Bull & Bear Bulletin

Volume 6, Issue 2 March 2015

Prepare for Liftoff:

Subtle changes in the Federal Reserve's (Fed's) rhetoric have many market pundits forecasting the first interest rate increase since 2006. The current forecasts estimate a 50% chance that the Fed looks to raise interest rates by 0.25% at its June or July meeting, with a 30% chance of an additional increase in the latter part of the year. This month we will look at some of the key components that influence the Fed's dual mandate to maintain stable prices and low unemployment and how they may shape the Fed's ability to increase interest rates.

Starting with price stability, the Fed has had little to control in the past few years. Deflationary pressures from the consumer debt bubble bursting in 2007 and the recent strengthening of the U.S. dollar have effectively suppressed inflation. The Personal Consumer Expenditure (PCE) Price Index, which tracks the overall price changes for goods and services purchased by consumers, was below the Fed's 2.0% target for most of the past six years (Chart 1). The lack of inflationary pressure is also evident from a business perspective, as the Civilian Employment Cost Index and the Producer Price Index remain below their pre-recession levels (Chart 1).

With little need to control price stability, the Fed has enacted unprecedented levels of stimulus over the past eight years to help fight stubborn economic growth and unemployment. Job gains have recently accelerated, which, when coupled with fewer people included in the labor force, has helped push the unemployment rate to 5.5% (Chart 2). As the unemployment rate approaches a more normalized level and declines below the 20-year average (Chart 3), there is a belief that wage growth will begin to accelerate and put pressure on the Fed's price stability mandate. The growing number of job openings further supports the expectation for wage growth to accelerate in the near future and the necessity of an interest rate increase (Chart 3).

With the labor market showing improvements from the past few years and growing concerns about the degree of price stability in the future, it is becoming more likely that the Fed will raise interest rates for the first time in nearly a decade. It is our belief that any interest rate increase is likely to be accompanied by a period of patience so that the Fed can accurately assess the impact of the increase. After a prolonged fight against stubborn economic growth and subpar labor gains, the Fed is unlikely to jeopardize the recent improvements by aggressively raising interest rates. Furthermore, with the odds of an interest rate increase sitting near 50%, expect market participants to closely scrutinize each economic data point and Fed speech between now and the summer to gain additional perspective on the timing and magnitude of any possible interest rate hike.

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An on-line publication by The Investment Committee

Chart 1

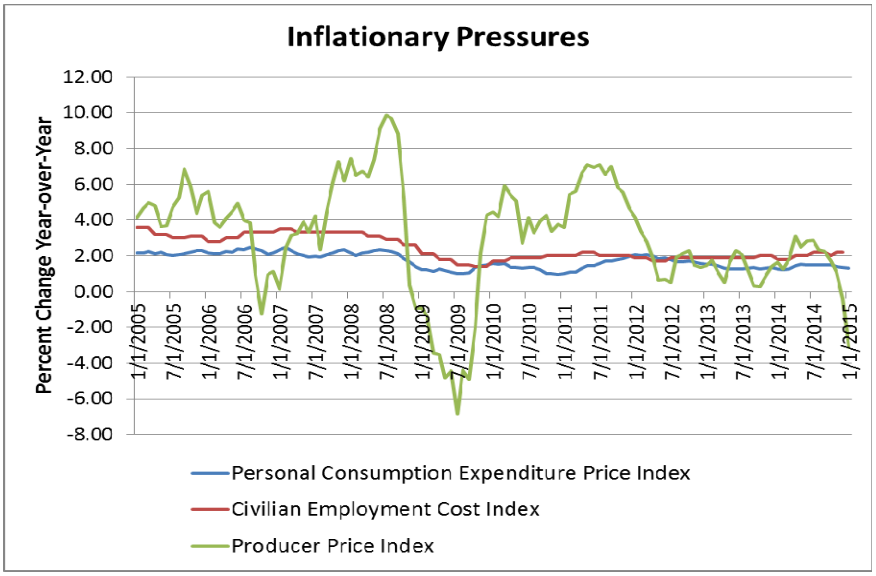

Chart 2

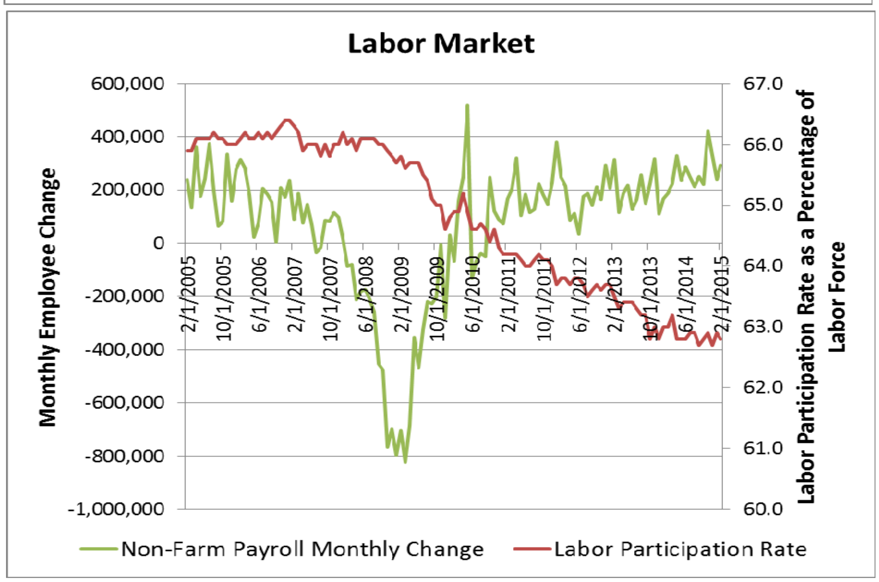

Chart 3