FFTW Weekly Commentary

FOR PROFESSIONAL INVESTORS

You Ain't Seen Nothing Yet

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Key takeaways

- The Federal Reserve raised rates for the only the second time since 2008.
- Despite being forecast, the tone of the statement and press conference were hawkish.
- Look for yields to push higher, and even more dollar strength.

Full commentary

The Federal Reserve (Fed) raised interest rates for only the second time since 2008 at the Federal Open Market Committee (FOMC) meeting on December 14th to 0.75%, surprising absolutely no one, and yet the Fed still managed to intensify the sell-off in U.S Treasuries, and cause the U.S. dollar to strengthen even further. For a Fed meeting the outcome of which could not have been less surprising, these moves were unexpected in their strength. 5-year Notes bore the brunt of the sell-off, moving from around 1.89% to 2.05%, with yields managing to edge higher through the remainder of the week, though with the curve flattening somewhat. The U.S. dollar strengthened against all the other major currencies, with the Dollar Index (DXY) reaching 102.90 by the end of the week, its highest level since 2002.

This was caused first by changes in the FOMC members' forecasts - the "dots" – which showed a move from two to three hikes in 2017. In addition, the median long-run neutral Fed Funds rate was moved back to 3%. Both of these are small changes and are thought to indicate less a change in the Fed's thinking in aggregate, than a signaling from some of the more influential FOMC voters as to their views on the likely path of rates, and that we should expect some of the other members in essence to catch up in subsequent meetings. It follows that this may be less a literal expectation of one additional hike, than the beginning of a shift towards more rate hikes, coming more frequently.

The statement itself was, as usual, an exercise not unlike the child's game of looking at 20 objects, leaving the room, and returning to identify which one has changed. On this occasion though, while the framework of the text remained essentially the same, key phrases were added, including: "Market-based measures of inflation compensation have moved up *considerably*," and "In view of realized and *expected* labor market conditions and *inflation*, the Committee decided…" Indeed, most of the phrases implying hesitancy or equivocation were removed leaving, by the admittedly muted standards of these things, an unabashedly hawkish tone.

Lastly, Fed Chair Janet Yellen gave the now-customary press conference. It was notable mostly for her gymnastic effort not to be drawn on commentary as to future fiscal policy almost immediately falling flat on its face at the hurdle of pro-cyclical infrastructure spending: "I would say at this point that fiscal policy is not obviously needed to provide stimulus to help us get back to full employment," with the immediate caveat that, "nevertheless let me be careful that I am not trying to provide advice to the new administration or to Congress as to what is the appropriate stance for policy. There are many considerations that Congress needs to take account of and many bases for justifying changing fiscal policy." We await the change of administration and the Fed's reaction to it was interest.

Of more immediate relevance to the path of monetary policy was in response to the suggestion that the Fed had wished to get behind the curve: "I do want to make clear that I have not recommended running a hot economy as some sort of experiment." There has been a persistent assumption for much of 2016, arguably informed by previous Fed commentaries, that the Fed would be looking largely to wait until some form of equilibrium rate of growth and unemployment and crucially inflation had been reached before meaningfully increasing rates – as opposed to tightening commensurately with these developments so as to arrive at the supposed neutral Fed Funds rate in synchronicity with them. That Chair Yellen was so emphatic to the contrary really shatters this belief, and with is support for the idea this set of rate hikes might be different from previous hiking cycles to the extent it has not already been so.

What we are left with is the idea that rates have little support even at current levels, and that we should probably price an even stronger dollar. While the extent to which monetary conditions have already tightened through currency appreciation is considerable, the Chart of the Week aims to put this in context: as Bachman Turner Overdive put it back in 1974: You Ain't Seen Nothing Yet.

