Weekly Commentary September 11, 2015

JEREMY SIEGEL .com

Fed Call: Hike With Dovish Language, Dot Plot Lower

Friday, 10:15 am EDT

There is no question that the Fed is coming into next week's meeting divided on whether to raise rates or not. It will be Janet Yellen's job (along with vice-chair Stan Fischer) to mold a directive that will satisfy the vast majority of the FOMC. I think they can do it.

The news since last week's labor market report has continued to argue for an increase. Today's PPI (Producer Price Index) data were on the "hot" side of expectations. Earlier in the week, the JOLTS job survey showed a record number of job openings. There is no question that Janet Yellen's labor market "dashboard" is flashing orange if not red. You could scarcely ask for a better set of labor market indicators showing that most, if not all of the labor market slack created by the Great Recession has now been absorbed. Today's PPI data (and commodity prices off their lows) also indicate that if inflation is not approaching its target, it is not falling further from it either. That may be reinforced by the August CPI date that will be released at 8:30 a.m. on the first day of FOMC meeting.

There is much that is made about the Federal Funds Futures market indicating a low probability of a hike. But one has to been careful interpreting that market data. Currently, the October funds futures rate is 19.5 bps, 7 bps higher than the midpoint of the current range. If one assumes the Fed will target the midpoint of the next range of 25 bps to 50 bps at 37.5 bps, then 19.5 bps is only 28% of the distance between them, indicating a 2-1 to 3-1 odds *against* tightening. But what if the Fed should start out targeting the bottom of the new range at 25 bps? Then the October rate is 60% of distance between the points, indicating a 3-2 odds *in favor* of an increase. The Fed has not indicated how it will target the rate, so interpreting the funds futures market is difficult. If the Fed decides to hike, I am sure they will wrap the directive in an extremely dovish package. Yellen may choose to use the term "patient" to describe the next increase, indicating that the Fed will take its time assessing the economy's reaction. Yellen had previously defined "patient" as "at least 2 meetings" and that would put a "one and done" label on the Fed's action for 2015.

As the week progresses, trading is apt to slow dramatically as investors wait for the decision. If, at 2:00 p.m. on Thursday, traders see the word "Rate Hike" in the scrolling headlines, I expect an immediate downward spike in equity prices, but as the words "Lower Dot Plot" and/or "Can be Patient" scroll seconds later, equities could recover smartly as finally this uncertainty gets resolved. On the other hand, a "no increase" decision would lead to an initial equity price jump, but those gains could fade as the market realizes it will have to go through more weeks of uncertainty about when the first increase will occur. It is time for the Fed to take that uncertainty out of the market.
