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Fed Thoughts: The Deep End of the Pool

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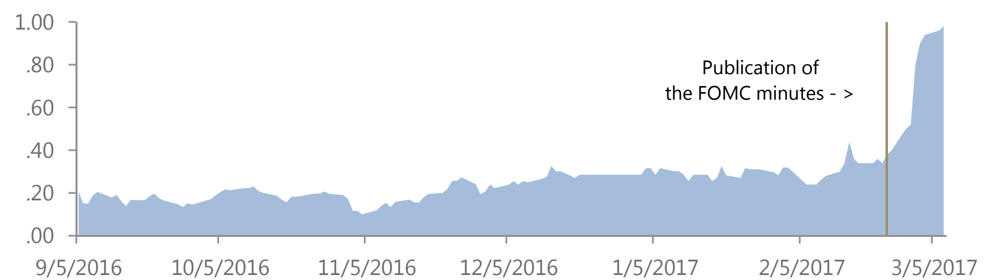
“If there has been a conscious effort to boost expectations of a rate rise, I’m about to join it.”

–Federal Reserve Vice Chairman Stanley Fischer, *The Wall Street Journal*, March 4, 2017

If? By the Friday that Fischer spoke, virtually every participant in meetings of the Federal Open Market Committee (FOMC) had relayed that the case to consider at their meeting on March 14 to 15 for adding 25 basis points to the federal funds rate target was compelling. March is on the table. The meeting is live. Rates will rise fairly soon. A rate hike will get serious consideration. A quarter-point hike is a live option. We really mean to light up the Board. (I made the last one up. All of the other euphemisms for actually doing something at an FOMC meeting came from Fed speakers.)

So evident a pattern raises the suspicion that, on weekends, Federal Reserve Board governors and Bank presidents practice synchronized swimming, copying Esther Williams’ routines as team-building exercises. The chart below plots the probability, implied from fed funds futures, of a quarter-point hike at the March meeting.

Probability of 0.875 Federal Funds Rate Target at the March FOMC Meeting



Source: Bloomberg, accessed 3/7/2017.

As is evident, FOMC folks first hit the water with the publication of the minutes of the January meeting. But this produced just a ripple in the pool, as those 18 anodyne pages only offered a cautious nudge toward the view that the policy rate would be going up “fairly soon.” Fed officials must have viewed this, in retrospect, as too subtle a hint because they subsequently started splashing about in earnest. After a collection of Fed bank presidents queued up for their moment in the bright lights, Chair Janet Yellen sealed the deal with her assurance that “...at our meeting later this month, the Committee will evaluate whether employment and inflation are continuing to evolve in line with our expectations, in which case a further adjustment of the federal funds rate would likely be appropriate.”[1]

[1] https://www.federalreserve.gov/newsevents/speech/yellen20170303a.htm.

Not FDIC-Insured. Not Bank-Guaranteed. May Lose Value.

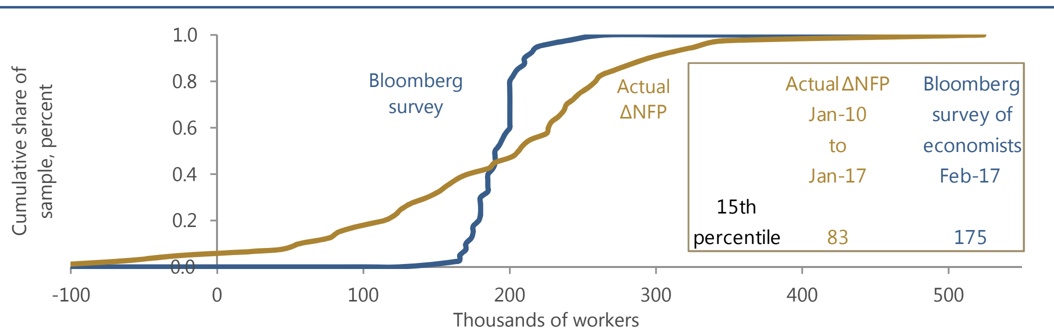
Of course, Yellen also tells us over and over again that all decisions are data-dependent and made meeting by meeting. The upcoming meeting in March, though, seems to be an exception, as the cards have already been dealt for a quarter-point increase in the fed funds rate. The pending action fits our model of Chair Yellen leading her committee from behind. As in 2015 and 2016, she acknowledges the general principle that rates should rise, mostly finds reasons to put off the event, and on occasion accedes to make sure that the pack does not get too far ahead. The difference this year is that three hikes (provisionally) have to be squeezed into four press-conference meetings.

