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Federal Reserve holds rates near zero

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In its long awaited rate decision, the Federal Reserve Open Market Committee held short-term rates near zero. Citing lack of inflation and international turmoil, the Fed put off its anticipated rate increase.

Leading up to the decision there was a great deal of uncertainty. Economists were almost evenly divided on whether or not the Fed would raise rates, but the dollar, commodity markets and Treasury and equity markets all pointed to no increase; they were right.

The Fed has long said that its decision would be data driven; it looked into its data and decided it was just not the time, even though pressure has built for a rate increase. The Fed has long wanted to raise rates, and at every meeting an increase is on the agenda; however, each time the Fed has decided that this time is not the right time.

Others think that there will never be a perfect time, and raising rates is the right thing to do. But many felt the Fed would be risking too much in raising rates. Christine Lagarde, head of the International Monetary Fund, warned against a rate increase. Larry Summers, former Secretary of the Treasury, joined Lagarde as did many notable bond managers.

The Fed was placed in a position that if it raised rates, and the weak economy suffered, it would have to reverse course and then lose all credibility. In addition, it had not prepared the market for an increase. Chairwoman Janet Yellen had not made a public comment about rates for 60 days. Members of the Open Market Committee had made conflicting statements regarding rates. During the June 15 meeting, 15 of the 17 officials said they expected rates to rise this year. As of Sept. 17, that number had dropped to 13. Additionally, the projections of Fed board members showed a distinct drop in the amount of future increases, and a stretching out to the dates for an increase.

The board members have become less optimistic about growth in the U.S. economy. In June they predicted growth of 2 percent to 2.3 percent, but now they project a growth rate of 1.8 percent to 2.2 percent.

A slower growing economy has less ability to absorb rate increases. The Fed, however, projects the unemployment rate to fall further, reaching 4.8 percent by the end of 2016. It doesn’t see inflation rising to 2 percent until 2018, near the end of Yellen’s first term as chairwoman, and the second year of the next presidency.

In putting off a rate increase, Yellen, who is known as risk averse, stayed to her course of gradual moves.

The effect on equity markets was immediate. Market averages fell, then recovered, only to fall at the close with the Dow down 65 points and the S&P down five points. The NASDAQ was up five points. The dollar fell, Treasury yields fell, commodities fell, and gold fell. The fall in the dollar should aid exporters and multinational firms. Lower yields should help borrowers, particularly mortgage borrowers and housing, but hurt savers and banks.

Now we can start worrying about when the next increase will occur. Yellen noted that a "great majority" of Fed officials expected a rate increase this year. With December as the next regularly scheduled meeting, they have only one more chance in 2015, unless they shock the market with an inter-meeting increase. Treasury futures place the expected increase into next year, not this one.

At Rutherford Investment Management, we think a December increase is "too close to call," but would not be surprised if the rate increase was deferred until 2016.

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