It’s the Great Pumpkin, Charlie Brown

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Kevin Flanagan
Head of Investment and Fixed Income Strategy

The money and bond markets’ Federal Reserve (Fed) expectations for 2016 have, thus far, been akin to Linus waiting for the arrival of the Great Pumpkin. Indeed, heading into this year, conventional wisdom was centered around four potential rate hikes from the U.S. policy makers, but so far not even one increase has happened. Next week, the Federal Open Market Committee (FOMC) is scheduled to meet for the second-to-last policy session of the year, and based on market valuations, a Great Pumpkin sighting (i.e., a Fed Funds Rate hike) may continue to remain elusive.

Although the Fed is not expected to raise rates next week, the voting members have set the stage for a potential move before year-end, with their scheduled December 13–14 meeting representing a more likely time frame, data permitting. As we’ve mentioned before, we believe the Fed is not really in the business of surprising markets with policy decisions but rather seems to show a preference of preparing them for potential moves.

In this case. the process began back in August of this year. It was then that the “Big Thee,” Chair Yellen, Vice Chair Fischer and New York Fed President Dudley, all put the potential for a rate hike back into the fixed income arena’s mindset. Remember, prior to August, the collective markets were still dealing with the aftermath of a post-Brexit world, a world where at one time, the implied probability for Fed Funds Futures posted a more than 20% chance of a *rate cut*. Given the policy makers’ outlook, they obviously felt the money and bond markets had become too complacent as summer progressed and saw the need to alter sentiment, which in hindsight, proved to be effective.
As of this writing, Fed Funds Futures-implied probabilities are at roughly 17% for a rate increase at next week’s meeting and a 69% chance for the December convocation. However, it is interesting to note that the aforementioned Big Three have, once again, been in the headlines over the last week or so. This time around, it appears as if these Fed officials may be trying to guide market expectations for what might occur following a 2016 rate hike. Specifically, the underlying tenor seems to be that if an increase does occur before year-end, investors should not necessarily expect the Fed to embark on a steady tightening campaign, as was the case during the 2004–2006 period. Rather, the policy makers will take a more deliberate approach and perhaps allow a “high-pressure economy.” This is essentially Fed speak for not tightening too much so as to avoid the need to reverse course if the economy were to falter or inflation did not reach their 2% threshold.

How the U.S. Treasury (UST) market would respond to this type of approach may have been put on display in small doses immediately following the Big Three’s remarks. Rather than the intuitive expectation that the yield curve flattens when the Fed raises rates, the UST 2-year/10-year spread actually widened. Allowing a high-pressure economy could create concerns at some point that the Fed would fall behind the curve in terms of warding off potential inflation pressures and/or heightened expectations, typically increasingly negative factors the further out on the yield curve one goes.

Conclusion

Given the Fed's language in the September FOMC policy statement, if upcoming economic data does not soften from current readings, the outcome could ultimately be different than what Linus experienced. In other words, fixed income investors may very well see their Great Pumpkin—a 2016 rate hike.
Unless otherwise noted, data source is Bloomberg, as of 10/21/2016.

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