

# IT'S THE GREAT PUMPKIN, CHARLIE BROWN

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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 Three," 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 increasing 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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## DEFINITIONS

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

**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.

**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.

**Brexit** : an abbreviation of “British exit” that mirrors the term Grexit. It refers to the possibility that Britain will withdraw from the European Union.

**Fed fund futures** : A financial instrument that lets market participants determine the future value of the Federal Funds Rate.

**Monetary tightening** : A course of action undertaken by the Federal Reserve to constrict spending in an economy that is seen to be growing too quickly or to curb inflation when it is rising too fast.

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

**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.

**Yield curve** : Graphical Depiction of interest rates on government bonds, with the current yield on the vertical axis and the years to maturity on the horizontal axis.

**2-Year Treasury** : a debt obligation of the U.S. government with an original maturity of two years.

**10- Year Treasury** : a debt obligation of the U.S. government with an original maturity of ten years.

**Spread** : Typically refers to a difference between a measure of yield for one asset class and a measure of yield for either a different subset of that asset class or a different asset class entirely.