LPL RESEARCH

WEEKLY ECONOMIC COMMENTARY

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FOMC FAQs: IS A RATE HIKE IMMINENT?

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KEY TAKEAWAYS

The Fed holds its fourth of eight FOMC meetings of the year this Tuesday and Wednesday (June 13–14, 2017).

The fed funds futures market is currently pricing in a 96% chance of a rate hike this week.

Fed Chair Janet Yellen will hold a press conference and the FOMC will release a new set of economic forecasts and "dot plots" at this week's meeting.

We continue to expect a total of two or three rate hikes in 2017.

WHAT IS THE SCHEDULE OF EVENTS FOR THE FED THIS WEEK?

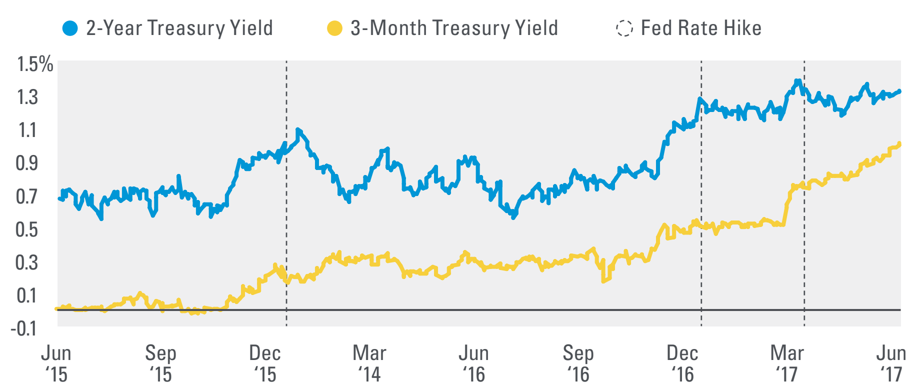
The Federal Open Market Committee (FOMC) meeting will take place on Tuesday and Wednesday (June 13–14, 2017) and will be followed by an FOMC statement released at 2:00 p.m. ET on Wednesday, June 14, 2017. Along with the statement, the FOMC will also release a new set of economic forecasts (gross domestic product [GDP], the unemployment rate, inflation, and fed funds projections, also known as the "dot plots"). Federal Reserve (Fed) Chair Yellen's post-FOMC meeting press conference—her second of 2017—starts at 2:30 p.m. ET.

HAS THE MARKET PRICED IN A RATE HIKE?

While the market has not priced in a 100% chance of a rate hike, it has come very close. As of Friday, June 9, the fed funds market was pricing in a 96% chance that the Fed will hike rates by 0.25% at this week's meeting. Of the economists surveyed by Bloomberg, 73 out of 78 believe a rate hike is in store. This would bring the fed funds rate to a range between 1.00–1.25%.

Short-term Treasury rates are another way to determine what the market is pricing in. Interestingly, two commonly used short-term Treasury yield proxies appear to disagree for the first time during this rate hike cycle [Figure 1]. The 3-month Treasury yield, which is more directly impacted by Fed moves, has moved higher since the last rate hike in March 2017, indicating that the bond market believes the Fed will hike again in June. However, the 2-year Treasury yield, which has also

