FED MONITOR: DON'T LET THE DOOR HIT YOU

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05/04/2016

With one-third of calendar year 2016 in the books, the money and bond markets have now weathered the first three Federal Open Market Committee (FOMC) meetings. It came as no surprise that at last week's policy gathering, the Federal Reserve (Fed) once again decided to keep interest rates unchanged. Now, the fixed income arena has quickly pivoted to the next FOMC meeting scheduled for June 14 and 15. As we wrote in our March 21 blog post "Fed Monitor: Watch Your Language", the area investors should focus on for potential future Fed action lies in its policy statement. The latest version did not offer any groundbreaking insights, but some subtle adjustments were made. The voting members did acknowledge that "growth in economic activity appears to have slowed," a point underscored by the Q1 real GDP data, but they did not appear to alter their broader outlook that growth will ultimately still "expand at a moderate pace." More important to the Fed outlook are the Committee's views on global economic prospects and financial conditions. This is where the most notable shift occurred in the statement's language. At the March FOMC meeting, and a subsequent public appearance by Fed chair Yellen shortly thereafter, there was little doubt that concerns had arisen on this front and that these considerations played an integral role in turning the mindset more cautionary. However, the Fed's tone was less anxious this time around, as the policy statement replaced the phrase "global economic and financial developments continue to pose risks" with "[t]he Committee continues to closely monitor inflation indicators and global economic and financial developments." Should we be scrutinizing the Fed's words so closely? The answer is an unequivocal yes, because this is how the policy makers attempt to provide guidance to the markets. This shift does not necessarily mean the Fed is now actively considering raising rates at its June meeting, but it was meant to signal that perhaps too much complacency had set in on this front, and left the door open, not closed. There is a long way to go, and a lot of data—both here in the U.S. and abroad—to digest between now and mid-June, but financial conditions (the U.S. dollar, equity prices, oil and commodity prices) have turned less restrictive compared to earlier in the year. In order for the Fed to consider a rate hike at its next policy meeting, U.S. growth will need to improve in Q2, global economies such as China must show signs of stabilizing and/or improving, and the aforementioned financial conditions cannot take a step backward. Without a doubt, those are several hurdles to cross, but April's policy statement was the Fed's way of trying to interject itself back into the money and bond market discounting process. **Conclusion** Based on the initial reactions to the FOMC meeting, the U.S. Treasury market does not appear to have been swayed and is still not priced for a potential rate hike in June. If the Fed is going to consider such a policy move, monetary officials will more than likely telegraph their intentions beforehand and not surprise the markets. Within fixed income, we continue to see more relative value in investment-grade corporates (IG) rather than interest-sensitive vehicles such as Treasuries. WisdomTree believes fixed income investors should focus on a qualitative approach to IG credit while tilting for income.

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DEFINITIONS

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

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

Interest rates : The rate at which interest is paid by a borrower for the use of money.

Gross domestic product (GDP) : The sum total of all goods and services produced across an economy.

Inflation : Characterized by rising price levels.

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.

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.