Fed is set to hold steady, which could surprise markets

by Franck Dixmier | 17/12/2018

Summary

A host of US economic issues – from trade tensions to a flattened yield curve – has drastically reduced expectations of rate hikes after the FOMC's December meeting. Yet the Fed sees a healthy US economy and may announce it is forging ahead, which could catch investors off guard and trigger volatility.

Key takeaways

- Ahead of the FOMC's December meeting, fed funds rate forecasts moved sharply lower – showing a 70% probability of an increase in December, virtually no expectation of a hike in 2019 and a rate decrease in 2020
- Yet we believe signs of a strong US economy mean the Fed will likely confirm its monetary-tightening strategy at its 18-19 December meeting
- Still, the Fed has consistently demonstrated that it is not on autopilot and will make decisions based on the latest macroeconomic developments; that could mean more unpredictability and more market volatility

The next meeting of the Federal Open Market Committee will be an important one, given the major differences between the markets' expectations and the Federal Reserve's own analysis of the US economy. If the Fed surprises investors by pledging to forge ahead with its monetary-tightening policy, it could result in higher volatility and a steeper US yield curve.

The FOMC's 18-19 December meeting will be held against a tense backdrop, consisting of many issues that have come to the fore in recent weeks:

- Trade tension between China and the United States.
- Concerns about US economic growth.
- High volatility and sharp corrections in the US equity market.
- Scepticism over the Fed's ability to pursue its monetary-tightening policy.
- Lower inflation expectations.
- A drastic flattening of the US yield curve.

These developments can be seen in downward revisions to the fed funds rate forecasts, which reflect a 70% probability of a rate increase in December, likely no expectation of a hike in 2019 and a rate decrease in 2020.

Yet we believe the markets may need to change this view, since a number of the indicators on which the central bank bases its analysis show a healthy – even robust – US economy:

- The purchasing managers' index reached 54.7% at the end of November, indicating an expansion in manufacturing activity.
- Consumer confidence moved higher. o Industrial orders rebounded, hitting 3.4% at the end of October vs 1.5% in September.
- The unemployment rate is at its lowest level (3.7%) in nearly 50 years.
- Wages grew at 3.1% year-on-year through the end of November.
- Purchasing power appears set to benefit from the drop in oil prices.

Given the strength of these figures – visible in the Fed's forecasts from September and recent comments from FOMC members – we believe the central bank is likely to forge ahead with its monetary-tightening plans and confirm its rate-hiking strategy. Admittedly, the Fed could trim its 2019 rate-increase forecasts from three to two, but we believe it won't project anything less.

As such, there is probably an element of surprise attached to the December FOMC meeting: investors could be caught off guard and be forced to adjust their expectations, fuelling volatility and causing the US yield curve to steepen again.

Whatever happens, the Fed has demonstrated that it is moving towards a neutral monetary policy – a fed funds rate of around 3% – and that it is no longer on autopilot. Every future decision on interest rates will likely be judged against the latest macroeconomic developments. That could make the Fed's decision-making process more unpredictable, which we believe would mean more volatility ahead.

All data from Bloomberg as at 12 December 2018.

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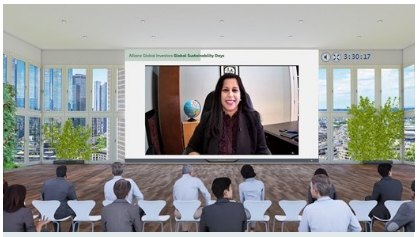

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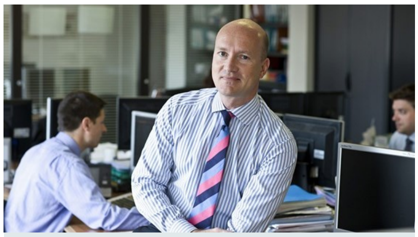

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