FED WATCH: NO NEED FOR “YELLEN” AND SCREAMIN’

Kevin Flanagan – Head of Fixed Income Strategy
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Taking a breather from the regular headlines emanating from Washington, DC, over the course of the last two days the other policy, i.e., monetary, got its chance to be in the limelight, as Federal Reserve (Fed) Chair Janet Yellen provided Congress with the Fed’s semiannual Monetary Policy Report.

Since the Fed raised rates back in December and projected it might lift the Fed Funds target range an additional three times in 2017, the U.S. Treasury (UST) market has been looking for some sort of sign as to whether this prediction is still valid. This year’s first FOMC meeting offered no hint that a Fed rate hike could be in the offing for the next gathering on March 15. Thus, these congressional testimonies were being viewed as an opportunity for Yellen to change the UST market’s current perception of “no rate hike in March,” if in fact the policy makers felt the market was ill-prepared for such an outcome. For the record, prior to Yellen’s appearances, Fed Funds Futures implied probability for a March rate hike was 32%, while a June hike was at 71% (post-Yellen: March at 34% and June at 74%).

Given the proximity of these testimonies to the recently concluded FOMC meeting, it did not appear as if Yellen would deviate much from that gathering’s policy statement. In other words, what could have changed so meaningfully to shift the Fed’s thought process in just two weeks’ time? Although Yellen’s testimony did not materially deviate from the aforementioned policy statement and other comments she had made in January, the UST market viewed the tone as being a bit more “hawkish.” The recurring theme is that “the Committee recognized the considerable progress the economy has made toward the FOMC’s dual objectives.”[1] In other words, depending on upcoming economic data, “a further adjustment of the Federal Funds Rate would likely be appropriate” and “waiting too long … would be unwise.” These statements are not necessarily groundbreaking or suggestive of an imminent move in March, but they did serve to put the UST market on notice as to not become too complacent.

Conclusion

Looking ahead, some of the key determinants for potential rate hikes will likely be wages, inflation expectations and, of course, the 800-pound gorilla in the room, fiscal policy. Interestingly, besides fiscal policy, Yellen also acknowledged “developments abroad” as a “source of uncertainty.” Remember, elections/voting overseas has a precedent with the Fed, à la Brexit. Thus, the outcome of the upcoming elections in the Netherlands and France bears watching.

Early in 2017, increasing attention has turned to their balance sheet. As of now, the FOMC is maintaining its existing policy of reinvestment of its agency debt, MBS and UST holdings “until normalization of the Federal Funds Rate is well under way.” This point was reiterated in Yellen’s appearance. In fact, during the Q&A session, Yellen restated this position and said that stopping reinvestment would happen in an “orderly and predictable way” and that the FOMC would be discussing balance sheet strategy in the coming months. That being said, various trial balloons and stories/reports have already cropped up regarding the Fed’s balance sheet. If the Fed keeps to its rate plan, get ready for more discussions about this as the calendar moves along this year. And by the way: the UST market is not “priced” for any specifics on this subject … yet.

[1]Federal Reserve Chair Janet Yellen’s semiannual Monetary Policy report testimony, 2/14/16.

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DEFINITIONS

Monetary policy : Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Treasury : Debt obligation issued by the U.S. government with payments of principal and interest backed by the full faith and credit of the U.S. government.

Federal Open Market Committee (FOMC) : The branch of the Federal Reserve Board that determines the direction of monetary policy.

Rate Hike : refers to an increase in the policy rate set by a central bank. In the U.S., this generally refers to the Federal Funds Target Rate.

Fed fund futures : A financial instrument that let's market participants determine the future value of the Federal Funds Rate.

Hawkish : Description used when worries about inflation are the primary concerns in setting monetary policy decisions.

Inflation : Characterized by rising price levels.

Fiscal Policy : Government spending policies that influence macroeconomic conditions. These policies affect tax rates, interest rates and government spending, in an effort to control the economy.

Brexit : an abbreviation of “British exit” that mirrors the term Grexit. It refers to the possibility that Britain will withdraw from the European Unio.