



FED Pulls Expectations in Both Directions

Over the past couple of weeks the Federal Reserve appears to be attempting to guide market expectations about near term policy in the direction of more rate hikes than are currently priced in:

Aug 16th Dudley: Fed funds futures market is under-pricing rate hikes.

Dudley: Market is complacent about need to gradually hike rates.

Aug 18th Williams: Calls for rate hike 'sooner rather than later'.

Aug 26th (Bloomberg) -- Federal Reserve Vice Chairman Stanley Fischer said Chair Janet Yellen's earlier remarks leave open the possibility of an interest-rate hike in September. Asked whether Fed watchers should be looking for such a move in September, and possibly for two hikes this year, Fischer says, "What the chair said today was consistent with answering 'yes' to both of your questions."

Aug 28th Mester: Making another gradual step - there is a compelling case for that.

Source: Bloomberg, Financial Times

At the same time several commentators, including Ben Bernanke ([The Fed's shifting perspective on the economy and its implications for monetary policy | Brookings Institution](#) - Aug 8th) have noted the substantial shift lower in the FOMC's longer term expectations for output, unemployment and the fed funds rate. According to Bernanke, this is driven less by "short-run factors" than by "the ongoing change in how most FOMC participants view the key parameters of the economy".

Long-run projections of output (y^*), unemployment (u^*), and the fed funds rate (r^*) from the FOMC's June Summary of Economic Projections

	y^*	u^*	r^*
2016	1.8 – 2.0	4.7 – 5.0	3.0
2015	2.0 – 2.3	5.0 – 5.2	3.75
2014	2.1 – 2.3	5.2 – 5.5	3.75
2013	2.3 – 2.5	5.2 – 6.0	4.0
2012	2.3 – 2.5	5.2 – 6.0	4.25

Note: Values shown are central tendencies for y^* and u^* , and the median for r^* . Central tendencies are the range of projections submitted by FOMC participants, omitting the top three and bottom three values.

Source: Brookings Institution, Federal Reserve

It seems to us that there is currently something of a conflict between the near term and the longer term in relation to FOMC policy expectations. There has been an effort to encourage the market to price greater 'normalisation' over the near term while the Fed is 'rethinking everything', according to Bernanke, in relation to longer term expectations. In foreign exchange markets the US dollar reacted strongly to Fischer's remark (see above) on August 26th recording upside 'reversals' against several currencies on the day. This was a meaningful technical signal and suggests to us that the USD will strengthen in coming weeks. In the near term this may act as a tailwind for European and Japanese equity indices but a headwind for commodities and emerging markets. Ultimately, however the degree of USD strength is likely to be limited by the downshift in the FOMC's longer term expectations for the fed funds rate.

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Sep 1st, 2016

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