This week's market developments

Monday, December 12

- Japan Machine Tool Orders growth increased to -5.6% y.o.y. for November

Tuesday, December 13

- Germany CPI growth (final estimate) remained at 0.1% m.o.m. for November
- UK CPI growth increased to 0.2% m.o.m. for November
- UK PPI Output decreased to 0.0% m.o.m. for November

Wednesday, December 14

- Eurozone Industrial Production ex. Construction growth increase to -0.1% m.o.m. (s.a.) for October
- US Retail Sales Advance growth decreased to 0.1% m.o.m. for November
- US PPI Final Demand growth increased to 0.4% m.o.m. (s.a.) for November
- US Industrial Production growth decreased to -0.4% m.o.m. (s.a.) for November

Thursday, December 15

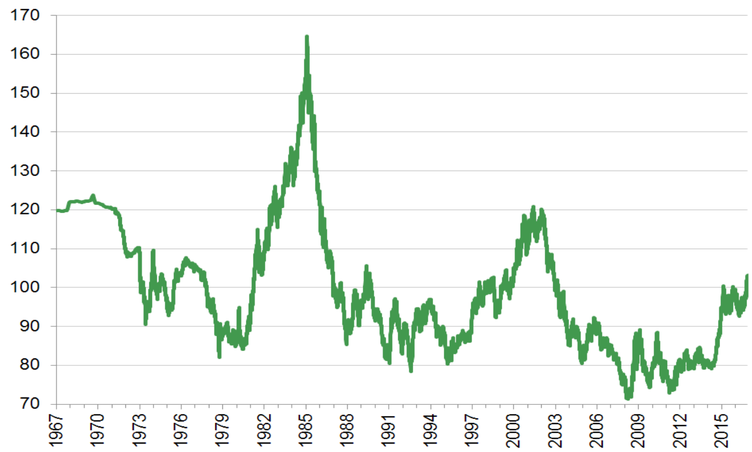
- US CPI growth decreased to 0.2% m.o.m. (s.a.) for November

Friday, December 16

- Eurozone CPI growth decreased to -0.1% m.o.m. (s.a.) for November
- US Housing Starts decreased to 1,090,000 for November

Source: Bloomberg, as of end December 19, 2016

Charts of the Week
U.S. Dollar Index 1/31/67 - 12/19/2016



Source: Bloomberg, as of end December 19, 2016

Central Bank Watch

	Last move	Date of move	Current policy rate	Implied 3m rate on March 2017 Interest Rates Futures Contract	Next meeting
Fed	+25 basis points	December 14, 2016	0.50 % - 0.75 %	0.68 %	February 1, 2017
ECB	-5 basis points	March 10, 2016	0.00%	-0.18 %	January 19, 2017
BoJ	-20 basis points	February 16, 2016	-0.10 % - 0.00%	0.07 %	December 20, 2016
BoE	-25 basis points	August 4, 2016	0.25 %	0.40 %	February 2, 2017

Source: Bloomberg, as of end December 19, 2016

Next week's market developments

Monday, December 19
- US Markit Services PMI (prelim estimate) is expected to decrease to 53.4 for December

Tuesday, December 20
- Japan All Industry Activity Index is expected to decrease to 0.1% m.o.m. (s.a.) for October

Wednesday, December 21
- Eurozone Consumer Confidence (advance estimate) is expected to decrease to -6.0
- US Existing Home Sales are expected to decrease to 5,500,000 for November

Thursday, December 22
- US 3rd Quarter Annualized GDP growth (third estimate) is expected to increase to 3.3% q.o.q.
- US 3rd Quarter Core PCE growth (third estimate) is expected to remain at 1.7% q.o.q.
- US Durable Goods Orders growth (prelim estimate) is expected to decrease to 4.9% m.o.m. for November
- US Personal Income growth is expected to decrease to 0.3% m.o.m. (s.a.) for November
- US Personal Spending growth is expected to remain at 0.3% m.o.m. (s.a.) for November
- US Leading Index growth is expected to remain at 0.1% m.o.m. (s.a.) for November

Friday, December 23
- UK 3rd Quarter GDP growth (final estimate) is expected to remain at 0.5% q.o.q.
- US New Home Sales growth is expected to increase to 575,000 for November

Source: Bloomberg, as of end December 19, 2016

Please note

The FFTW Weekly will not be produced on December 26, 2016 or January 2, 2017 due to the holidays. The next issue will be produced on January 9, 2017. FFTW wishes you and your family a wonderful holiday.