## FED WATCH: THE DAY AFTER TOMORROW

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The highly anticipated "Fed meeting of the year" has now come and gone, and investors still seem to be asking themselves: What comes next? As we discussed in our pre-FOMC blog post Fed Watch: Decision Day, the potential answer could lie in the September meeting's accompanying policy statement. Obviously, the "will they or won't they" debate was answered when policy makers, yet again, refrained from raising rates. However, based on market-related expectations, this decision was more or less the consensus going into last week's convocation. So, let's take a look at that aforementioned policy statement. As expected, the Fed acknowledged that the "labor market continued to strengthen" and the economy had "picked up" from the slow first half of the year. Yet it also recognized that it had missed its inflation target but continued to feel that the 2% threshold would be achieved, albeit based upon its most recent central tendency estimates, i.e., that it may take a year or two. Our view has always been that when the voting members were moving closer in the direction of a second rate hike, they would prepare the markets for this possibility—something the Fed had not yet done from a more formal policy perspective. After the September meeting, the policy makers have now prepared the markets for a rate hike as a potential outcome. Two phrases in particular stand out: first, the Fed stated that "the case for an increase in the federal funds rate has strengthened," and secondly, that "near-term risks to the economic outlook appear roughly balanced." The second reference takes us back to the Fed's 2015 playbook, when similar language was inserted and was followed up by lift-off in December. Could history be repeating itself? Well, once again the Fed hedged its bets and emphasized that such an outcome will be data dependent, and of course global economic and financial conditions will continue to play a role. What has changed is the policymakers' own trajectory for future rate hikes, as this year's median forecast now looks for only one such move, and for 2017, the number has been lowered to only two increases as compared to three in June. **Conclusion** Certainly, the Fed does appear to be itching to raise rates at least one time this year. Chair Janet Yellen said as much at the post-meeting presser. While upcoming data may give the FOMC the opportunity to raise rates before year-end, one development that has received scant attention is the increase that has already occurred in the 3-month Libor rate due to the upcoming money market reform date. Many borrowing arrangements are pegged to this instrument, and some upward resets could be taking place. Nevertheless, it appears that as long as the economic data does not take a turn for the worse, the likely scenario at the present time would be for the Fed to potentially lift the Fed Funds target before 2017 gets ushered in. From a rate outlook, the gradual, cautious approach the Fed appears to be taking should keep <u>Treasury yields</u> in a volatile, range-bound setting.

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## **DEFINITIONS**

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

**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.

**Inflation**: Characterized by rising price levels.

**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.

**U.S. 3m LIBOR**: the average 3-month rate that major banks offer to lend to one another for short-term unsecured funds in U.S. dollars in London. LIBOR refers to the London Interbank Offered Rate.

**Treasury yield**: The return on investment, expressed as a percentage, on the debt obligations of the U.S. government.

