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A Laser Focus on the Fed



Next week, the first Federal Reserve Open Markets Committee meeting under Jerome Powell's Chairmanship will take place on the 20-21st March. Whilst a quarter-point increase in the Fed Fund Rate from the current range of 1.25%-1.5% is seen as a 'done deal' by markets, what is less clear, is whether the Fed will add a fourth hike to its guidance for 2018. Recent market sell-offs have been driven by investor fear that rising inflation might force the Fed to raise interest rates more quickly than expected. Thus, the Fed's communication will be key and markets are likely to wax and wane as participants digest its message.

In advance of the meeting, economic data shows that the Goldilocks scenario persists. US nonfarm payroll data, released on Friday 9th, revealed that 313,000 new US jobs were created in February, versus an expected 200,000. The jewel in the number was the participation rate, which came in at a strong 63%. Unemployment remained at a 17-year low of 4.1%. The strong labour market, coupled with injections of fiscal stimulus into an already-stimulated economy, is giving the Fed extra ammunition to continue hiking.

But the question is how quickly and whether an additional hike will be deemed necessary for 2018. The quarterly dot-plot which depicts Fed officials' projections for appropriate interest rate

levels for the future will be released at the meeting. When it was last released in December 2017, it showed three rate hikes for this year. There is a chance that this could be upgraded to four, and that the terminal rate - that is the rate considered to be the neutral end point in the tightening cycle - will be revised upwards, indicating an increased pace of hiking.

However, thus far in the economic expansion, inflation has failed to act in the typical textbook manner - rising as the economy reaches full employment. In February, core CPI inflation held steady at 1.8%. Wage growth (an inflation driver) fell from 2.8% to 2.6%. This indicates that US economic conditions are still running closer to "just right" than "too hot". If the Fed hikes too quickly, it could choke economic growth.

That said, policy makers expect inflation to gradually rise and are eager not to fall behind the curve, allowing inflation to overshoot and the economy to overheat. Powell has suggested that an upgrade to four rate rises could be on the cards and that this will still be considered gradual. The way the market digests the Fed's decision will be influenced by the press conference communication.

The market's heightened sensitivity to central bank communication was demonstrated during the ECB's March 8th policy meeting. The ECB dropped its pledge to increase its asset purchase program if needed, which the markets perceived as hawkish. They reacted by piling into the euro and selling out of bonds, causing yields to shoot up. However, during the press conference, the President, Mario Draghi, played down the importance of the communication pivot, and markets were pacified. Yields and the euro subsequently retreated. The danger is that Powell is still learning the art of central bank communication.

German 10-Year Government Bond Yields (yellow) and the Euro (black)



Source: Bloomberg, BIL

What is key is that the Fed reassures markets that it will stay consistent in its actions, focusing

on the macro picture. If they do this, we don't see any imminent reason to fear higher rates. The danger is all about market psychology and the risk that markets perceive that the Fed will hike too aggressively. In anticipation of rising rates, we are reluctant on fixed income, particularly on duration. However we believe that if the rise is gradual – something the Fed has emphasized – it should not derail equities. We maintain an equity overweight focusing on cyclical sectors such as Financials, which have historically benefitted from rising rates.

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