The Fed-Trump Divergence

To the surprise of almost no one, the Federal Open Market Committee (FOMC) announced that it raised its benchmark interest rate by 25 basis points (0.25%) to the range of 0.75% to 1.0%. This was the third interest rate hike in a decade, but the second since December. This seems to signal that the Federal Reserve is moving into a new policy phase, exiting its nine-year-old campaign of economic stimulus following the economic crisis of 2007-2008.

The central bank also maintained its forecast for two additional increases by the end of the year. The consensus immediately after the announcement was for an increase during the June FOMC meeting and another when the committee meets in December. Through Thursday's close, the **CME FedWatch Tool** pegged the probability of a May rate increase at only 4.3%. In the statement released following its two-day meeting, the FOMC cited "realized and expected labor market conditions and inflation" for the rate increase. Additionally, in her subsequent press conference, Fed chair Janet Yellen said, "The simple message is the economy is doing well." The unemployment rate fell to 4.7% in February, which many economists cite as being a level of "full employment" for the U.S. economy. Also, inflation is starting to warm up; it has been an average of 1.9% over the 12 months ending in January, close to its 2% annual target. The Fed indicated that stabilizing inflation is now its focus.

Yellen's comments, as well as the FOMC statement, indicate divergent views between the Fed and President Trump when it comes to the state of the U.S. economy. Trump has repeatedly said that the U.S. economy could expand by as much as 4% annually by way of tax cuts, deregulation and added infrastructure spending. However, Fed officials have stated their belief that the economy is already growing at its maximum sustainable pace. Fed officials' economic projections were little changed from December, with the median projection of 2.1% growth in gross domestic product (GDP) this year and next year. In addition, the median projection of the long-run unemployment rate ticked downward to 4.7% from a prior projection of 4.8%. Therefore, faster growth would most likely lead to faster increases in interest rates, which could tap the brakes on expansion.

In the near term, the rate increase itself will probably have little impact on the overall stock market. However, some sectors do benefit from interest rate hikes. One sector that tends to benefit the most is the financial industry. The earnings of banks, brokerages, mortgage companies and insurance companies often increase as interest rates move higher because they can charge more for lending. Overall, though, the rate increase is an indication of the Fed's confidence in the overall economy. As such, the major U.S. indexes took the rate hike in stride and jumped after the announcement. Furthermore, remember that, after two rate increases in three months, the benchmark interest rate is still less than 1%.

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