There are reasons to delay, to be sure, including breaking developments on fiscal policy, looming European elections, and the snapback of the Treasury debt ceiling 10 hours after the Fed announcement. Besides, for a dovish chair, a tightening delayed may never come. But too many FOMC participants saw the same sequence during the prior two years and apparently wanted to take one firming to the bank when they had the chance. In that regard, as to the opening quote, the conscious effort was a spontaneous FOMC flash mob formed to get the Fed chair's attention.

ONE REMAINING SPEED BUMP

At this time, fed funds futures place a probability of 100% of action on Wednesday. Choosing a corner never feels right, especially with data (nonfarm payrolls) and political theater to entertain us. The reality, however, is that Friday's release on the employment situation offers little peril to the Fed call; a weak number would be dismissed as an aberration and a strong one as a confirmation of policymaking foresight. Economists are locked arm in arm on the headline to the report, with the median in the Bloomberg survey pinned at 200,000 net jobs created in February. There are no discernible tails to the distribution. As shown in the chart below, a disappointing number—one at the 15th percentile of the Bloomberg survey—is a robust 175,000 workers. By way of comparison, the same slice of the distribution occurs at about half that number in the historical record of monthly changes during the ongoing economic expansion. The difference between the expected and realized outcomes suggests that there is scope for disappointment, as is true with any monthly Friday jobs report.

Nonfarm Payrolls (NFP) (monthly change, thousands of workers)



Sources: Bureau of Labor Statistics and Bloomberg, accessed 3/7/2017.

WHATEVER IT TAKES

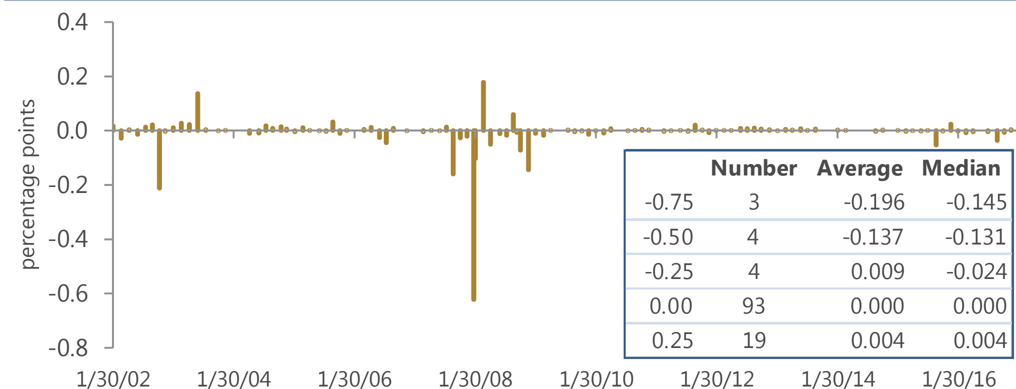
While it may not matter to Fed officials, who once again have painted the tape as to the path of their action, the reality is that the Fed is attempting to use its communications as the only instrument to cater to multiple audiences:

1. Academics, who put rule-based strategies associated with data dependence in their models;
2. Financial news outlets, which get more traffic as the clock ticks down to a decision, and which feel the tension made meeting by meeting but are quick to assign blame whenever red shows up on quote tables; and
3. Market participants, who would be conflicted if they were forced to choose between an outbreak of Ebola in midtown Manhattan and a surprise from the FOMC.

