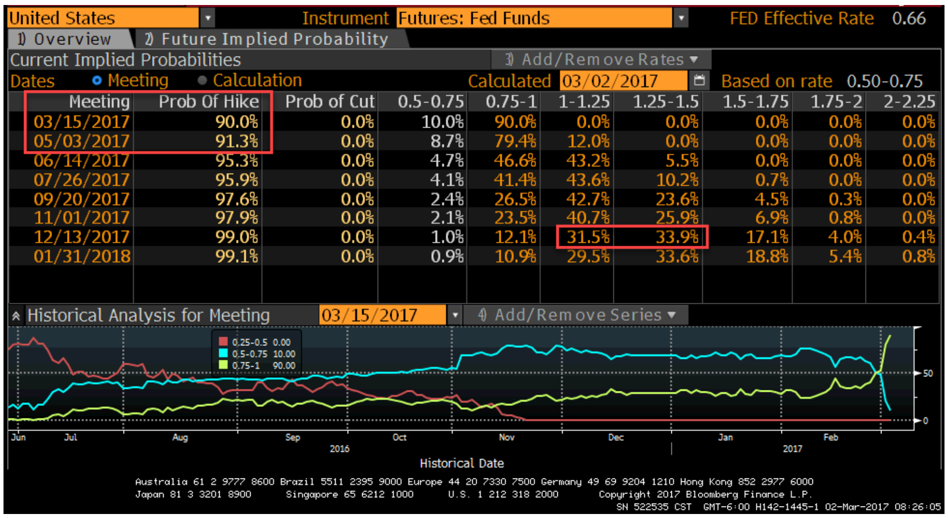
Making the Case for a March Rate Hike

Less than a year ago, the probability of a rate hike in March 2017 was 0%, today it's 90%. So what's changed? Although a move in March is not a certainty at this point, here are a few reasons why the market is now pricing in a rate hike 2 weeks from today:

Fed Funds Futures Have Already Priced in a Move

Fed Funds Futures have now priced in an 90% chance of a March rate hike and they have also priced in a 3rd move in 2017 for the first time. This is as close to a "free lunch" for the Fed as possible, allowing them to remove accommodation without disrupting the markets. Since the market is already expecting a move in March, not hiking rates will only add unnecessary volatility and could be counterproductive. The stock market certainly hasn't cared much about another hike in March – the Dow was up 300 today and is up a whopping 18% since the day before the election!

