Fed rate hike: Further monetary tightening expected amid synchronized global growth

Bond markets likely to absorb rate increase with limited impact, but questions remain on Fed's economic projections

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In its March 14–15 meetings, the Federal Reserve (Fed) will decide whether to raise interest rates for the third time since it began monetary policy normalization 15 months ago.[1] Invesco Fixed Income believes there is a high probability that the Fed will raise its policy rate by 0.25% next week. Fed Chair Janet Yellen and Vice Chair Stanley Fischer have indeed signaled in recent statements that they believe a rate increase is likely to be appropriate. Further monetary tightening has been in the cards for some time; however, the bond markets had not placed a high probability of a March rate hike even a few weeks ago.

What has changed in the last few weeks to cement expectations of a March hike? First, after many years of falling short, recent economic data finally show that the Fed appears to be achieving its dual mandate of maximum employment and price stability. The US economy's solid pace of growth has enabled job seekers to find jobs, reducing the unemployment rate to 4.8%, generally considered to be near-full employment.[2] In terms of price stability, once elusive inflation is now nearing the Fed's long-time objective of 2%.[1]

Second, we are seeing a better global growth environment than we have seen in several years. For the first time in a long time, other major economic blocs are growing in synchrony with the US. Europe is seeing its aggressive stimulus policy (including negative interest rates) pay off with higher inflation and green shoots of growth, especially in the North. China is managing its transition from an old, export-led economy to a more domestic-oriented one through fiscal stimulus and targeted measures to maintain financial stability. We estimate that China is currently growing by around 6.5% per year, somewhat better than many analysts had expected a year ago, and defying some investors' fears that a major slowdown was around the corner. This encouraging global growth picture is important because global economic uncertainty has caused the Fed to delay interest rate hikes in the past. Now that other major economies are also on the upswing, there is less risk that the Fed might postpone a tightening move due to fears that higher rates could generate a US dollar surge, creating headwinds for US growth.

What would a rate hike mean for bond markets?

According to bond futures markets, the bond market appears to be pricing in a roughly 90% chance of a rate hike next week.[3] This very high expectation means that bond markets will likely readily absorb a rate hike with limited impact. Markets will likely be more focused on what Chair Janet Yellen relays in her press conference, such as the Fed's economic projections, in order to gauge how fast the Fed might hike rates. Although the bond market has priced in a March rate increase, it has not increased its forecast of the total number of interest rate hikes this year (currently three) or its forecast of the so-called "terminal rate" – the final level of the federal funds rate once monetary tightening is complete. Any information that the Fed conveys next week to change those expectations would likely have a bigger impact on the bond markets than the rate increase itself.

Looking ahead

Invesco Fixed Income expects a total of three interest rate hikes this year based on the factors described above – solid US growth and inflation against a backdrop of positive global growth. However, we do not rule out the possibility of four interest rate hikes if financial markets remain stable and global growth stays buoyant.

Therefore, we believe developments in other global economies are important to watch. For example, if global growth falters due to a China slowdown or political tensions increase in Europe, the Fed may become more cautious. We are especially focused on potential policy moves by other global central banks, particularly those with large quantitative easing (QE) programs. Removal or tapering of QE abroad could create upward pressure on global interest rates and may play a large part in the direction of the US Treasury market.

[1] Source: Federalreserve.gov, March 8, 2017.

[2] Source: Bureau of Labor Statistics, March 8, 2017.

[3] Source: Bloomberg L.P., March 8, 2017.

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