Economic Commentary

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Fed Meeting Tomorrow: No Hike in Rates, … Yet

The FOMC is holding its third regularly scheduled meeting in Washington, D.C. tomorrow amid increasing evidence that the risk of deflation has dissipated and concern over the timing of the next hike in rates builds up.

The almost unanimous assessment of analysts and bond traders is that there will be no rise in rates tomorrow. What is the subject of speculation is what the change in the Fed's statement that accompanies the decision will be. I believe that the Fed will remove its deflation watch and say –as the Fed Chairman himself stated in Congressional testimony two weeks ago- that "the probability of an unwelcome fall in inflation has diminished in recent months and now appears almost equal to that of a rise in inflation", in other words that the risks between inflation and deflation are now balanced.

Such a change in view is the precursor to the expected and inevitable rise in rates, which is on its way, sooner or later. The question is how soon? Since last months March employment report the market has markedly stepped up its expectations for the turn in Fed policy direction. Tomorrow's FOMC statement and Friday's report on payroll growth will leave a volatile week for the funds futures market.

Currently, the July federal funds futures contract puts the probability of a rate tightening at the June 30th FOMC meeting at 44%, the August futures contract, at 1.27%, prices fully a 25 basis point hike in the August 10th FOMC meeting while the October futures contract price, currently at 1.51%, prices in a second 25 basis point hike at the September 21st FOMC meeting.

While one should not expect the Fed patience to be ever-lasting, one must also not expect the FOMC to jump too quickly given the remaining economic excesses and low core inflation. My view is that the Fed will talk up the need for higher rates for now, but it will hold back on rate hikes a little longer to give the recovery a stronger footing. One month's positive employment data is still not enough. The Fed would like to see the April employment report that will be released this Friday (May 7th) and would like to see payroll numbers to start approximating the levels before the economy went into recession. Besides, inflationary pressures are still tame for now with the core CPI rate of inflation at 1.6% and Greenspan's favoured core PCE price inflation at 1.4%. I expect to see the first hike if not at the September meeting most probably by the November meeting.

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