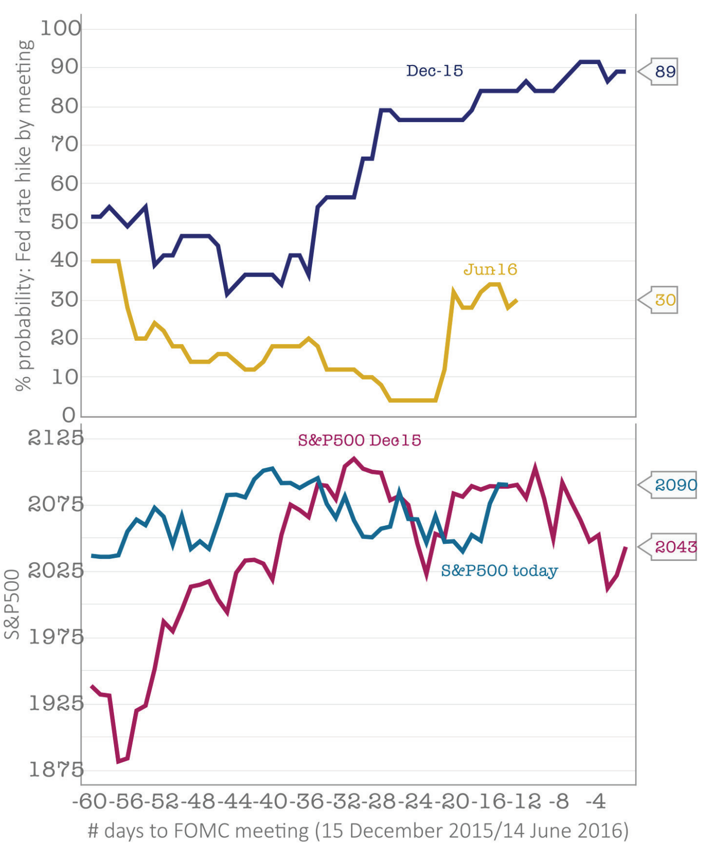
Financial Markets Influence the Fed

May 27, 2016

Financial Markets have a Part to Play in the Fed's Rate Setting Decisions

The more 'hawkish' than expected minutes of the U.S. Federal Open Market Committee (FOMC) meeting in April and rhetoric from FOMC members has led to a dramatic re-evaluation of the probability attached by the market to a rate hike at the June 14-15 or July 26-27 meetings. Past behaviour suggests that if the key members of the FOMC judge that an interest rate hike at its next meeting is warranted, market expectations will be managed such that it is not a 'surprise' once announced.

Exhibit 1
Fed Hike Probabilities and the S&P500: Today vs December 2015



Source: Macrobond; Bloomberg; data at 27 May 2016

The upper panel of the chart shows the probability of a rate hike at the Fed's forthcoming June meeting (the gold line) and in the run-up to last December's meeting (the blue line) implied by Fed fund interest rate futures. Around two weeks before the Fed raised interest rates for the first time in more than 9 years on 16 December, the market-implied probability of a rate hike had risen to more than 80%. Despite the recent shift higher in the market-implied probability of a Fed hike at its forthcoming June meeting from just 4% in mid-May to 30% currently, the Fed will prefer a higher probability before the June meeting if it is set on the path to raise interest rates. In this respect, Fed Chairwoman Janet Yellen's speech in Philadelphia on 6 June will be a key event.

The Fed's 'data dependence' for setting interest rates extends beyond the flow of US economic data and includes the 'signal' sent by financial markets, notably the S&P500, regarding investors' assessment of the current balance of risks to U.S. and global growth.

The sharp decline in the S&P500 and global risk assets (credit as well as equity) in the first part of the year signalled investor fears that higher U.S. interest rates and a stronger dollar would tip the global economy into a China-led downturn. The Fed got the message and provided policy relief by effectively shifting from a tightening to a neutral bias at its March meeting. The Fed is now however once again signalling that it has a bias to raise interest rates – the flow of economic data and market performance will have to provide reasons not to raise rates in June or July rather than reasons to do so.

A key indicator of markets' confidence in the U.S. and global economy's capacity to absorb further Fed rate hikes is the S&P500 shown in the lower panel of the chart. If, as was the case last December, the S&P500 does not suffer a meaningful fall in the run-up to the meeting, the likelihood of a Fed hike in June/July will move higher.

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