The Fed And The Coming Rate Hike. Between A Rock And A Hard Place.

What will the Fed do?

The Fed might raise rates in September because:

- It wants to reset a policy tool.
- It honestly thinks that inflation is a future risk and that the labour market is sufficiently healthy.
- It has signaled to the market that it wants to raise rates and if it doesn't the current market volatility will get worse.
- If it postpones a rate hike to December things might look worse and if it doesn't raise rates this year, the market reaction might be even more severe.

The Fed might postpone a rate hike because:

- There is no sign of inflation anywhere.
- Even the labour market strength is hardly excessive.
- USD strength may be exacerbated and this is already hurting profits.
- Markets have already tightened credit and liquidity conditions on behalf of the Fed.
- Recent equity market weakness around the globe may cause a negative wealth effect.

If the Fed stays in September, it might have to move in December because:

- If it doesn't it will be a signal of a weak economy which would spook markets further and could end up tightening liquidity conditions.
- It would have a pretty hard time managing expectations. If it didn't hike this year it would have to prepare the markets well before December and guide the market toward an early 2016 move.

Conclusions:

- If the Fed moves in September it will be raising rates into a slowing global economy, if not a slowing US economy. The US economy is likely still stable but is not overheating and an early rate hike will slow it down. The impact on the short end of the treasury curve will be quite direct, as one would expect, but the impact on the long end might be to suppress it. The curve is more likely to flatten. The impact on the USD would be negative. A rate decision in September would take away the expectations supporting the USD since the next rate hike would probably skip a couple of meetings and be no more than 25 basis points. USD weakness would put pressure on European and Japanese equities via the EUR and JPY as funding currencies.

- If the Fed doesn’t move in September it will be under pressure to move in December. Delaying into 2016 may be taken as a sign of weakness which could increase volatility and likely depress equity and credit markets. The impact of a delay to December will be positive for USD as it keeps the prospect of a rate hike on the table. The impact on European and Japanese equity markets is likely to be positive through the EUR and JPY as funding currencies.
- Looking at general conditions the Fed may have to delay liftoff indefinitely and only raise rates when data suggests it is suitable to do so. This will likely introduce short term volatility into treasuries and credit markets and weaken the dollar in the short term but keep it on a firm footing over the long term. The dollar will probably only weaken after a rate hike and not before.