When It Comes to Predicting a Fed Rate Hike This Week, Here's Why You're Probably Wrong

By Emily Stewart
December 14, 2015

If the Federal Reserve doesn't raise interest rates in December, it wouldn't be the first time this year it's faked us out.

Fed officials are widely expected to boost the benchmark federal-funds rate on Wednesday for the first time in nearly a decade. According to a *Wall Street Journal* survey, 97% of business and academic economists expect an increase to happen.

But don't count your interest rate chickens before they hatch: in August, a similar *WSJ* survey had 82% of respondents predicting a rate hike in September, and we all know what happened with that.

The Fed has balked on a rate boost all year, leaving plenty of anticipatory forecasters, journalists and traders looking like Miss Cleo.

"Traders bet the Fed will start raising rates next July," read the headline of a *Reuters* piece published last December, citing a strong jobs report. At the time, rate-futures contracts showed traders perceiving a 53% likelihood of the first hike to come mid-year.

The February jobs report sparked rate hike speculation as well -- and a strong market reaction. The Dow Jones Industrial Average tumbled 270 points the day workforce numbers were released on fear of a Fed rate increase.

In March, a *Reuters* poll had about half of a group of 70 economists anticipating an increase in June, and a *WSJ* survey had similar findings, with about half of respondents predicting a mid-year rate hike (the other half bet on September).

"The Fed is going to raise rates in June," *Business Insider* declared.

The summer came and went, and still no rate hike.

"The problem in June was that there was a significant scare in Europe...so the Fed postponed, they chose not to act as a precaution, to be on the safe side," said **Bernie Baumohl, chief global economist at the Economic Outlook Group**, a forecasting advisory services company.

"Many participants expressed concern that a failure of Greece and its official creditors to resolve their differences could result in disruptions in the financial markets in the euro era, with possible spillover effects on the United States," the FOMC's June meeting minutes read. They also note that "some participants reiterated the importance of effective Committee communications in reducing the likelihood of an outsized financial market reaction around the time that policy normalization begins."

Fed Chair Janet Yellen said at a news conference after the June meeting that "it would be wrong" to provide a road map on rate increase timing, but many set their sights on a hike in September.

"Fed will raise rates in September," read a *MarketWatch* headline in July. A mid-August Bankrate survey of economists found two-thirds of respondents anticipated a September rate hike, and the aforementioned *WSJ* poll had even more predicting an increase.

But when market turmoil hit in August, spurred in part by China's surprise currency devaluation, doubts about what weeks before appeared all but inevitable began to seep in.

New York Fed President William Dudley said the prospect of a September rate hike "seems less compelling," and the proportion of economists in that Bankrate survey predicting an increase dropped to 40%.

Still, some stuck to their bets.

"China hasn't closed the door on September," wrote *WSJ* Heard on the Street reporter Justin Lahart in late August.

Even within the committee there appeared to be quite a bit of dissent.

Richmond Fed president Jeffrey Lacker laid out his case against further delay in early September. "I am not arguing that the economy is perfect, but nor is it on the ropes, requiring zero interest rates to get back into the ring," he said. "It's time to align our monetary policy with the significant progress we have made."

Just days prior, Dennis Lockhart, president of the Atlanta Fed, said the chances of a September rate hike were "50-50." In July, long before market uncertainty hit, Chicago's Charles Evans said he didn't want to see an increase until mid-2016.

On September 17, at the close of the FOMC meeting, the committee announced that it would hold off once more, citing "global economic and financial developments."

"Again, the Fed came to the conclusion that it probably would not be a great idea to time the first rate increase in 10 years when there was such uncertainty and anxiety," **Baumohl** said.

Why has the timing of the Fed rate hike been so hard to predict?

According to Edward Leamer, professor of economics at UCLA and director of UCLA Anderson Forecast, it's because it's not just a question of economics -- it's also psychology.

"If you do the econometric modeling, the forecasting-type models, they long ago were calling for rate increases," he said. "The Fed overestimates the influence that they have on the economy. They're like the Wizard of Oz who doesn't realize that the levers they're pulling don't have much impact."

Others, however, say the decision to hold off has made economic sense.

"I think they are responding to the data. They've been about to raise rates, and then there would be weakness, most recently in September," said Dean Baker, a macroeconomist and co-founder of the Center for Economic and Policy Research, a left-leaning think tank based in Washington, D.C.

Or maybe it wasn't so much about psychology or data but a nebulous conception of "timing," like the perfect moment to steal a kiss on a first date.

"What the Fed was looking for was the right opportunity," said **Baumohl**.

Or maybe a better way to look at it is through the eyes of a child experimenting with the world around her -- just trying something to see the result.

"In some ways, the best argument for raising rates is to see what would happen," said Baker. "It might be helpful to see, okay, what happens if you raise it a quarter point? Do markets go nuts, or do they say, 'Okay, it's a quarter point, no big deal.'"

So, will the Fed finally raise rates this month? Most on Wall Street appear to think so.

Credit Suisse CEO Tidjane Thiam said in a November interview he expects the Fed to move this month. Goldman Sachs has had its money on a December increase since June. Some 80% of respondents to a *WSJ* survey believe the Fed's credibility would be damaged if it doesn't finally act.

Will the psychology, data and timing issues evaporate as this week's meeting and result in an increase? There are no guarantees.

November's strong jobs report may encourage the Fed to test the waters. But if recent history is any indication, the Fed could get spooked and hold off.

"These are like medieval doctors who are handing out leeches and bloodletting, and the patient isn't improving. As long as the patient doesn't improve, they're going to prescribe more leeches and bloodletting," said Leamer. "You've got to figure out when the doctor's going to call a halt to that."

###