much focus is given to the raw payroll numbers. The recent rise in the participation rate, despite the demographic trends to the contrary, have allowed the labor market to absorb the 180k average monthly increase in payroll, at least twice what the Fed says could be accommodated if the participation rate didn't rise. This has prevented the labor market from tightening and putting undue pressure on wages. The rise in the participation rate is due to individuals entering into the labor market seeking jobs now that the employment picture has improved substantially. However, it is likely that demographic trends will reassert themselves and, unless job growth falls off dramatically, unemployment will resume its decline and Fed will be forced to tighten.

Risk markets reacted well to Fed announcement, particularly since Yellen stressed that the FOMC has an optimistic view of the economy going forward. The Fed chair also confirmed that the Fed is struggling with determining the "right" level of the neutral Fed Funds rate. Indeed the Dot Plot indicated that the long run rate neutral Fed funds rate fell below 3% for the first time, well below the 4 ½% level thought appropriate several years ago, but still above the 2% level that I believe if appropriate.

With the presidential race close, Monday's debates loom large. If a clear winner emerges, the odds could shift quickly. Voters have sometimes given the loser another chance, in the second debate, but not more.
