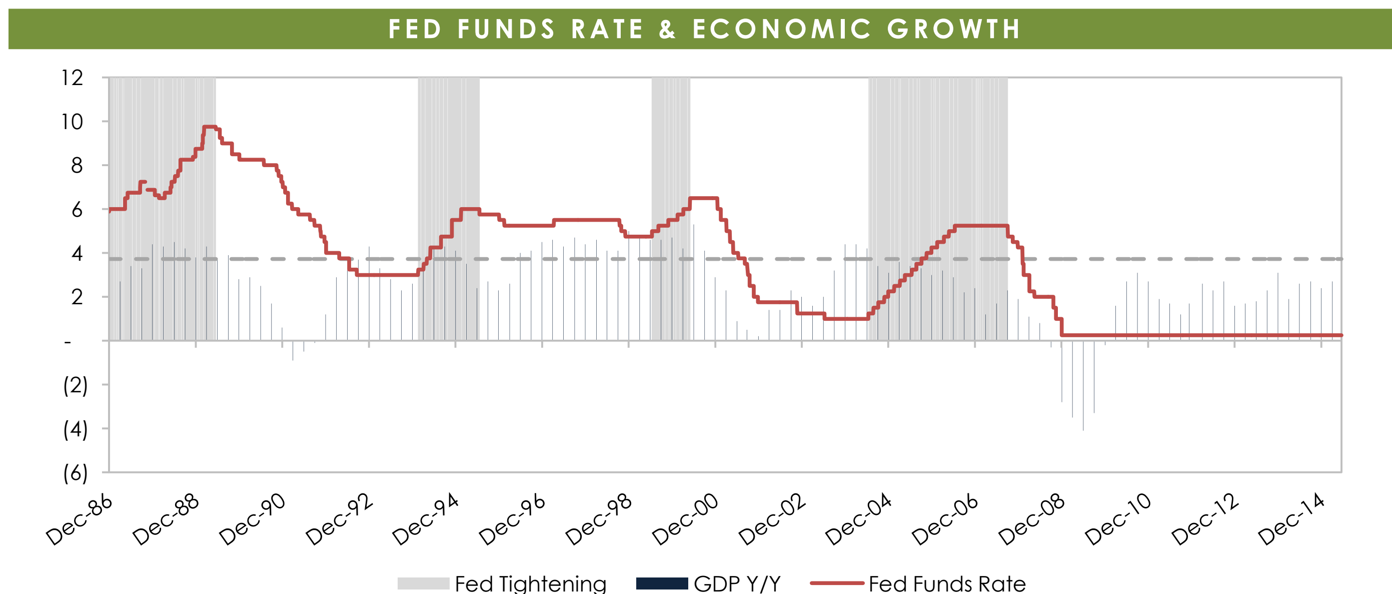
GODSEY & GIBB
WEALTH MANAGEMENT
A history of securing futures

NORMALIZING THE FEDERAL FUNDS RATE
THIRD QUARTER 2015

We have been in a long period of unprecedented Federal Reserve (Fed) accommodation and the possibility that the Fed might raise short-term interest rates has been widely debated over the last year. The uncertainty surrounding the timing and magnitude of any changes in the fed funds rate has increased as we appear to be getting closer to lift-off. While this uncertainty has increased the volatility in the financial markets, we do not believe that higher rates will derail the U.S. economy or the equity markets. The U.S. economy can continue to grow at a moderate pace even at higher interest rates and this growth should help support continued gains in the equity market. To put this in perspective, it is helpful to look at where we are today relative to when the emergency measures were enacted, as well as to take a look at how previous Federal Reserve tightening cycles have affected the U.S. economy and financial markets.

