Weekly Market Summary

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The US Federal Reserve Forward Misguidance & Irrelevant Dot Plots - Part II

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Last week, I provided our valuable clients with insight on what we perceived as US Fed manipulation, forward misguidance and irrelevant dot plots (the "dot plot" shows where each participant in the FOMC meeting thinks the Fed funds rate should be at the end of the year for the next few years and in the longer run), following the conclusion of the Fed's March 16th rate setting meeting. And whilst many readers assume that our coverage of central bankers' policy actions is rather harsh, market developments and Fed speak over the past days have further validated our philosophy.

Inflation may be starting to fire up and the Federal Reserve's credibility could get burned!

Just days after policy makers softened their outlook for the pace of interest-rate increases, evidence has accumulated that prices are beginning to move higher. If that trend continues, it could shake investors' confidence that price pressures remain in check, or lead them to conclude that this is a deliberate effort by the Fed to test the 2% target to ensure the US economy remains durable despite weakness and deflationary forces abroad. Either way, Fed's credibility would be tested and long term US bonds could succumb to selling pressures.

Oil prices, whose collapse since mid-2014 has been blamed for holding inflation well below the Fed's 2%, hit a three-month high on March 18th (May16 WTI contract traded to a high of US$ 42.49 on that day, after hitting a low of US$ 29.85 on January 20th. It closed yesterday at US$ 39.60). In addition, measures of core inflation, which strip out food and energy prices, have also shown a decisive upswing that the Fed could struggle to explain away. "*They are going to have a communications challenge*," said Ethan Harris, co-head of global economic research at Bank of America in New York. "*Can you only raise interest rates twice this year if core inflation is steadily accelerating?*" (*in reference to Fed officials halving the number of times they expect to hike rates this year from four moves projected last December*).

U.S. central bankers gave a lot of weight to global risks while keeping their estimates for core inflation unchanged at 1.6% for the final quarter of this year, according to their median estimate for the personal consumption expenditures price index released at their March 16th meeting. Trouble is that core PCE was already 1.7% higher for the year ending January. Additionally, a different gauge of price pressures - the year-over-year rate on the consumer price index minus food and energy (referred to as core CPI) - has hit a pace of 2.3% in February, a 7-1/2 year high! Chair Janet Yellen in her press conference was dismissive, saying the committee hasn't "*yet concluded that we have seen any significant uptick that will be lasting in, for example, in core inflation*." Harris, in a note to clients, said the FOMC appears to be intentionally risking an overshoot

because there is a "*very strong economic case*" for doing so. The Fed has been below its inflation target for approaching four years. "*We are still in a world of very unbalanced risks*," Harris said. "*The Fed is close to the zero boundary, the global economy is weak, and overshooting on inflation is a minor problem*."

Nonetheless, the risk for investors relying on the Fed's shallower rate-hike projection is that officials could switch their message suddenly if inflation data comes in stronger than expected, leading them to raise rates at a faster pace!

The US Federal Reserve wants You to stop taking the Dot Plot so Seriously! (Count Me in!)

Since the day they were unveiled in January 2012, the Federal Reserve's interest rate forecasts have been criticized for taking on too much importance, though most recently their release has had minimal impact on financial markets. What is more, market participants often disagree with the dot plot, exposing a gap in communication that can be costly. For instance, when Fed officials released a fresh forecast on December 16th, the median of their estimates signaled four rate hikes for 2016, whereas investors were much more cautious: Pricing in interest rate futures markets suggested less than 10% probability that policy makers' rate-hike outlook was correct, according to data compiled by Bloomberg. Market perceptions of the central bank's intentions are crucial as they help set rates on everything from government bonds to mortgages and car loans, and the Fed wants investors to understand how their views change with new information. The dots simply cannot do that!

Furthermore, views at the Fed are very diverse (in financial market's jargon, such multiplicity results in Fed governors being labeled as hawks, doves or neutral), and the dots surely highlight this diversity. Earlier this month, for example, the range on Federal funds rate estimate was 0.6% to 1.4% for the end of 2016. For 2017 and 2018, the gaps were wider at 1.6% to 2.8% and 2.1% to 3.9% respectively.

When he introduced the dots in January, 2012, Fed Chairman Ben Bernanke was clear that they weren't "*unconditional pledges". "There is no mechanical relationship between these projections and the outcomes of the FOMC decisions,*" he said. Now Fed officials are trying to enforce that signal to preserve transparency, at a time dissatisfaction with the dots starts growing within the FOMC.

St. Louis Fed President James Bullard, a voting member of the policy-setting Federal Open Market Committee this year, said in a Bloomberg News interview last Wednesday that the rate projections contribute to uncertainty. "*I have even thought about dropping out unilaterally from the whole exercise*," he said. Additionally, Fed Vice Chairman Stanley Fischer is leading an internal subcommittee which is trying to figure out ways to tell the public that the dots are at best a guess in a moment in time about what rate would best achieve their economic forecasts. One proposal, revealed in minutes of the Fed's January 26-27th meeting, is to use a fan chart to illustrate how much uncertainty there is around the forecast (if a dot can confuse markets, just imagine what a fan would do!!). This could help the public understand that rates could be higher or lower than the dot plot's median estimate. Another possibility discussed by academics and former Fed officials is to leave the dots as they are and focus on describing scenarios instead. These would be charts of how policy makers would respond to shocks and surprises that diverge from their baseline outlook, or their best guess about how the economy and policy will develop. "*I like that idea better than a fan chart*", said Laura Rosner, U.S. economist at BNP Paribas NY. Yellen "*could walk us through the scenarios in her press conference and discuss how policy might respond*."

Until enhanced clarity/communication is agreed at the Fed and appropriately passed to markets, brace yourself for more confusion & price volatility!

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