THE DEVIL IS IN THE DETAILS

EDGE is an independent financial firm whose objective advice helps individuals and institutions realize their goals in the areas of investment management and corporate finance. The Edge Research Team's thoughtful and timely reports are based on extensive independent research and analysis of firms, financial developments, and macroeconomic trends.

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ANNOUNCEMENT:

For the first time in over ten years, the Federal Reserve has adjusted course and started raising the Federal Funds (Fed Funds) rate in a unanimous vote. The Fed Funds rate (the interest rate at which banks can borrow from the Federal Reserve overnight) will now be allowed to fluctuate in a range of 0.25% to 0.50% from the current 0-0.25%. The interest rate action was widely expected, but "the devil is in the details" as the idiom goes. Words remain one of the Fed's most powerful tools, and they were at work once again during the release of the written statement and the press conference after the decision. It was stated time and again that a wide variety of data points will be assessed including labor market conditions, inflation, and financial and international developments in assessing future action. That said, it is expected that the future "will warrant only gradual increases….[and] is likely to remain, for some time, below levels that are expected to prevail in the longer run."

INITIAL MARKET REACTION:

The reaction in the fixed income market was interesting in the minutes following the announcement. Yields on maturities ranging from 2 years to 10 years spiked briefly and then almost immediately drifted lower especially in the longer maturities (10-30 years) causing a so-called flattening of the yield curve (the difference between short-term and long-term yields became less). Banks too took action with announcement that the "prime rate," or the interest rate that banks lend to their most credit worthy customers, increased as well. US equity markets saw the action as a vote of confidence and started to rally higher.

LOOKING FORWARD:

Clearly, Federal Reserve Chairwoman Janet Yellen is trying to walk the tight rope of taking action to raise rates while calming markets that future action will not unravel the modest economic progress in the US. The path for future Fed action is critical. While logic would suggest that an increase of 0.25% or 0.50% would not affect the cost or availability of credit in the economy, there is concern about how rising rates will work when the Federal Reserve balance sheet stands at $4.5 trillion (up from under $1 trillion in 2007) and US government debt outstanding is $18.7 trillion (up from under $9 trillion

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in 2007). Specifically, investors are worried that too swift a pace of increase may choke off growth at a time when traditional counter-cyclical tools (monetary and fiscal stimulus) are limited due to actions during the global financial crisis. This is in the context of recent credit concerns which have caused the premium demanded by investors over the "risk free" interest rate to increase. Fed officials have kept flexibility by saying they will remain data dependent when considering future action, but that flexibility comes at the cost of uncertainty. Inflation expectations are clearly a driver of Fed decision making, but inflation has been hard to manufacture despite a massive increase in the money supply. The October reading of the Fed's favorite inflation gauge (the Personal Consumption Expenditure or PCE deflator) showed a 0.1% increase for the month (1.3% annualized), well below the annualized target pace of 2%. Granted, the decline in energy prices have kept headline measures of inflation low but the effect will be subsiding in 2016 and we all know inflation expectations can change rapidly.

History has shown that asset prices tend to do fine after the first-rate hike. Equities tend to rise as it is perceived that there remains time left in an economic expansion and longer term bond yields tend to fall as inflation expectations are contained. We will see whether the average of history will repeat itself again. Companies and markets need the right words to foster economic confidence for business investment and growth while also showing a willingness to keep inflation contained. Slow and steady, in both words and action, can help steer a positive outcome all around.

S&P 500 Performance Before & After First Fed Tightening

Date of First Raise	-6 Mos.	-3 Mos.	+3 Mos.	+6 Mos.	+12 Mos.
Mar-'83	27.0%	8.8%	9.9%	8.6%	4.1%
Jan-'87	0.2%	7.9%	19.1%	21.2%	2.6%
Mar-'88	-19.8%	4.1%	6.0%	5.4%	13.3%
Feb-'94	4.7%	2.7%	-3.9%	-2.4%	1.9%
Jun-'99	11.7%	6.7%	-6.6%	7.0%	6.0%
Jun-'04	2.6%	1.3%	-2.3%	6.2%	4.4%
Average	**4.4%**	**5.2%**	**3.7%**	**7.7%**	**5.4%**

Source: Strategas