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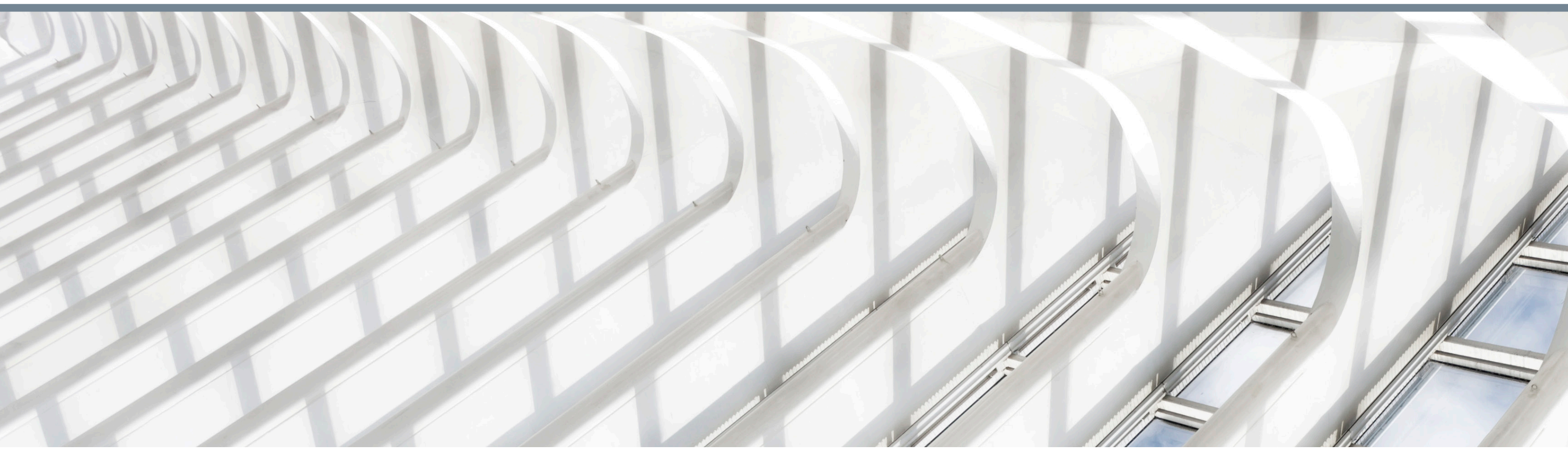

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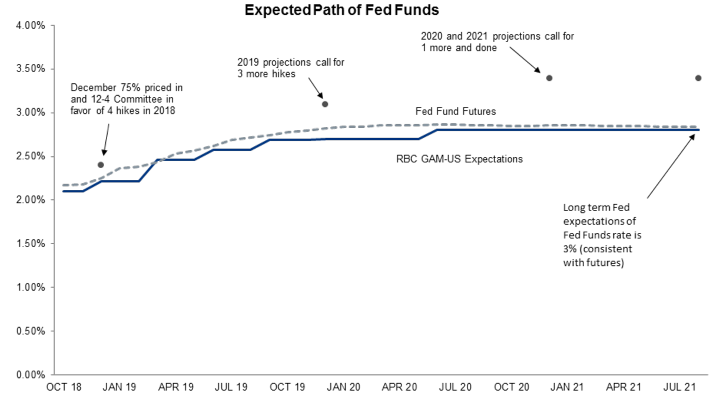
No Surprises – The Fed Continues to Enact the Year of the Dots

The Federal Open Market Committee (FOMC) continues to fulfill the path of its 'dot plot' (Exhibit 1) and has voted to raise the Fed Funds Rate 25 basis points (bps). In view of realized and expected labor market conditions and inflation, the FOMC decided to raise the target range for the federal funds rate to 2.00 -2.25 percent.

This is the third hike this year, and the Fed anticipates a fourth hike in December. Since the last hike in June, the economy has shown no signs of slowing down and the pace of gradual rate hikes is set to continue. Economic growth has accelerated, supported by strong fiscal stimulus. Employment data continues to be strong. We expect GDP to be 3% for 2018 with tail winds from the fiscal stimulus. Current estimates of third quarter GDP are expected to be around 4%, following on the strong growth of the second quarter. Also, inflation has risen above the Fed's 2% target, meeting their expectations for the year.

Exhibit 1
Expected Path of Fed Funds



Source: RBC, Bloomberg, and federalreserve.gov as of September 26, 2018

At the Fed's August 2018 Jackson Hole Symposium Chairman Jay Powell said, "Over the course of a long recovery, the US economy has strengthened substantially. The unemployment rate has declined steadily for almost nine years and, at 3.9 percent, is now near a 20-year low. Most people who want jobs can find them. Inflation has moved up and is now near the Federal Open Market Committee's (FOMC) objective of 2 percent after running generally below that level for six years. With solid household and business confidence, healthy levels of job creation, rising incomes, and fiscal stimulus arriving, there is good reason to expect that this strong performance will continue."

The September policy statement continues to describe the risks to the economic outlook as roughly balanced. The FOMC introduced its first 2021 estimates; notably, the median expectation for 2021 Fed Funds is unchanged from 2020 and growth is expected to decelerate.

Despite smooth sailing for the remainder of 2018, risks continue to loom on the horizon. At the forefront there are continuing trade tensions with China and a flattening yield curve (Exhibit 2).

Despite recent increases, the 10-year Treasury yield continues to hover around 3%. If the Fed were to raise rates 3 more times in 2019, as the dot plot projections currently indicate, the Fed Funds Rate would be above 3% by the end of the year.

Absent further increases in yields on the longer end of the curve, the Fed's current trajectory risks potentially inverting the yield curve. Historically, inverted yield curves introduce recessionary risk.

Looking forward to 2019, the key question will be whether the economy can accommodate the Fed's policy. We expect that the Fed will be challenged to fulfill their projection.

Exhibit 2
2-year & 10-year bond yield spread

Source: Bloomberg data, September 26, 2018

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