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## Five questions on the Fed rate hike

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- **A first rate hike is largely priced-in, though path for 2016 hike may have further to go.**
- **Still Fed message is likely to be relatively soothing, as we expect Fed to show a slightly more cautious path of rate hikes compared to September.**
- **US economy to be relatively resilient to Fed hikes, but manufacturing may suffer more from strong US dollar.**
- **Emerging markets have already seen most of the adjustment to Fed hikes, but there may be bouts of volatility. If commodity prices continue to fall, emerging markets will likely be more vulnerable.**

### **What is the likely outcome of the December FOMC meeting?**

At Wednesday's FOMC meeting, we expect the Fed to raise the target range of the federal funds rate 25bps to 0.25%-0.5% and the interest rate on excess reserves (IOER) to 0.5% from 0.25%. We think that the FOMC statement will continue to convey that economic activity is expanding at a modest pace. However, it will be adjusted to signal that the labour market is strong, in contrast to the slow pace of job gains mentioned in the October statement. As for inflation, the Fed will likely signal that the strength of the labour market has made them reasonably confident that inflation will move back to mandate-consistent levels. Although FOMC members are in favour of a gradual increase of rates, we think that the statement will mention that further increase in the federal funds rate will be data dependent, to imply that future movements will not follow a pre-determined tempo as in the past. This will give room for FOMC members to evaluate the impact of the first rate hike on financial conditions and on the Fed's dual mandate. After the December liftoff, we think that the Fed will hike rates again in June, then two more hikes in September and December, reaching 1.25% at year-end 2016.

### **What have financial markets priced in?**

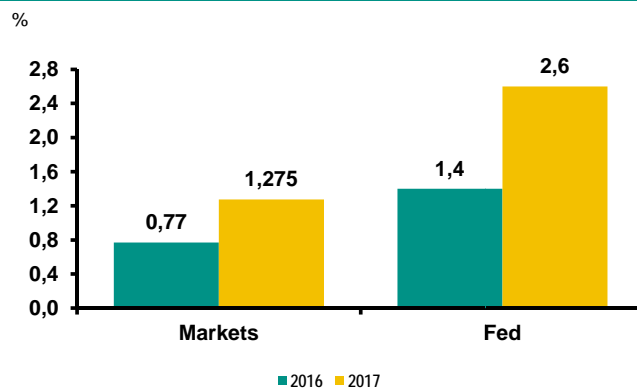
Markets have already started pricing-in a December rate hike and a gradual pace of rate hikes thereafter. The turning point for a December rate hike was the October FOMC meeting. Market sentiment changed following this meeting and has since then turned more positive in the wake of the strong US labour market reports in October and November. The implied probability of a rate hike, based on the futures market, has

increased from around 65% in October to around 74% currently. US bond yields rose and the dollar re-asserted its strength, reflecting expectations that monetary policies will diverge across the major advanced economies. As a result, the US dollar reached a seven-month high against advanced economy currencies in early November. More recently, the ECB's communication on monetary policy easing, which was less dovish than the markets, anticipated, forcing investors to re-calibrate their expectations. This was followed by a more modest appreciation of the euro vis-à-vis the dollar. Although markets have fully anticipated the liftoff in December, they are considering a slower pace of rate hikes than the Fed. This implies that there could be a surprise effect if the Fed communicates

### How big is the risk of a faster pace of hikes after the liftoff?

We think the risk is low. The Fed has described the pace for rate hikes as gradual. However, the most recent comments from the Fed Chair, avoided using 'a gradual pace' as forward guidance, suggesting that all options are open after the liftoff. Futures prices imply only two further quarter-point hikes in 2016. Fed policymaker's forecasts show a steeper rate hike, reaching 1.5% at end-2016. We think that Chair Yellen will do her best during the press conference, after the FOMC meeting, to indicate that the Fed will proceed with caution. Still the Fed message is likely to be relatively soothing, as we expect Fed to show a slightly more cautious path of rate hikes compared to September. However, Given that financial markets are recovering from the summer volatility, the biggest risk to the downside would be if the rate hike path is more hawkish than currently priced-in.

