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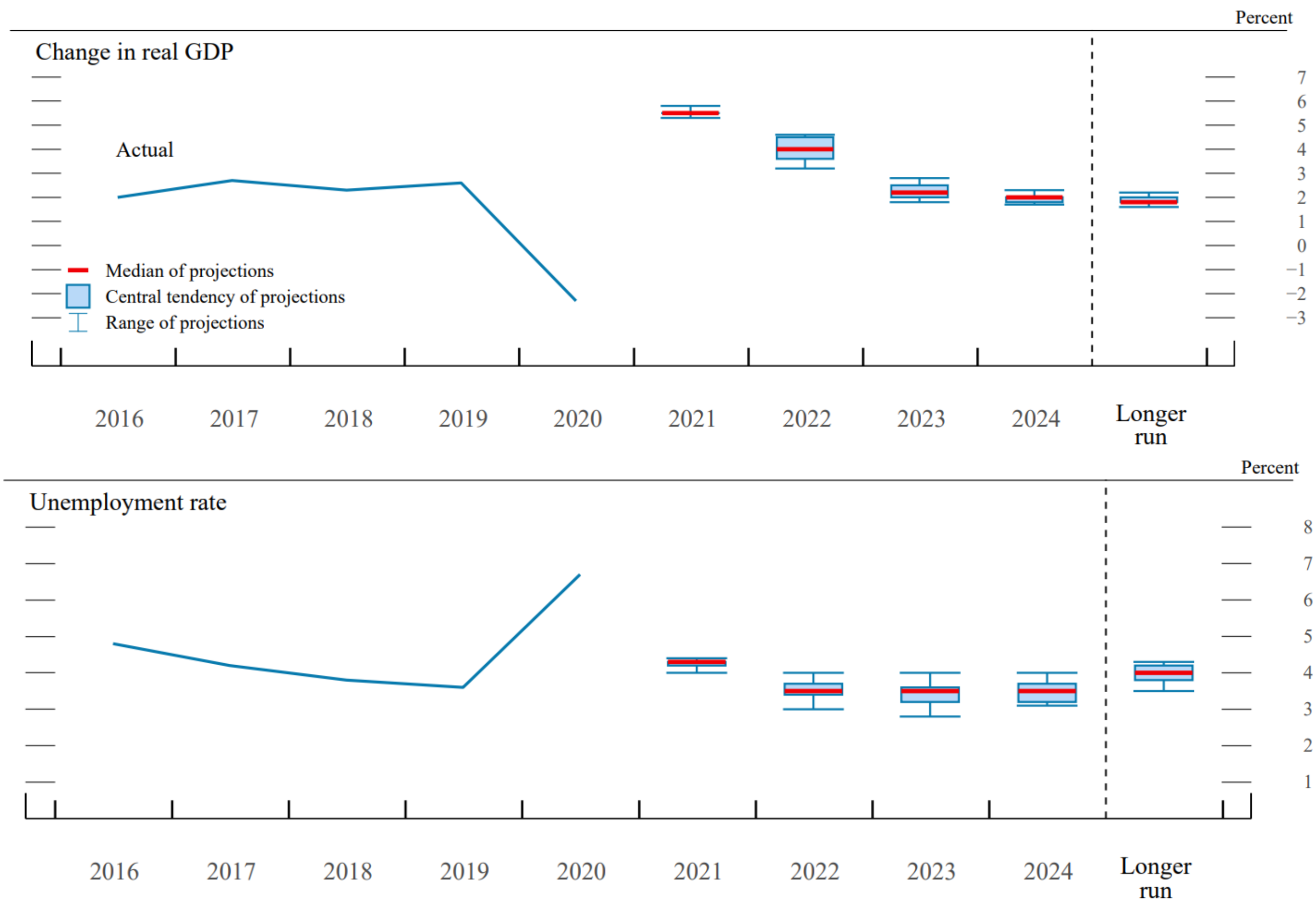
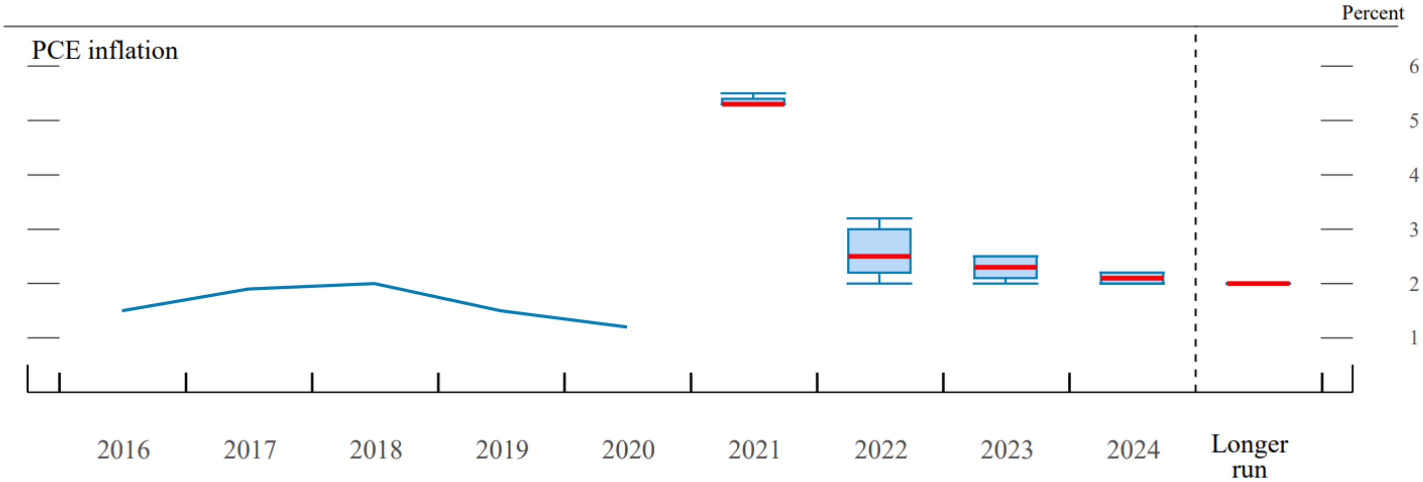
Why is the Fed Raising Rates and What are the Implications?

