

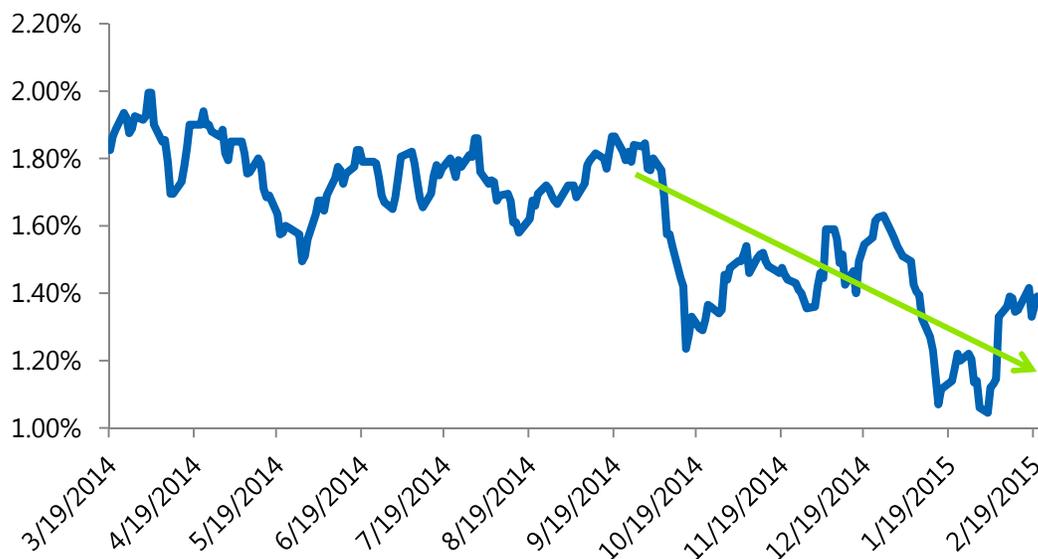
Market Participants Win Tug of War with Fed

By Jason M. Thomas

Over the past several months, the path of the fed funds rate implied by futures markets and that forecast by members of the Federal Open Market Committee (FOMC) have become disconnected. Market participants simply do not believe that the Fed will hike rates at the pace suggested by its Summary of Economic Projections (SEP). Fed Chair Yellen had a distinct opportunity to use Tuesday's testimony before the Senate Banking Committee to highlight this disconnect and guide forward interest rates higher. By choosing not to do so, Yellen implicitly signaled that the Fed is comfortable with current expectations for rates to remain lower for longer.

While policy rates implied by futures markets have generally been below the Fed's SEP forecast, the gap has widened materially since September 2014. Since then, 22 central banks have combined to lower interest rates 32 times.¹ In addition, the Bank of Japan (BOJ) and European Central Bank (ECB) have expanded or initiated asset purchase programs that are scheduled to add more than \$1.5 trillion in central bank liquidity over the next twelve months.² Market participants have bet that the Fed would be unwilling to raise rates in the face of such massive external policy easing, especially considering the upward pressure rate hikes would place on the foreign exchange value of the dollar, which has already appreciated by 16% since June 2014.³

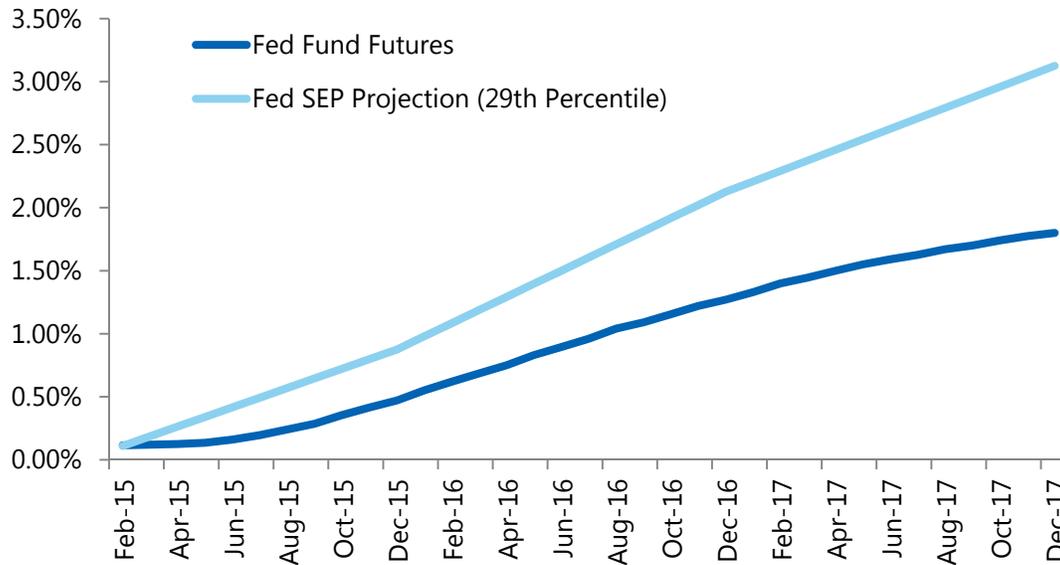
Figure 1: Implied December 2016 Fed Funds Rate, Fed Funds Futures⁴



The external developments did little to alter Fed forecasts; the pace of rate hikes anticipated in the December 2014 SEP was virtually unchanged from September 2014. As a result, the difference between Fed and market forecasts for the fed funds rate in December 2016 widened to 1.25%, or the equivalent of five rate hikes. Although much is made of differences among Fed governors and bank presidents, even the most dovish third of FOMC members anticipate four-to-five more rate hikes over the next two years than implied by futures markets.

1. Carlyle Analysis of Central Bank policy statements.
2. The BOJ and ECB purchase programs are converted to dollars at February 23 exchange rates.
3. Federal Reserve, H.10, Major Currencies.
4. CME, February 24, 2015.

Figure 2: Expected Path for Fed Funds Rate, 2015-2017⁵



Expectations gaps of this magnitude could prove problematic if closed abruptly. Since the “taper tantrum” of May 2013, Fed officials have been acutely sensitive to market expectations and gone to great lengths to telegraph policy changes so as to avoid sudden, unwelcome adjustments in financing conditions. If the Fed were determined to normalize policy rates at a pace commensurate with December 2014 SEP forecasts, Chair Yellen would have used Tuesday’s testimony to prepare market participants for this eventuality. Instead, by effectively making market participants more comfortable in their current positions, the Fed Chair’s testimony has made it more likely that FOMC rate forecasts will eventually adjust down to market-implied levels rather than the other way around.

5. Fed SEP, December 2014; CME, February 24, 2015.

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