To achieve this hat trick, policymakers (1) say that they are data-dependent, (2) do it breathlessly and repeatedly to keep up the Nielsen ratings, and (3) use any and all means possible to convey the policy decision before the FOMC meeting.

To demonstrate this, consider the chart plotting changes in one-month overnight indexed swap rates on the days that the FOMC meets (or acts between meetings) since 2002. Conventional policy decisions, whether increasing or decreasing the policy rate one-quarter percentage point or standing pat, never really elicit a market response, presumably because they have already been telegraphed. Indeed, the heartbeat of market surprises since the financial crisis is faint.

Change in the One-Month Overnight Indexed Swap Rate Around FOMC Events



	Number	Average	Median
-0.75	3	-0.196	-0.145
-0.50	4	-0.137	-0.131
-0.25	4	0.009	-0.024
0.00	93	0.000	0.000
0.25	19	0.004	0.004

Source: Bloomberg, accessed 3/3/2017.

PLANNING AHEAD

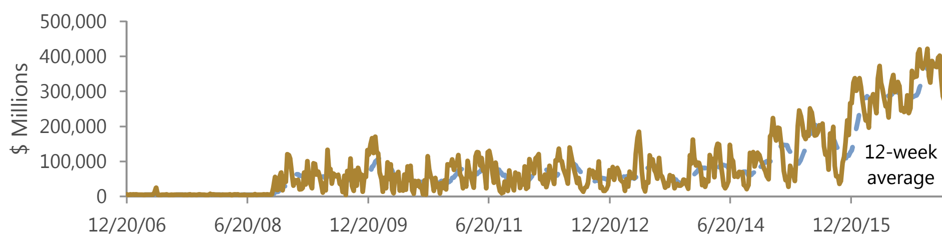
At 2:00 p.m. on March 15, save the FOMC statement to savor later and go straight to the supplementary material on the Summary of Economic Projections. The real GDP forecast for this year will probably edge higher, as it is pulled lower by the more discernible first-quarter GDP pothole, but pushed up by easier financial conditions and the expectation of fiscal and regulatory impetus. Those tailwinds will be evident in the outlook for next year and perhaps a pulling forward of some interest rate dots into 2017 and 2018. The cloud of points will be pinched at its ends by the number three; at the front, there will likely be a median outcome of three moves this year and the endpoint will rest at 3% in the long run.

One last point to keep in mind: the debt ceiling rises from its grave at midnight on FOMC day. As a result, Treasury Secretary Steven Mnuchin will declare a debt-ceiling emergency to permit accounting maneuvers that make some government IOUs not count toward the limit. Lengthening the runway in this now familiar manner gives about six months of room for the legislative budget-setting plane to take off. As opposed to previous performances of this long-running play, the Treasury starts with much more cash in its account at Fed banks (the Treasury General Account, or TGA) to run through

before needing to issue debt. Indeed, as seen in the chart, the TGA peaked at $400 billion at the end of January, but has shrunk to around $100 billion. Presumably, working off cash allowed the Treasury to pay down securities to create more running room under the looming ceiling.

Remember, though, that since the FOMC continues to roll over maturing and prepaying securities in the System Open Market Account, the aggregate of the asset side of the Fed balance sheet has remained stuck at $4.5 trillion. Balance sheets balance, even at the Fed, so liabilities and capital have also held steady. If the Treasury has reduced its deposits at the Fed by $300 billion, someone else (the banking system) must be holding that much more. That is, the Treasury has already been stuffing the banking system with extra liquidity in the run-up to Fed firming and will do some more subsequently. This probably means that the volume of the Fed's reverse repo facility will pick up as banks seek to work off those unwanted reserves.

Treasury General Account at the Federal Reserve



Source: Federal Reserve H 4.1, accessed 3/7/2017.

The gross domestic product (GDP) is one of the primary indicators used to gauge the health of a country's economy. It represents the total dollar value of all goods and services produced over a specific time period; you can think of it as the size of the economy.

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