Harbour Navigator

US Fed holds the market's hand

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Markets breathed a sigh of relief today, after the US Federal Reserve (Fed) delivered a "dovish" hike, lifting the US Fed Funds Rate to a new range of 0.75% - 1.00%, but leaving their projections of future monetary policy unchanged for the end of 2017, 2018 and 2019. The US equity market rose around 1% in response, with the US dollar down around 1% on the day.

This was a very well telegraphed hike from the Fed. A little over a month ago, the market was only placing a 20% - 30% probability on the chance of a rise in the Fed Funds at this March meeting. However, in recent weeks pricing jumped to 90% - 100%, after a series of speeches and testimonies from FOMC members left the market with no doubt that a March move was a done deal. The continued US job creation and convergence of US inflation to the 2% target had made a compelling case for the Fed to deliver on the first of 3 hikes that they had projected for 2017 back in December.

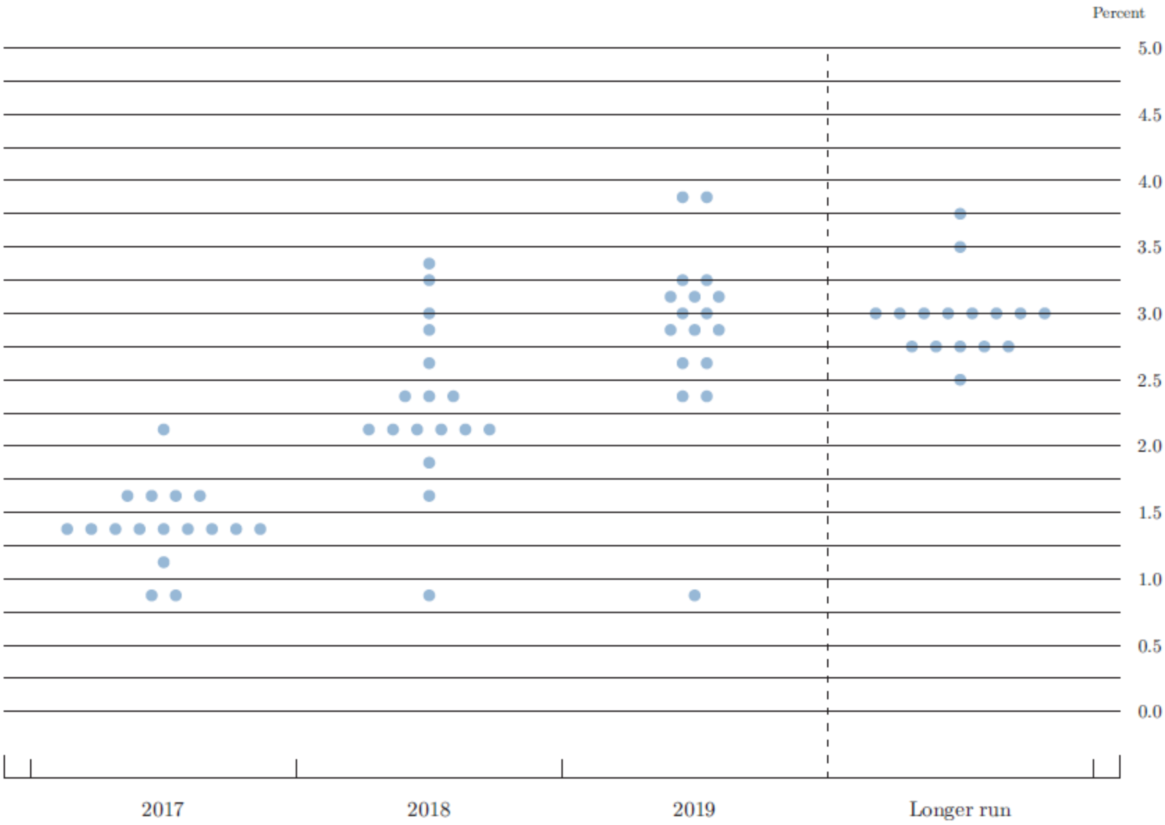
The market's fear going into this Fed decision was that the US economic data had been so encouraging that it would prompt the Fed to signal a more aggressive path of hikes in years to come. This did not happen. The median 'dot plots' for the end of 2017, 2018 and 2019 were unchanged at 1.375%, 2.125% and 3.0% respectively (see chart.) Indeed, the main change was that the range of dot plots for individual FOMC members has converged closer to these median forecasts, implying more consensus amongst the committee on the outlook.

In New Zealand, as global interest rates continue to rise, this may constrain the near term performance of New Zealand interest rate sensitive stocks, including electricity generation retailers. If long term bond yields increase, investors have less need to buy stocks with low growth but high certainty dividend income. However, if US interest rates are increasing because the economy is strong, some New Zealand companies with exposure into the US may do relatively well as their target market strengths.

While the US dollar took a breather today, as the Fed has signalled tighter monetary policy this has tended to lift the US dollar and take the pressure off the NZ dollar. As a result, the NZ Trade-Weighted Index (TWI) is down 4.5% since its February peak. This will be a welcome development for the Reserve Bank of NZ.

Central banks are always at pains to emphasise that future monetary policy decisions are 'data dependent'. If the economic data changes, so does the outlook for interest rates. Today's FOMC statement was once again silent on the inflationary implications of Trump's agenda for fiscal, infrastructure and trade policies. As the Trump administration produces more concrete policy details and progress with Congress becomes clearer, the Fed will be able to formally incorporate the implications into their own projections. In this sense, monetary policy may have moved from being 'data dependent' to being 'policy dependent'.

Chart 1. FOMC member's projections for the US Fed Funds Rate



Source: US Federal Reserve Board.

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