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Cross Market Reactions

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FOMC Preview

How are the Markets Positioned for FOMC?

Since Monday, the markets have been thinking about nothing other than tomorrow's Federal Reserve monetary policy meeting. Traders have already begun to position for it as they send the stock market, US dollar and bond yields higher. Even though yields on the 10 year notes and December Eurodollar futures have been moving up significantly, Fed fund futures have not budged much, indicating that regardless of how the Fed sways, the key takeaway point is that interest rates will be left unchanged. The stock and FX markets have not recognized this, but with both the Dow Jones Industrial Average and the EUR/USD at key levels, these markets may only have a limited reaction to a hawkish tone in the FOMC statement.

What are the Fed's options?

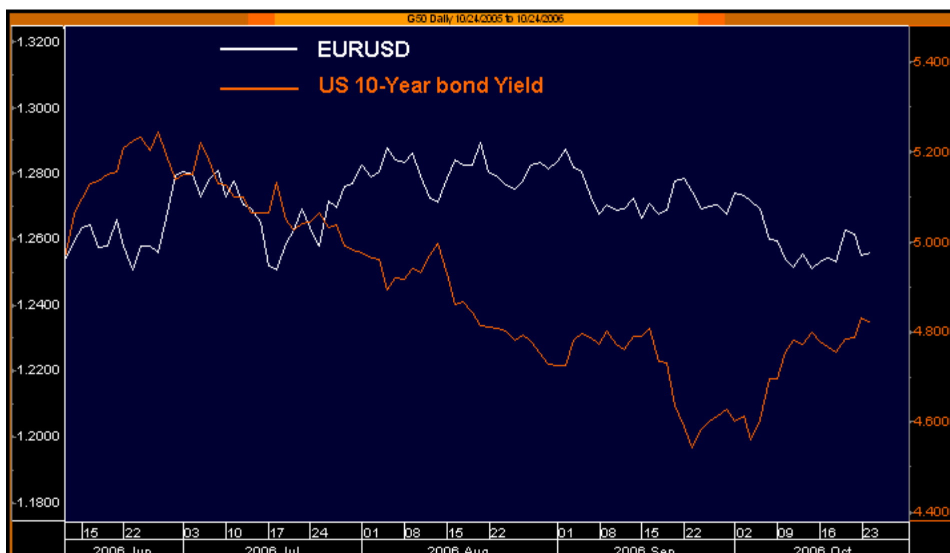
To answer this question, we look at what the Fed is not expected to do, which is to increase or decrease interest rates from its current level of 5.25 percent. However what they could do is to change their assessment of the economy and price stability. Even though recent economic data have been far from stellar, the details of the reports suggest that there is still enough underlying strength to keep the economy running. In regards to price stability, core prices tend to lag headline prices and for the time being, core price inflation remains persistently strong. Individual Fed Presidents have already raised concern about the high level of core rates, which suggests that the statement could make that view official. Yet judging from the recent movements in the bond and currency markets, most traders have already priced this in, which raises the question of how much more the US dollar and yields can rise if the Fed really is hawkish. The 1.2500 level in the EUR/USD and the 120 level in USD/JPY have proven to be tough barriers to break in many previous instances and unless the Fed is ultra hawkish, they could continue to hold. The case for an ultra hawkish statement is weak as the strong earnings reports in the market as a whole mask the weakness in companies like Ford and Caterpillar. Furthermore, sparking speculation of a return to rate hikes could be disastrous for the US consumers who are stretched thin on borrowed credit. Therefore, we believe that traders have greatly overestimated the hawkish intent of the Fed. At best the Central Bank is likely to keep rates steady in the next few quarters rather than raise them.

Bonds – 10 Year Notes

Looking to 10 year treasury yields, they have broadly trended higher since the beginning of this month as investors are already beginning to push back any possibility of a Fed rate cut. Having hit a high in July, treasury yields have fallen significantly up until the month of September as traders bet on a housing market collapse and high oil prices putting a big dent on the US economy. However since the beginning of October, yields have perked up as the underlying strength seen in the details of previous economic releases such as non-farm payrolls and retail sales suggest that the economy is not losing enough steam to warrant a rate cut. In addition, the jump in the core CPI release last Tuesday to a 10 year high has already pushed yields even higher. With a 20 plus basis point rise in yields since the beginning of the month, hawkish comments from the Fed tomorrow may have already been priced into the market suggesting that a further rise in yields may be difficult.

Source: Bloomberg (10 Year Treasury Note - Daily)

The chart below shows the clear relationship between US Bond yields and the EURUSD currency pair. The US dollar began a clear turn in early October, as markets pared bets that the Fed would cut rates in the coming quarters giving traders the confidence to send the US dollar higher. In fact, over the past month, the EUR/USD has already fallen over 200 pips. Indeed, this coincided with a pronounced drop in bond prices, with yields rallying off of 10-month lows. More recently, however, the EURUSD has had great difficulty breaking the psychologically significant 1.2500 barrier, while bond yields have similarly stalled at just above 4.8 percent. These developments suggest that traders have sufficiently discounted the likelihood of steady interest rates through the medium term. As such, the risks remain to the upside for the EURUSD, which stands to benefit if the FOMC is considerably less hawkish than Dollar bulls would hope for. A subsequent drop in bond yields would likely spell the end to the Greenback's recent ascent, as it hovers near 6-month highs against its European counterpart.



Source: Bloomberg (EURUSD vs. 10-Year T-Note Yield)

Equities – Dow Jones Industrial Average

Stocks on the other hand have continued to remain strong. In fact, US shares have grown to unprecedented levels, consistently setting new record highs for four consecutive sessions. If the market expects hawkish comments from the Fed, the stock market does not show it. Strong earnings and persistently low oil prices have kept stock market traders very optimistic but today's rather mild rally shows hesitation. Not all companies participated in the strong earning releases. Yesterday, we had warnings from Ford and Caterpillar. Today, we had weaker results from Texas Instruments. Should hawkish comments come out of the Fed, the reaction in the stock market could be far sharper than the reaction in other markets. Bond and FX markets tend to be a far more accurate reflection of how the US economy is really performing which suggest that we could see a top soon in stocks. Yet, should the stock market be right, be ready for another high in the Dow.

Source: Bloomberg (Dow Jones Industrial Index - Daily)

Looking Beyond October

Over the longer term, status quo by the Fed or even mildly hawkish comments does not mean that a rate hike will come before a cut. Taking a look at the chart below, which compares core price inflation with the Fed Funds rate, the Fed rarely cares about the rise in core prices and have frequently cut rates before core CPI hits a peak. Instead, since the 80s, the trend of Fed Fund rates has been far more aligned with the movements of headline inflation than core price inflation, which means that even if the Fed is slightly more hawkish tomorrow, they could still cut rates later in the year. It is just that for the time being, the stock market has rallied too much for them to cut rates, but once it begins to top out, we may see the Fed begin to focus less on inflation and more on growth. This validates our belief that hawkish comments from the Fed will have less of an impact on the global markets than dovish comments. The market is looking for the Fed to talk about the rise in core prices and the return of inflation pressures, if they do not, the dollar could suffer greatly.

Source: Bloomberg (Annualized Core CPI vs. Fed Funds Rate)