

### No surprises the Fed lifts rates, but inflation has a stronger impulse

There were no surprises that the US Federal Reserve lifted interest rates by 25 basis points at its December policy meeting, given that the US treasury market was pricing in a 100% probability. The market reaction was calm. US treasury yields are higher, but not meaningfully so, and the US dollar is firmer on a trade-weighted basis.

This was the first rate hike since last December and only the second increase since borrowing costs were lowered to zero in 2008. Looking forward, the Fed provided a slightly more hawkish assessment of the future interest rate path - three rate hikes in 2017 compared with two hikes projected in September - but we do not believe it to be a game changer.

The language accompanying this decision was going to be as important as the decision itself. There were no material changes to the policy statement, but there was one key takeaway: the difference with December 2015 is that inflation has a positive impulse.

Headline inflation is rising on the impact of higher energy prices over the past year, but also a strengthening labour market is another factor to watch. As well as the downward trend in the unemployment rate to 4.6%, Chair Janet Yellen noted the reduction in labour market slack and the stabilisation in the participation rate (i.e. the number of people employed or actively seeking work). These developments suggest tighter labour market conditions, which imply a potential build-up of wage pressures.

US treasury yields are likely to continue rising over coming weeks and we expect the US dollar to be well supported. While the market reaction in the closing weeks of 2016 is not irrelevant, it will be into January when we will see whether the markets have over-tightened financial conditions.

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## Contact

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