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FED VERSUS THE MARKET — ROUND 2

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KEY TAKEAWAYS

The latest statement from the Fed suggests that it will continue, and even accelerate, its policy of increasing interest rates, even as it starts to shrink its balance sheet.

The Fed has been a relatively poor predictor of its own actions, and tends to overestimate the speed at which it will raise rates.

The market believes that the Fed will raise rates, though not to the extent that it says.

In its September 20 policy statement, the Federal Reserve (Fed) suggested that it will increase interest rates once more this year and three times in 2018. But the market is predicting that the Fed will only raise rates two times between now and the end of 2018—and it isn't even certain that the Fed will raise rates this December, though according to fed fund futures it is likely. One reason for this skepticism is the Fed's history of being overly aggressive in estimating its own future actions.

The market accepts that both the Fed and the Bank of England (BOE) are likely to raise rates this year. However, it also questions comments made by the European Central Bank (ECB) regarding its possible normalization of monetary policy. In fact, it thinks that the ECB and Bank of Japan (BOJ) are more than a year away from raising their rates, suggesting continued divergence among global central banks.

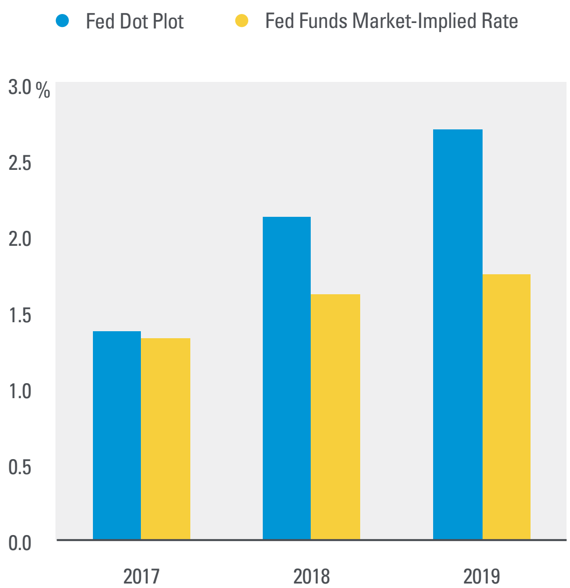
WATCH WHAT THEY DO, NOT WHAT THEY SAY

The Fed has evolved how it communicates both current and future interest rate policy to the financial markets. The first Fed statement on changes to monetary policy was issued after its February 1994 meeting; prior to that, the market had to discern Fed policy from its actions. The Fed began to release a more explicit look at future monetary policy in January 2012, publishing the so-called "dot plots," a graph displaying the midpoint of the range of interest rate projections of each member of the Fed's Board of Governors. Since its introduction, the dot plots have been one of the most scrutinized, and criticized, aspects of monetary policy.

The Fed's September 20 dot plot indicates that in aggregate, members believe that rates will be 25 basis points (0.25%) higher by the end of this year and 100 basis points (1%) higher by the end of 2018, equating to four rate hikes over the next 15 months. But based upon futures contracts, the market thinks that the Fed will be less aggressive, pricing in only two interest rate increases over this period. The gap between the dot plot and the market grows in the forecasts for 2019 [Figure 1].

Why is there such a divergence? Isn't the Fed in the best position to know what the interest rate will be since it's responsible for setting it? It turns out that the Fed is a relatively poor predictor of its future actions. Or more formally, we can say that the Fed has misjudged what the appropriate monetary policy for the future will be [Figure 2]. In December 2014, the Fed thought that the appropriate fed funds rate in December 2017 would be 3.6%, and by December 2015 it had

1 FED AND MARKET DON'T AGREE ON FUTURE RATES

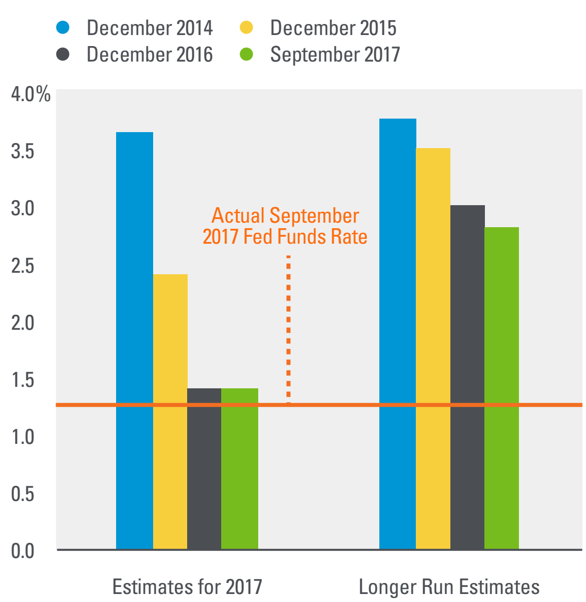


Source: LPL Research, Federal Reserve 09/20/17

The market-implied chances of a rate hike are calculated based on pricing of various fed funds futures contracts.

