Expect an upbeat Fed, but markets aren't convinced

What about sluggish inflation and low wage growth? The markets question the Fed's Janet Yellen as the central bank meets.

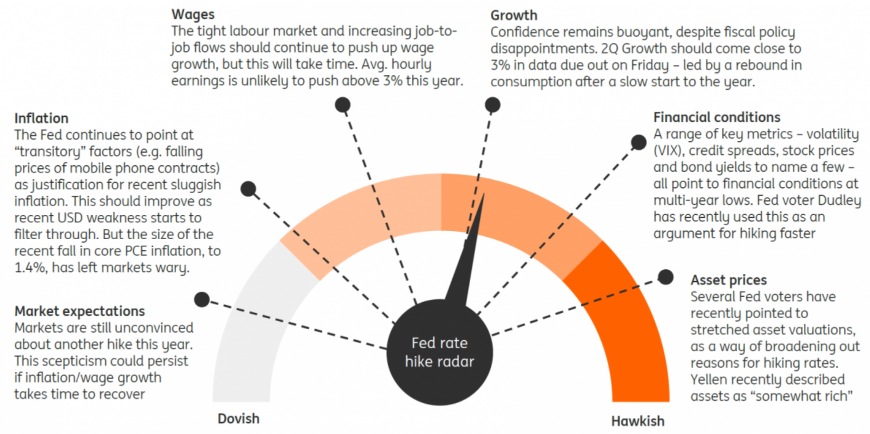
Source: Federal Reserve

Markets and Fed at odds over rate hike timing

We expect the Fed to stay relatively upbeat this week, despite recent mixed economic data. But markets will be particularly interested in the Fed's thoughts on recent sluggish inflation readings, which have caused a big divide between the Fed's rate hike projections (four hikes by the end of 2018) and market expectations, seeing as barely one has been priced in.

We suspect the next hike won't come until December, while the Fed keeps an eye on recent inflation developments. We'll also be watching closely for any fresh hints on the timing of balance sheet reduction; we think this will be announced in September for an October start. Looking further ahead, we still forecast two Fed rate hikes in 2018, with recent comments on asset price valuations and loose financial conditions suggesting Fed officials are broadening out their reasoning for tighter monetary policy.

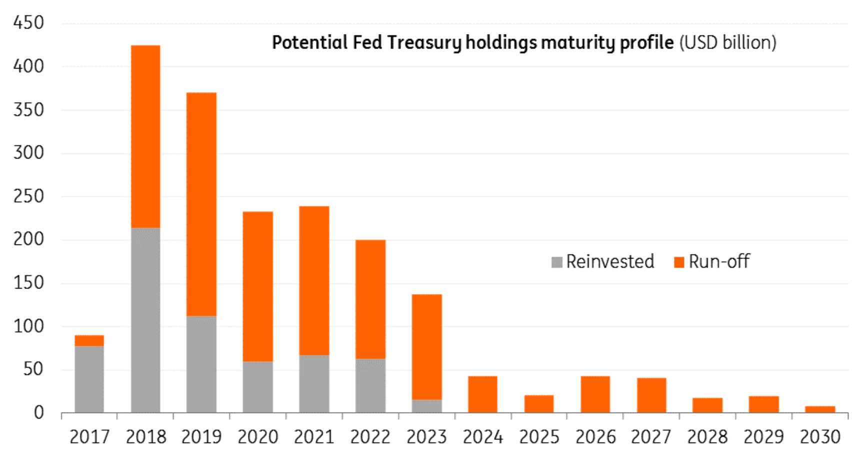
Fed rate hike radar: December hike looking more likely than September



Clues on balance sheet reduction in focus

The plan is to start the process with USD10bn per month in balance sheet shrinkage – USD6bn from Treasuries, USD4bn from agency & mortgage-backed securities (MBS) – rising by similar amounts at three-month intervals over 12 months until the monthly 'caps' for Treasuries and MBS reach USD30bn and USD20bn, respectively.

If the Fed were to start the process in October, only USD197bn of the USD425bn in maturing Treasuries in 2018 would still be reinvested.There's a risk that the Fed hints in this week's statement that the process could commence "soon" – an implicit signal ahead of the next meeting in September.



Source: Bloomberg, ING Debt Strategy Team calculations

Market Impact

Markets seem to be priced correctly for a September balance sheet policy change, with investors still undecided over a December hike. A 'status quo' Fed statement could be mildly supportive for a politically plagued dollar. For global markets, we are shifting to the idea that a rise in long-term yields, driven by a pickup in the term premium, may be the lesser of two evils; risky assets stand a better chance of withstanding such a bond market adjustment, rather than a sharp repricing of policy rate expectations.

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