1 3-MONTH TREASURY YIELDS HAVE MOVED HIGHER SINCE THE MARCH RATE HIKE, BUT 2-YEAR YIELDS HAVE STALLED



Source: LPL Research, FactSet 06/09/17

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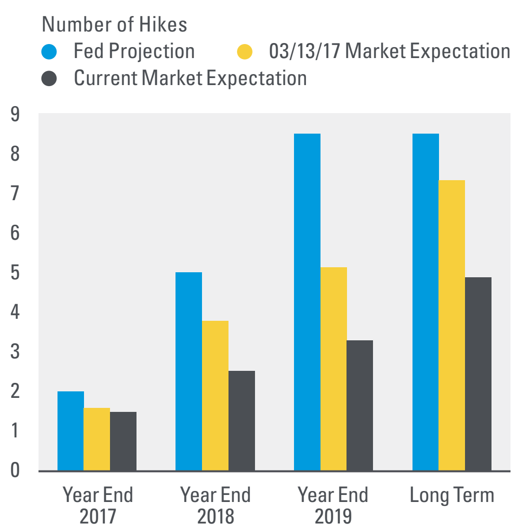
moved higher prior to the last three rate hikes, has stalled. This may indicate that markets don't believe that there is much economic benefit (in the form of inflation control) to be gained by increasing rates further, but given that the 2-year Treasury yield is flat relative to March, it also may indicate that markets don't believe the rate hike poses huge downside risks to economic growth over that time horizon either. This explanation also fits given market-based inflation expectations have been trending lower in recent months.

HOW LARGE IS THE DISCONNECT BETWEEN THE FED AND THE MARKET ON RATES?

The FOMC's latest forecast (March 2017) puts the fed funds rate at 1.375% by the end of 2017. The FOMC will release a new set of "dot plots" at the conclusion of this week's meeting. The market (according to fed funds futures) puts the fed funds rate at around 1.24% by the end of 2017 [Figure 2], close to the Fed's own projection, and just one basis point (0.01%) lower than what the market was predicting immediately after the March rate hike. While short-term market expectations have remained basically stable, longer-term market expectations have fallen since the last rate hike. The latest set of dot plots from the Fed puts the fed funds rate at 2.125% by the end of 2018, while the market currently expects the fed funds rate to be 1.50% at year-end 2018, down approximately 25 basis points (0.25%). That would equate to one full rate hike from the level seen immediately after the March Fed meeting (1.75%). Longer-run market expectations have also fallen since March.

2 THE MARKET IS EXPECTING FEWER RATE HIKES THAN IT DID HEADING INTO THE MARCH FED MEETING



Source: LPL Research, Bloomberg 06/09/17

Forecasts may not develop as predicted.

While markets and the Fed are never perfectly aligned on the future path of interest rates, they were as close as they had been in a while prior to the March Fed meeting. Since that time, market expectations have fallen considerably, and it will be interesting to see if the Fed makes a move to lower its own expectations through the dot plots it releases following the June meeting.

The last major disconnect between markets and the Fed began in early 2016, just after the Fed's first rate hike of the cycle in December 2015. At that time, the FOMC's dot plots implied eight 0.25% rate hikes in 2016 and 2017, while the market expected just two 0.25% hikes. That large disconnect between the market and the Fed was one of the root causes of the imbalances that plagued global financial markets in late 2015 and the first few months of 2016. The divergence in recent months is not as severe, but is something worth watching moving forward.

WHAT SHOULD WE EXPECT FROM YELLEN'S Q&A?

As always, markets will closely watch the language of the Fed's statement, and will also be closely watching Fed Chair Yellen's Q&A responses for any hint of future Fed policy moves. The Fed largely shrugged off softer economic data in the May meeting statement, and markets will be tuning in for any adjustment to this language, as well as any change to the Fed's inflation outlook given that market-based inflation expectations have decreased slightly over the past month.

Questions about fiscal policy and softer economic data were popular during the Fed's last press conference in March, and we would expect these topics to come up again at this meeting. We also expect more questions around the potential for balance sheet normalization given the more detailed discussion of this topic in the Fed's May meeting minutes.

CONCLUSION

Market-based measures of rate hike expectations continue to point toward an increase in the fed funds rate at the upcoming June meeting, and we agree that a hike is likely. However, markets are pricing in a flatter trajectory of rate hikes moving forward, and relatively short-term 2-year Treasury yields are flat relative to levels seen in the aftermath of the Fed's March meeting. This may be the market's way of warning the Fed that with inflation expectations broadly contained, being too aggressive in the near term may harm growth moving forward. Additionally, markets will be attentive to the Fed statement and press conference for any changes to economic growth or inflation outlooks, as well as any additional details regarding balance sheet normalization. ■

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