The U.S. Federal Reserve (Fed) is expected to raise short-term interest rates by 0.25% on Wednesday, the first interest rate hike in three years. This will be the official start of a tightening, or more restrictive, monetary policy. This is typically not favorable for the financial markets, but it's important to understand why they are doing it. Generally, a restrictive monetary policy is implemented to control an overheated economy and/or high levels of inflation.

The Fed is mandated to promote the goals of 1) maximum employment 2) stable prices and 3) moderate long-term interest rates. This generally translates to positive and stable economic growth as measured by gross domestic product (GDP), low unemployment rate, and low and stable inflation generally targeting 2% per year, as measured by personal consumption expenditures (PCE).

Economic projections of Federal Reserve Board members and Federal Reserve Bank presidents, under their individual assumptions of projected appropriate monetary policy, December 2021





Source: Federal Reserve, Summary of Economic Projections, December 15, 2021 [***https://www.federalreserve.gov/monetarypolicy/fomccalendars.htm***](https://www.federalreserve.gov/monetarypolicy/fomccalendars.htm)

To get a better understanding of the Fed's reasoning, let's review the Fed's last economic forecast from December 2021, and how the current economic environment may impact those projections.

3 Key Economic Indicators

1. **Economic Growth:** The global pandemic hit economic growth hard in 2020, but it rebounded strong in 2021 from pent up demand. As the economy settles into a more sustainable level, the uncertainty surrounding Russia and Ukraine could impact consumer and corporate spending, putting downward pressure on future growth projections.
2. **Labor Market:** The unemployment rate has dropped considerably since the pandemic highs, now at under 4%. Additionally, job openings outweigh unemployed workers by a wide margin. The labor market is quite strong based on historic standards and the unemployment rate projection may see an improvement, despite the geopolitical concerns.
3. **Inflation:** As the economy heated up in 2021 with high consumer demand and government stimulus support, it was met with supply-chain disruptions caused by new COVID variants in the second half of the year, leading to significant increases in prices. The war has only made supply issues worse and raised prices for basic commodities such as food and energy, thus the expectation will be for even higher inflation.

Ultimately, the reason to increase interest rates is driven by the desire to curb inflation (which has increased to levels not seen in 40 years), supported by the notion that the U.S. economy is on level footing and strong enough to withstand the impact of the conflict in Eastern Europe.

3 Key Areas of Uncertainty

1. **China:** On the COVID front, while the U.S. is seeing some of the lowest levels of cases since the start of the pandemic, China appears to be having a resurgence. Any significant outbreak could put yet another strain on the global supply chain with disruptions in manufacturing from shutdowns.
2. **Washington:** Some U.S. government risks have been subdued with a debt ceiling increase last December and the spending bill that was passed last week. However, the outlook for any further fiscal stimulus may be limited and significantly lower than the past couple of years.
3. **Russia:** Last but not least, the conflict in Ukraine remains the biggest question mark. Russian sanctions, global commodity prices, European energy dependence and many other issues will weigh heavily on the minds of Fed members as they contemplate the decisions for future monetary policy.

Ultimately, this global uncertainty will drive the Fed to a more cautious tightening cycle throughout the year. Fed Chairman Jerome Powell has repeatedly communicated the desire to proceed in a controlled and transparent manner to not cause further disruption in financial markets.

As always, Dynamic recommends staying balanced, diversified and invested. Despite these short-term market pullbacks, it's more important than ever to focus on the long-term.

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