Forecasts may not develop as predicted.

2 ESTIMATES FOR FED FUNDS ARE TYPICALLY REVISED DOWN



Source: LPL Research, Federal Reserve 09/20/17

adjusted its projection to 2.4%. The fed funds rate, however, is currently 1.25%, with the expectation that it will be 1.5% by year-end following an anticipated December 2017 rate hike. Similarly, the Fed's anticipation of interest rates in the "longer run"—or when the Fed thinks it will stop adjusting interest rates for the current economic cycle—has also decreased by 1% since the end of 2014.

The primary reason that the Fed has delayed anticipated rate increases is because inflation has been much lower than anticipated. The Fed does not see inflation reaching its 2% target until 2019. We looked at inflation in last week's *Weekly Economic Commentary*. A faster rise in inflation might cause the Fed to meet its current forecast for rate hikes, or even accelerate them. However, based on the data since the dot plots began to be published, the Fed has erred on the side of caution in raising rates, even relative to its own predictions. The market comes by its skepticism honestly.

HOW IS THE MARKET SCORING THE FED?

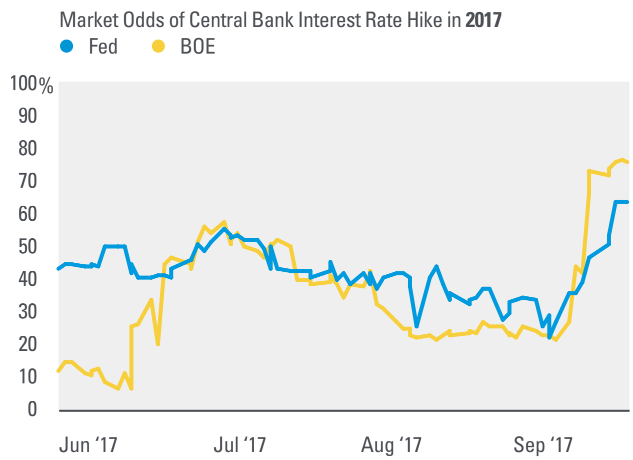
The Fed only publishes the dot plots four times a year. In contrast, the market for fed funds futures trades daily, and can be quite volatile, especially around Fed meetings and other major economic events. The markets also make similar predictions regarding other major central bank interest rate policies [Figure 3]. Before the recent Fed meeting, the market was indicating a 25% chance of a December 2017 rate increase. Following the meeting, that probability went up to 65%. Looking at the BOE, the market is showing a 75% chance of a rate increase. Therefore, although it's not certain, the market believes that it is more likely than not that both the Fed and the BOE will increase interest rates at their respective December 2017 meetings.

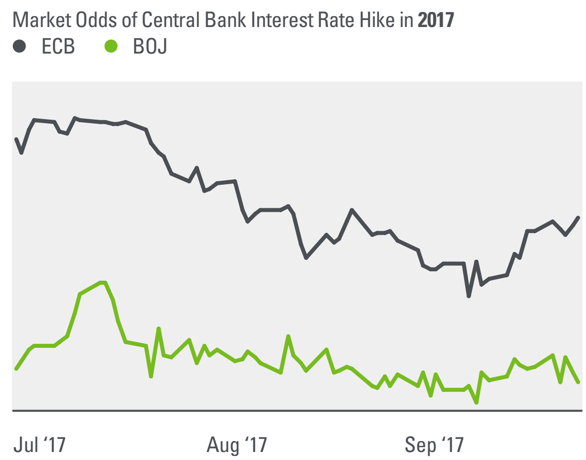
For contrast, we show the similar market-implied probabilities for the ECB and BOJ for interest rate increases by the end of 2018. This chart for the end of 2017 would effectively be a straight line at zero. Not only does the market think that the odds of interest rate hikes are low over the next 15 months, it has become more pessimistic regarding the probabilities for these central banks since this summer.

CONCLUSION

Global financial markets pay close attention to every statement from central banks, even if they do not always take the statements at face value. At the very least, these statements provide some guidance as to the general direction of monetary policy, even if the speed at which that policy is implemented is inaccurate. We can see the increasing divergence between the tightening policies expected in the U.S. and U.K. and the continued ultra-loose monetary policy expected from the rest of Europe and Japan.

3 U.S. AND U.K. ARE WELL AHEAD OF EUROPE AND JAPAN IN REVERSING MONETARY POLICIES





Source: LPL Research, Bloomberg 09/22/17

The market-implied probabilities of interest rate hikes are calculated based on pricing of various future contracts. Forecasts may not develop as predicted.

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