FOMC 16 Dec 2015

The Fed has form. When it wants to take away the punchbowl, it usually telegraphs its intentions well in advance so partygoers have time to go buy their own moonshine. So it was with QE taper, signaled in 2013, executed in 2014. By the time the Fed stopped net purchases of bonds the market had digested the eventuality and 10 year US treasury yields ended 2014 lower than at the beginning. The idea behind this is simple; the Fed wants to give the economy time to prepare for tighter policy, and constantly communicates with the market, managing expectations until when the move comes, the reaction is one of indifference. As we have seen in September, sometimes, the expectation becomes so entrenched that failure to act as signaled results in disappointment.

Forward guidance was meant more narrowly to mean central banks promising to keep interest rates lower for a longer period than signaled by traditional reaction function, an augmentation to policy once the traditional and the traditionally extraordinary have been exhausted, a last resort. Today, could it be interpreted as a more detailed statement about the intended objectives of the Fed, not just at the front end of the curve but across the curve as well? The Fed wants to hike rates, but it doesn’t want 10 year or 30 year yields to rise excessive or at all. Hence the numerous signals that the path of rate hikes will be slow, that inflation risk is de minimis, that treasury bonds will be in short supply, and so on.

Surely today, the Fed has once again engineered conditions to its tastes. The market expects a rate hike of 25 basis points, and little impact if any at the long end of the term structure. Quite in line with what the Fed intends.