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Economic Update

THOUGHTS FROM OUR ECONOMICS TEAM

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INFLATIONISTAS DEFLATED

Investors expected accelerating inflation to bring rate hikes sooner. Has a rethink occurred?

Through the first half of 2014, many traders and strategists in the US rates market were convinced: the Fed was behind the curve. One Wall Street strategist was particularly adamant and summed up sentiment nicely: "The more rates markets believe in the lower neutral fed funds story the more it will be wrong. Because [sic] the longer rates stay too low the more it will boost the economy and hence inflation, and if inflation goes up faster then the Fed will have to hike faster and overshoot the neutral fed funds rate to keep inflation under control."

At the time such thinking might have seemed appropriate. The unemployment rate was falling fast (down nearly 1% in 2014). Growth began to rebound in the second quarter. Next, it was assumed, inflation would accelerate. The Fed itself forecasted a return to 2% inflation and reiterated the view that low rates of inflation experienced in recent years were "temporary." But inflation has hardly moved. And the low inflation environment goes well beyond US shores. Core measures of inflation are +0.3% in Europe year-over-year, 1.2% in the UK, 1.3% in Japan, 1.6% in China and 1.5% in the US. We attribute at least some of the recent move in rates markets to a reassessment of the inflation story. The new conclusion: low inflation means later rate hikes.

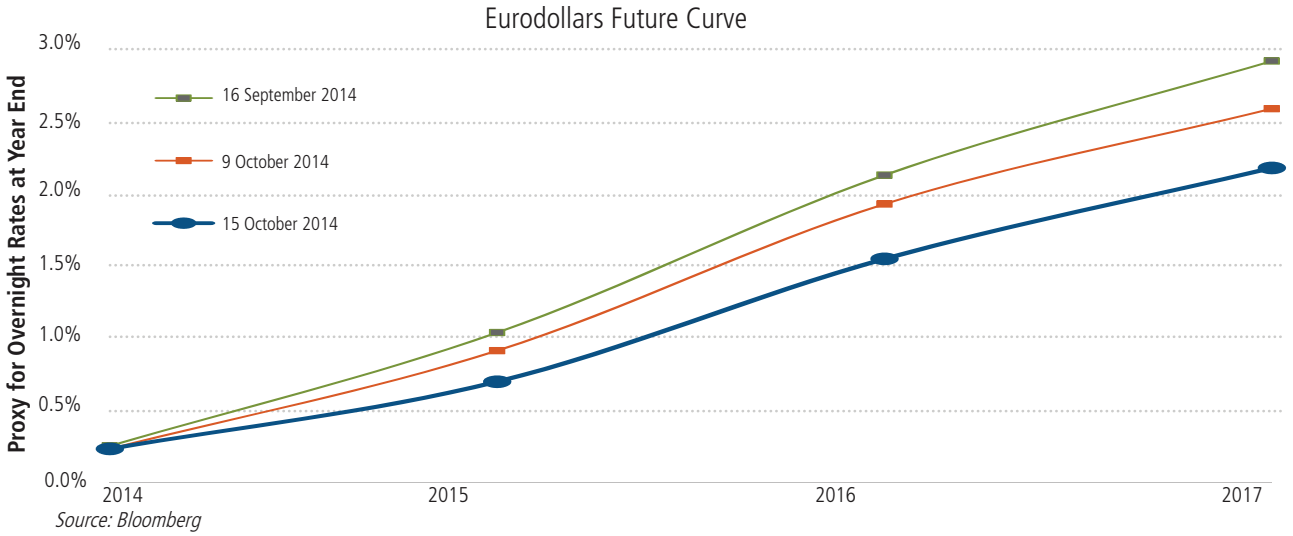
Evidence for the re-think comes from the Eurodollar futures market. In this market, investors trade contracts which price the future interest rate on 3-month dollar deposits outside of the United States. As the most inclusive short-term market for dollars, the Eurodollar market is one of the most liquid in the world. Because of its popularity, Eurodollar futures offer investors a view on the market's vision of the path of future short-term interest rates.

The chart below plots the various Eurodollar futures contracts over a long time horizon. What we see is that in the past month, market participants have substantially revised down their expectations for the level of short-term interest rates. One month ago, the market envisioned the short rates at roughly 1.05% at the end of 2015 (that is roughly three 25 basis point interest rate hikes from current levels). Now, futures contracts clear at a rate of just 0.70% for overnight dollar deposits.

The re-pricing has profound consequences for the entire Treasury yield curve and for fixed-income securities in general. One needs only observe price action in bond markets in the past week to discover the chaos wrought by speculation over Fed policy. More specifically, though, if inflation continues to run below the FOMC's 2% target then interest rate hikes come later. If front end rates are lower and inflation remains subdued, longer-term interest rates could hover at lower levels as well.

So what's the Fed to do? One approach: prolong QE. We don't like this because a) there is scant empirical evidence QE actually works in generating inflation (in our view and as evidenced by the absence of inflation despite 5 years of QE) and b) even the theoretical evidence for QE is shaky (in the view of the world's foremost monetary policy theorist, Michael Woodford). Instead, it is more likely that the Fed could push out market expectations of the first rate hike as a means to address a perceived low inflation problem. In a sense, that's already happened with several Fed speakers in recent days reiterating the data-dependent nature of monetary policy: lower inflation (coupled with the global economic risk du jour) means later rate hikes.

ESTIMATES OF FUTURE INTEREST RATES HAVE DECLINED OVER THE LAST MONTH



Source: Bloomberg