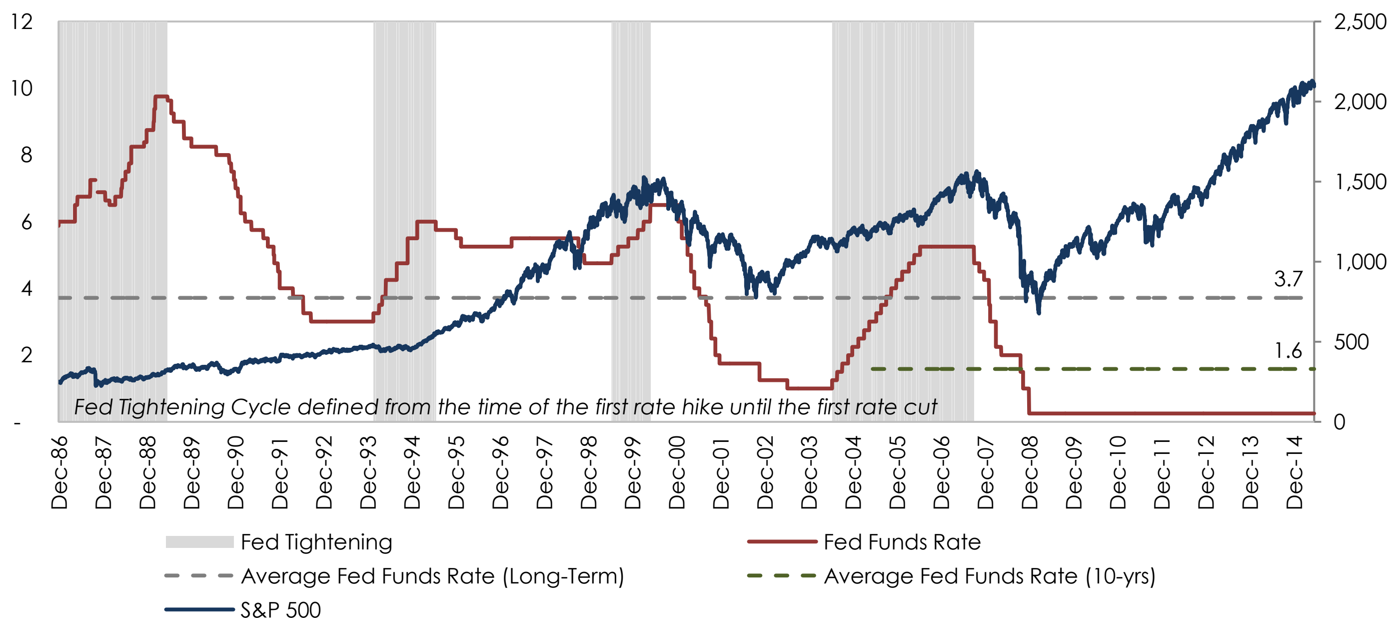
In response to the financial crisis and subsequent recession, the Federal Reserve cut short-term interest rates from 5.25% to the current range of between 0.0% and 0.25%. At the same time, the Fed also embarked on several non-traditional quantitative easing programs that saw the Fed's balance sheet grow to over $4 trillion. We are now six and a half years into this zero interest rate environment. While economic growth has not been as strong as in other recoveries, we have seen 5 years of positive growth in the U.S., and 2015 is expected to continue this trend of moderate growth. The unemployment rate, which peaked at 9.9% in 2009 has fallen to 5.3%. At this point, it is hard for the Fed to justify maintaining these emergency levels. The distinction between removing emergency measures and tightening monetary policy is an important one. With today's moderate economic growth and relatively low inflation, the Fed is looking to normalize interest rates, not to enact a tight monetary policy stance. While it is hard to know what the appropriate funds rate should be, it is useful to look at the historical fed funds rate in the graph below (Fed Funds Rate & Economic Growth).



Over the past 10-years, the fed funds rate has averaged 1.6% and its longer-term average is 3.7%. Monetary policy would probably still be considered "easy" at levels between the 10-year average and longer-term average. There are multiple examples of strong and accelerating economic growth, even as the fed funds rate increases. For instance, U.S. GDP accelerated on a year-over year basis beginning in Q3 1993 through Q1 1995, despite the fact that the fed funds rate increased from 3.0% to 6.0% during that time period. This move from "easy" to "tight" monetary policy was in response to concerns that strong economic growth might lead to an unwanted acceleration in inflation.

Given our belief that removing emergency accommodation will not weaken the U.S. economy, the next step is to look at the potential effect that higher rates could have on the financial markets. Continued gains in the equity markets will be driven by companies' ability to grow sales and earnings. Fed rate hikes are associated with strong economic growth and more importantly rising inflation and/or inflation expectations. A moderate acceleration in inflation can be good for company earnings and therefore supportive of higher equity prices. As shown in the graph below (Fed Funds Rate & the S&P 500), we have seen four major tightening cycles over the last 30 years and in three of the four, equity markets continued to rise even as rates moved higher. We are currently looking for the Fed to normalize interest rates and not to move to a tight monetary policy stance. We expect the economy to continue to grow at moderate pace supported by healthy consumers with rising disposable incomes. There is no reason to believe that higher short-term rates will change this outlook.

FED FUNDS RATE & THE S&P 500



	I	II	III	IV
First Rate Hike	Dec-86	Feb-94	Jun-99	Jun-04
First Rate Cut	Jun-89	Jul-95	Dec-00	Sep-07
End of Cycle Fed Funds Rate	9.75%	6.00%	6.50%	5.25%
Total Change in Fed Funds Rate	3.88%	3.00%	1.75%	4.25%
Total Return of S&P 500	18.76%	18.84%	-2.33%	29.96%

At 79 months and counting, this is by a wide margin the longest that the Fed has left rates unchanged. Prior to this, in March of 1992, the Fed cut the funds rate to 3.0% and kept it there for 23 months before embarking on a series of rate hikes. Additionally, the average fed funds rate at the start of the last four tightening cycles was 3.6%, and the Fed raised rates an average of 3.2% over the course of those cycles. Both the economy and the equity markets held up well during those periods when the Fed was actually trying to engineer a more slowly growing economy. The equity market generally did not turn over until after the Fed was on hold. Today, again, we are not talking about a tightening in monetary policy, but a removal of emergency accommodation. The move to higher interest rates we have seen recently is due to a number of global factors, not just the expectation of Fed action. We would not expect a significant move to higher long-term interest rates unless and until we see a sustained rise in inflation or inflation expectations. In conclusion, a slow move to a modestly higher fed funds rate should not be considered detrimental to the economy or the equity market, but a chance to move away from the crisis era and get us closer to a more normal and preferred interest rate environment.