# US Fed lifts interest rate and reassures markets

**By Nick Beams**
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The US Federal Reserve yesterday lifted its base interest rate by 0.25 percentage points and indicated that two further rises were likely this year.

There had been some belief in financial markets that four rises could occur this year but that now seems unlikely. The "dot plot"—the expectation of members of the Fed's open market committee (FOMC) as to where interest rates will be over the next period—remained basically unchanged from last December.

The money markets, which had priced in the 0.25 percent increase, welcomed the decision. All the major indexes ended at just below their record highs after experiencing a rise for the day. The Dow closed near 21,000.

Bond market yields also fell marginally, as bond prices rose, because of the fading of the prospect of four rate rises this year, rather than three. (Bond prices and yields have an inverse relationship.)

Markets were reassured by the language of the decision, with most analysts concluding that Fed chairwoman Janet Yellen had "dovish" views on rate rises.

The FOMC said it expected economic conditions would evolve in a manner that would "warrant gradual increases in the federal funds rate." That was a slightly more hawkish outlook because its previous statements referred to "only gradual" increases.

However, the statement indicated that the base interest rate was expected to remain for "some time" below levels that were expected to prevail in the longer run.

Two other phrases in the FOMC statement boosted the markets. It said the Fed would "carefully monitor" actual and expected inflation developments "relative to its symmetric inflation goal." This was taken to mean that with inflation now approaching the Fed's target rate of 2 percent, it would not move too sharply on lifting rates if the inflation rate went above that level.

The markets also took heart from the FOMC's statement that the Fed would continue its policy of reinvesting principal payments from its massively expanded holdings of financial assets, including mortgage-backed securities and Treasury security holdings. As a result of its financial asset purchases under its previous "quantitative easing" program, the Fed now holds $4.5 trillion in financial assets, compared to $900 billion before the financial crisis of 2008.

The statement said the reinvesting policy would continue until "normalization of the federal funds rate is well under way." Keeping the holdings of longer-term financial assets at "sizable levels" should help maintain "accommodative financial conditions."

If the Fed started to sell off its financial holdings, this would push their prices down and lead to a significant rise in market interest rates, with a substantial impact on the stock market.

The Fed appears to be trying to tread a fine line. It is keeping rates at historically low levels in order to finance the ongoing rise in the stock market. At the same time, it is lifting interest rates in order to improve profit conditions for the banks and other lending institutions.

By lifting rates it is also signalling that it stands ready to put a clamp on the economy if there is any sign of a movement by workers on wage demands to try to reverse protracted cuts in real pay.

In her press conference, Yellen tried to give the impression of a US economy returning to "normal" conditions. Near-term risks to the economic outlook, she said, "appear roughly balanced" and the decision to "make another gradual reduction in the amount of policy accommodation reflects the economy's continued progress."

While there has been some improvement in economic conditions—sparking fears of a possible wages movement—the US economy is far from returning to conditions that prevailed before the 2008–09 financial crisis. The long-term growth rate continues to remain at around 2 percent, well below the level experienced in any post-war economic recovery.

According to the Atlanta Federal Reserve, US annualised gross domestic growth for the first quarter may be as low as 0.9 percent, following growth of only 1.6 percent in 2016, the worst result for five years.

The stock market, however, is continuing to rise on the expectation of major cuts in corporate and personal tax rates by the Trump administration, the scrapping of regulations that inhibit profit making and an infrastructure spending program which will benefit corporations through massive tax write-offs.

Since Trump's election on November 8, the stock market has surged, with the Dow up 17 percent, the S&P 500 14 percent and the tech-based NASDAQ 16 percent.

According to Yale economist and Nobel Prize winner Robert Shiller, the market is "way over-priced." He told *Bloomberg* that investors may be valuing a narrative rather than economic fundamentals, as took place in the dot-com bubble at the turn of the century.

"They're both revolutionary eras," he said. "This time a 'Great Leader' has appeared. The idea is, everything is different." A kind of herd mentality was developing in which everyone piled into the market because the cost of losing out on making gains was greater than staying out.

Another area of concern is the impact of rising US interest rates on global bond markets. There is now a divergence between the policies of the world's three major central banks. While the Fed is lifting rates, the European Central Bank (ECB) is still buying €80 billion worth of bonds a month and has kept its base interest rate at minus 0.4 percent. The Bank of Japan is keeping the rate on its 10-year bonds at between zero and 0.1 percent.

With the rate on the US Treasuries hovering at around 2.6 percent, money is coming into US financial markets from Europe and Japan.

But that situation could change rapidly, according to long-time bond market trader Bill Gross. In an interview with the business channel CNBC yesterday, he said that "hell could break loose in terms of the bond market on a global basis" once ECB president Mario Draghi began to taper—probably not for a few months—the €80 billion a month purchases were reduced and restrictions on the Japanese rate were eliminated.

In comments reported by the *Financial Times* earlier this week, Gross warned that the US economy was like a "truckload of nitroglycerine on a bumpy road." A mistake could "set off a credit implosion."