### Fed expects faster pace of rate hikes than markets



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

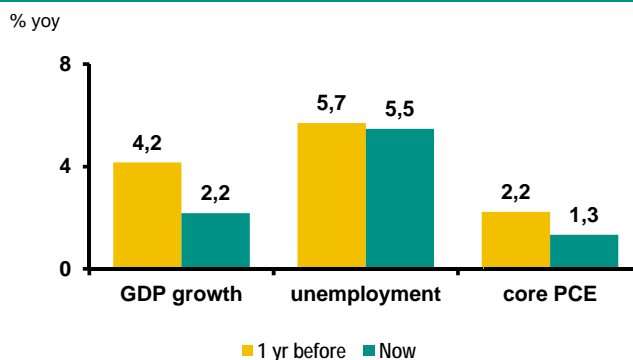
There are essentially two reasons to expect the Fed will maintain a gradual pace of rate hikes. First, the more dovish members of the FOMC remain cautious about a Fed rate hike. The slow progress on inflation, together with the likely low level of the longer-term neutral real rate suggest that the federal funds rate is likely to adjust more gradually and to a lower level than in previous expansions. As one of the FOMC members, Governor Brainard put it: in short, "gradual and low" is likely to be the new normal. Second, the divergence in monetary policies and stress in emerging markets raised concerns about the impact of tighter financial conditions, particularly related to a strong US dollar. That's why the Fed, delayed the rate hike in September. We think that the Fed will be cautious and increase rates gradually, to avoid putting its mandate of low unemployment and price stability at risk.

**How will higher interest rates impact the US economy?**

After previous tightening cycles, US economic growth remained quite strong in the subsequent quarter. The economy slowed only somewhat thereafter, but growth remained above trend. Meanwhile, the employment rate stabilised. We think an increase of 25bp will not have much of an impact on the economy, given that the hike is already priced in. The pace of subsequent rate hikes is what really matters. But with more clarity about the pace of hikes and the economy continuing to do well, investor sentiment should improve. Our real GDP growth forecast of 2.5% in 2016, suggests that the economy will grow around trend. We think the impact tighter monetary policy on consumption will be muted and expect bank credit conditions to remain in an easing mode, offsetting the somewhat higher lending rates for consumer credit. As for mortgage lending, these rates are usually at fixed rates, which shields lending costs from shifts in monetary policy. On top of this, past tightening cycles suggest that mortgage rates, which tend to be longer-term, rise at a slower pace than the policy rate. Given that we now expect a gradual rate increase, this should result in a modest rise in mortgage rates.

Things could be different for manufacturing activity, given that this is the soft spot of the economy. The strong US dollar is affecting export competitiveness, particularly of the manufacturing sector, while lower oil prices – due to the direct impact on energy related investments - have also been a drag for manufacturing activity. We expect the divergence in monetary policy to result in a further appreciations of the currency, but we think the largest appreciation of the US dollar is already behind us, given the pricing-in from investors. Over the past year, the US dollar has appreciated by 13%. If the Fed follows its forecasts, the US dollar will rise further but at a more modest pace.

**Comparison to past cycles, only employment stronger**



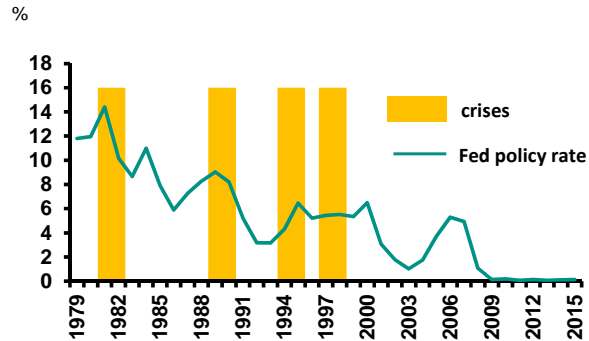
Source: Thomson Reuters Datastream, ABN AMRO Group Economics

**What will be the impact on emerging markets?**

Emerging market assets have wobbled during two periods over recent year. This partly on the prospect of less easy US monetary policy. First the taper tantrum, when emerging markets, including India, Brazil, Indonesia and Turkey reacted strongly. Second during the summer, when the prospects of a rate hike increased the uncertainty surrounding emerging markets, together with the prospects of a China slowdown and falling commodity prices. Indeed, the summer turmoil, resulted in a drag on equity markets and considerable losses for emerging market currencies. Meanwhile, funding conditions for emerging markets have tightened more abruptly than during the taper tantrum. In fact,

because the rate liftoff was preceded by financial market turbulence, we think that the worst of the adjustment for emerging markets has already taken place.

**Fed tightening unsettled emerging markets in the past**



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

This means that, there may be some bouts of volatility after the rate hike, we expect them to be short-lived. Particularly, we expect the path of rate hikes will be gradual. Moreover, since the rate hike has been in discussion for a while, some emerging markets have taken pre-emptive measures, including raising policy rates. Nonetheless, emerging economies with weaker fundamentals, including Brazil and South Africa, will likely feel a larger impact from the Fed tightening. All in all, we expect a modest recovery for [emerging markets](#) in 2016, although risks are tilted to the downside.

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