Deutsche Asset
& Wealth Management

CIO Flash
The Fed: Time for more excitement
Dec 14th, 2015

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A looming rate hike unlike most others

— When it comes to interest rates, watchers of the U.S. Federal Reserve (Fed) have long had it easy. For much of the past 11 years, market expectations have largery been met.
— Between June 2004 and June 2006, rates went up by 0.25% at every consecutive meeting of the Federal Open Market Committee (FOMC). Since December 2008, they were stuck at 0 to 0.25%.
— There is now near unanimous agreement that the Fed will raise rates at the FOMC meeting ending on December 16 – federal funds futures imply a 74% probability. Anything else would surprise markets. Markets are on the edge already, due to a plunging oil price, downward pressure on the Chinese yuan, and troubles in the high-yield market. With the hike widely anticipated, low liquidity in many asset classes ahead of Christmas would further accentuate price movements. This is hardly what the Fed would possibly want.

What to watch out for

— The real question is what will happen after the first hike. Having dramatically increased the size of its balance sheet after the financial crisis, the Fed now controls two levers. One is the federal funds rate. The other is how soon it changes its policy of reinvesting proceeds from maturing bonds.
— We see two more rate hikes in 2016 and no balance-sheet shrinkage until after the first few rate hikes. The Fed is entering uncharted waters. It has never before raised interest rates with trillions of dollars of excess reserves on its books. To get the federal funds rate to its new target range of 0.25 to 0.5%, it will need to increase both the interest paid on reserves to 0.5% and the overnight reverse repo rate to 0.25%. It is likely to wait and see how its first lever works, before it pulls the second.
— The Fed is likely to stress in its statement and the subsequent press conference that its decisions will depend on incoming data. Beyond that, we will watch out for the risks the Fed sees, signals that policy will remain accommodative and any dissent within the FOMC (which we think is unlikely).
— Markets will also pay close attention to the Fed's "dot plot", charting the target rates of FOMC participants going forward. However, note that this can be misleading, as some dots (i.e. those of the Fed leadership) carry more weight than others.

Market implications

— We would caution against reading too much into initial market reactions.
— For U.S.-treasuries, there may be some upward pressure on rates, probably most pronounced around 5 years of maturity. Any short-term movement in 10-year Treasury rates would pull yields on foreign bonds, such as Bunds, in the same direction.
— Longer term, we see the dollar strengthening. Beyond that, investors may well have to learn to live with greater uncertainty about the path of monetary policy. Having squeezed volatility in recent years, monetary policy may well have the opposite effect in the months to come. Watching the Fed looks set to become a lot more interesting.

Glossary

Explanation of terms

Bunds are issued by Germany's federal government, most frequently with a maturity of 10 years, and are the German equivalent of U.S. Treasury bonds.

Excess reserves are the capital reserves held by a bank or financial institution in excess of what is required by regulators.

The **federal funds rate** is the interest rate at which banks actively trade balances held at the Federal Reserve.

The **Federal Open Market Committee (FOMC)** is a committee that oversees the open-market operations of the U.S. Federal Reserve.

High-yield is often used as a shorthand for high-yield bonds.

Monetary policy focuses on controlling the supply of money with the ulterior motives of price stability, reducing unemployment, boosting growth etc. (depending on the central bank's mandate).

Overnight reverse repo rate is the rate at which the central bank of a country borrows money overnight, while posting securities from its bond portfolio as collateral. (The next day, the central bank returns the cash plus interest at the specified rate and takes back the bonds.) This helps put a floor under interest rates and is an important tool of monetary policy.

Treasuries are fixed-interest U.S. government debt securities with different maturities: Treasury bills (1 year maximum), Treasury notes (2 to 10 years), Treasury bonds (20 to 30 years), and Treasury Inflation Protected Securities (TIPS) (5, 10 and 30 years).

The **U.S. Federal Reserve Board (Fed)** is the board of governors of the Federal Reserve; it implements U.S. monetary policy.

Volatility is the degree of variation of a trading-price series over time.

Yuan refers to the Chinese yuan (CNY).

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