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Why the Fed May Leave Markets Hanging on Interest Rates For a While

The Fed left clues that it's in no hurry to raise rates; one economist says the central bank may be worried that a 'bizarre' presidential campaign will hurt hiring.

Tim Mullaney June 15, 2016

The Federal Reserve didn't just leave short-term interest rates unchanged -- it also left a trail of Reese's Pieces that suggest its next hike won't come until December.

The clues are in the central bank's statements, both the written ones and those made by Fed Chair Janet Yellen during a news conference at the end of the monetary policy committee's two-day meeting.

In some ways, the bank's written statement reads like a defense of the economy and a case for boosting rates as soon as September. It says growth has picked up since the Fed's April meeting, that household spending is accelerating and that a drag from exports has lessened. All those statements are more bullish -- and thus hawkish for rates -- than the central bank's explanation of its decision to leave the Federal Funds Rate alone.

But ah, the details.

Detail 1: The Fed cut its economic projections, estimating the economy will grow just 2% this year, down from a 2.4% estimate as recently as January and 2.2% in March.

Detail 2: Members of the committee also altered their estimates of appropriate short-term interest rates from now through 2018. True, a dot chart included in the documents still shows nearly all of the committee leaning toward rates of 0.75% to 1% at the end of this year -- which means two rate increases.

But that's still more dovish than the outlook from the Fed's March meeting,Moody's Analytics economist Ryan Sweet said. And that suggests the Fed may have more surprises up its sleeve.

"The dots have two hikes this year, but a number of Fed officials moved from 2 to 1," Sweet said in an e-mail referring to a chart that assigns one dot to each of the participants in the monetary policy meeting. "My gut is that one of those dots is Yellen."

It's a significant surprise, since data other than May's jobs report has been consistently strong. Futures markets have been betting heavily on a hike by September.

The biggest indicator that the Fed will not raise soon is probably language, both in the press conference and the statement, acknowledging that market-based measures of inflation expectations have actually been dipping recently, even as the 12-month increases in the consumer price index edge above 2%.

The Fed relies on a different measure that Yellen said is still around 1.5%. Absent inflationary pressure, the Fed doesn't have a short-term reason to rush into higher rates.

And there is still a very muddled political picture to consider, both in the U.S. and Europe, said **Bernard Baumohl, chief economist at the** Economic Outlook Group**.** "The Fed is starting to worry that employers may be paring back hiring because this bizarre presidential campaign has terribly clouded the economic outlook," **Baumohl** said. "Add to that the close vote on whether Britain leaves the European Union and the implications this may have on global financial markets next week. Finally, there are the unintended consequences that stem from the growing divergence between U.S. and foreign monetary policies. Had the Fed tightened, it would have lifted the dollar, hurt exports and threatened deflation."

The Fed is walking a line, basically. By emphasizing the real economy's improvements since March, it is trying to reinforce the pickup in housing and consumer spending Yellen mentioned, which is good for stocks fromAmazon and Wal-Mart to home builders Toll Brothers and D.R. Horton.

By emphasizing how much the drag from exports has lessened, the central bank feeds bullishness about exporters from Boeing to Caterpillar.

If there was one clear goal in Yellen's remarks, it was to make sure people don't read too much into the May jobs report that convinced people that the economy's expansion might be in trouble.

"It's important not to overreact to one or two monthly readings," Yellen said.

She's right that the balance of new evidence since the Fed's last meeting has been increasingly positive. She might be exaggerating how quiet inflation is.

But for investors who just want to know what the meeting means about when rates may next rise, the answer appears to be December. Futures markets aren't yet taking that for granted, but the odds of waiting until then have moved up seven percentage points in the past 24 hours.

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