FED WATCH: TAKE A HIKE

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Unless the Federal Reserve (Fed) offers up an unexpected curveball to the markets at today's FOMC meeting, investors will be presented with a new setting to begin calendar year 2017: a Fed Funds target that is 25 basis points (bps) higher than where we've been operating over the last 12 months. In a somewhat rare development, the implied probability of a rate hike at this Fed gathering has been placed at 100% for the last three weeks. Thus, if the voting members follow through on this expectation, the money and bond markets will quickly pivot to any hints the Fed may provide as to what the outlook for 2017 monetary policy may be.

Going back to our "Fed 101" textbook, the December FOMC meeting will contain the usual accompanying policy statement, the Fed's updated Summary of Economic Projections (SEP) as well as Chair Yellen's press briefing. In other words, the markets will have plenty of headlines to digest in relatively short order, and as we have seen in the past, this much Fed-related input can be subject to potential misinterpretation if the policy makers try to fine tune their message too much, especially when compared to what has already been discounted by the U.S. Treasury (UST) market. As we witnessed just last week following the European Central Bank's (ECB) meeting, an unintended market reaction can accompany any monetary policy announcement. Indeed, based upon ECB President Draghi's post-meeting presser, it would appear the ECB was not trying send a "taper" message to the bond markets, but that was nonetheless the initial interpretation.

This is essential to how the Fed frames this expected rate hike. According to the yields currently in place in the Treasury market, one could make the case that the UST market has not only discounted such a move but continues to see two additional increases in 2017, an expectation that aligns with the Fed's own median forecast, which was presented following its September gathering. In addition, based upon post-election "Fed speak," Fed officials have continued to emphasize that their policy outlook, at least for now, can't be based upon potential fiscal stimulus that has not even been signed into law. Thus, while the UST market has certainly been repriced for this potential, the FOMC appears to be taking more of a wait-and-see approach.

So, where should investors focus their attention at 2:00 p.m. eastern time? Let's look at the policy statement first to see what changes are potentially made to the Fed's language guidance. The key phrases utilized at its November meeting were "the case for an increase in the Federal Funds Rate has continued to strengthen," and "near-term risks to the economic outlook appear roughly balanced." Obviously, if the target for overnight money has been lifted, the former will either be altered or removed altogether, while the latter will be looked to for any shift in the policy makers' thinking for early 2017. At the same time, the market focus will be on the "Blue Dots" (the Fed's median forecast) to see if there has been any change to the expectation of two rate hikes for next year.

Conclusion

Looking at the makeup of the FOMC, the membership is already short two Fed governors. Thus, as the annual rotation occurs among the Fed bank presidents, President Trump will have the opportunity to fill the aforementioned governor voids. Should these moves affect the outlook for monetary policy in 2017? More than likely, the answer is no. Typically the FOMC follows the lead of the chair, with the vice-chair's and the New York Fed president's views also carrying some weight, and "the names here will remain the same." The bottom-line message seems to be that Fed policy will most likely begin the next year by maintaining a gradual, deliberate approach to rate hikes and will respond to potential fiscal stimulus once it's actually in place and the data warrant additional action.

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DEFINITIONS

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Federal Open Market Committee (FOMC) : The branch of the Federal Reserve Board that determines the direction of monetary policy.

Federal Funds Rate : The rate that banks that are members of the Federal Reserve system charge on overnight loans to one another. The Federal Open Market Committee sets this rate. Also referred to as the "policy rate" of the U.S. Federal Reserve.

Basis point : 1/100th of 1 percent.

Rate Hike : refers to an increase in the policy rate set by a central bank. In the U.S., this generally refers to the Federal Funds Target Rate.

Monetary policy : Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

Treasury : Debt obligation issued by the U.S. government with payments of principal and interest backed by the full faith and credit of the U.S. government.

Tapering : A shift in monetary policy by which the Federal Reserve would begin decreasing the amount of bonds it purchases.

Fiscal Stimulus : Using fiscal policy as a tool to provide economic growth.