

J E R E M Y
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Fed is Ready for December and so are the Markets

Friday, 3:55 a.m. EDT

The Fed gave a clear signal last week that, if the current economic data do not deteriorate, they will be ready to raise the funds rate in December. This signal was made by (1) removing the sentence implying that the Fed was worried about “global risks” impacting the US economy, and (2) the change in language in the directive to “whether it will be appropriate to change the rate at the next meeting,” from “how long” the Fed decides to maintain the current low rate. Stocks, initially sold off on the news, but rallied strongly later in the day as the uncertainty surrounding the hike date was reduced and the Fed indicated it was no longer worried about global developments, one of the reasons for the August stock plunge.

The January Fed funds rate, the first full month to reflect a December decision, now trades at 25 bps, which on the surface predicts a 50-50 chance of an increase. However, there are several reasons why that is an underestimate. First the Fed may initially target the lower end of the range and secondly, the futures rate may be a downward biased estimate of the expected funds rate since investors may buy these contracts as a hedge against negative economic shocks, i.e., the futures contract becomes a “negative beta” asset.

Although the stock market changed direction Wednesday afternoon, bonds did not and yields jumped substantially. Nevertheless, I don’t expect the ten-year to rise much above 2.50% this year or 3% next. The deflationary forces in the economy combined with slow growth and still large liquidity demands will keep rates low. The early call for next Friday payroll number is 181k, up 39k from the weak September number and a one tenth reduction in the unemployment rate to 5.0%. If the unemployment rate drops, the Fed will be on track for a December tightening.

There were positive developments for the Republicans this week. Certainly Paul Ryan election’s to Speaker of House put a serious and thoughtful lawmaker in charge of the House agenda. And another strong performance by Marco Rubio in the debates solidifies his support among establishment Republican voters. In my view, Rubio has the best chance against Hillary Clinton, although the odds are still long. The electorate is looking for a new face, and Clinton versus Bush will just not do it. Republican operatives just have to figure out how to keep Trump or Carson from nabbing the nomination first. There is still a lot of time before the primaries and no reason yet for desperate measures.

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