Exhibit 1: Fed Funds Probabilities: 90% Chance of March Hike

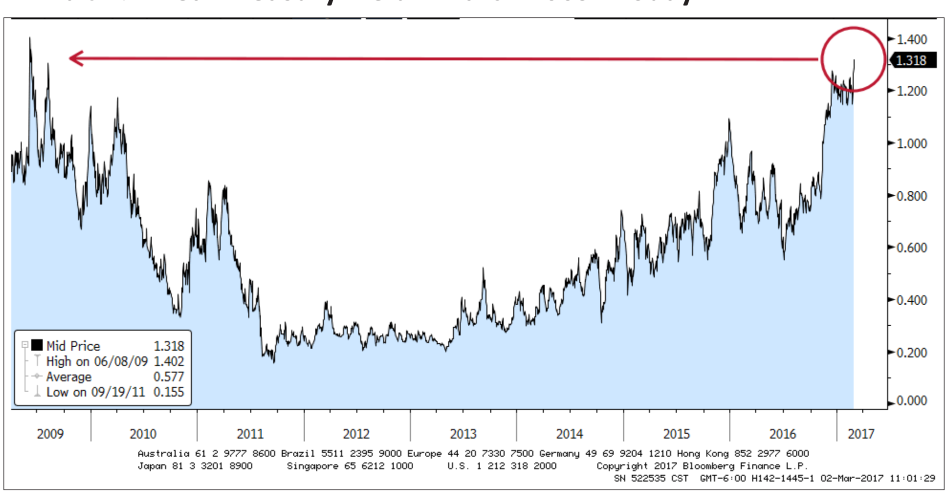


Meeting	Prob Of Hike	Prob of Cut	0.5-0.75	0.75-1	1-1.25	1.25-1.5	1.5-1.75	1.75-2	2-2.25
03/15/2017	90.0%	0.0%	10.0%	90.0%	0.0%	0.0%	0.0%	0.0%	0.0%
05/03/2017	91.3%	0.0%	8.7%	79.4%	12.0%	0.0%	0.0%	0.0%	0.0%
06/14/2017	95.3%	0.0%	4.7%	46.6%	43.2%	5.5%	0.0%	0.0%	0.0%
07/26/2017	95.9%	0.0%	4.1%	41.4%	43.6%	10.2%	0.7%	0.0%	0.0%
09/20/2017	97.6%	0.0%	2.4%	26.5%	42.7%	23.6%	4.5%	0.3%	0.0%
11/01/2017	97.9%	0.0%	2.1%	23.5%	40.7%	25.9%	6.9%	0.8%	0.0%
12/13/2017	99.0%	0.0%	1.0%	12.1%	31.5%	33.9%	17.1%	4.0%	0.4%
01/31/2018	99.1%	0.0%	0.9%	10.9%	29.5%	33.6%	18.8%	5.4%	0.8%

The Bond Market Has Already Priced in a Move

The 2-Year Treasury yield is at the highest level in nearly 8 years and the 2-Year is often considered the most reactive to changes in expectations for future rate hikes. The bond market is ready for a March rate hike and won't necessarily sell off if they move. But that will all depend on what they say in their statement and the all-important press conference.

Exhibit 2: 2-Year Treasury Yield - March 2009 - Today



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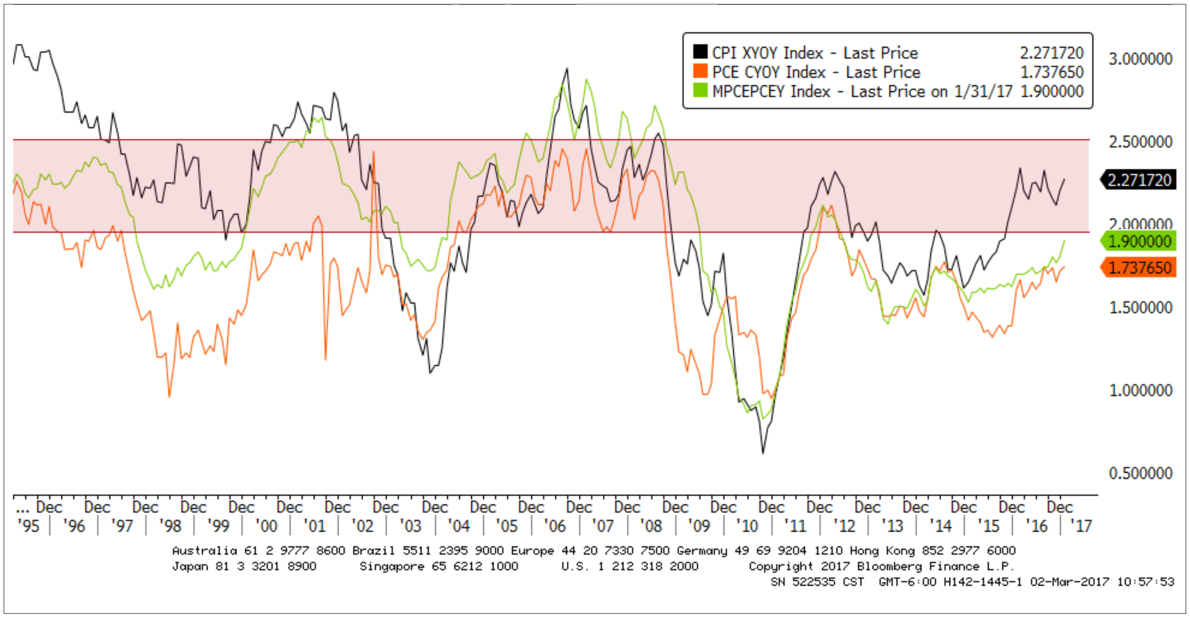
Core Inflation Is Almost At The Fed's State Goal of 2%

The Fed has long said they are hesitant to raise rates as long as inflation remains below their long-term goal of 2%. While the Fed's preferred measure of inflation (Core PCE) is still below 2%, it has moved closer to that target over the last 2 years and other measures of inflation are within the Fed's target zone.

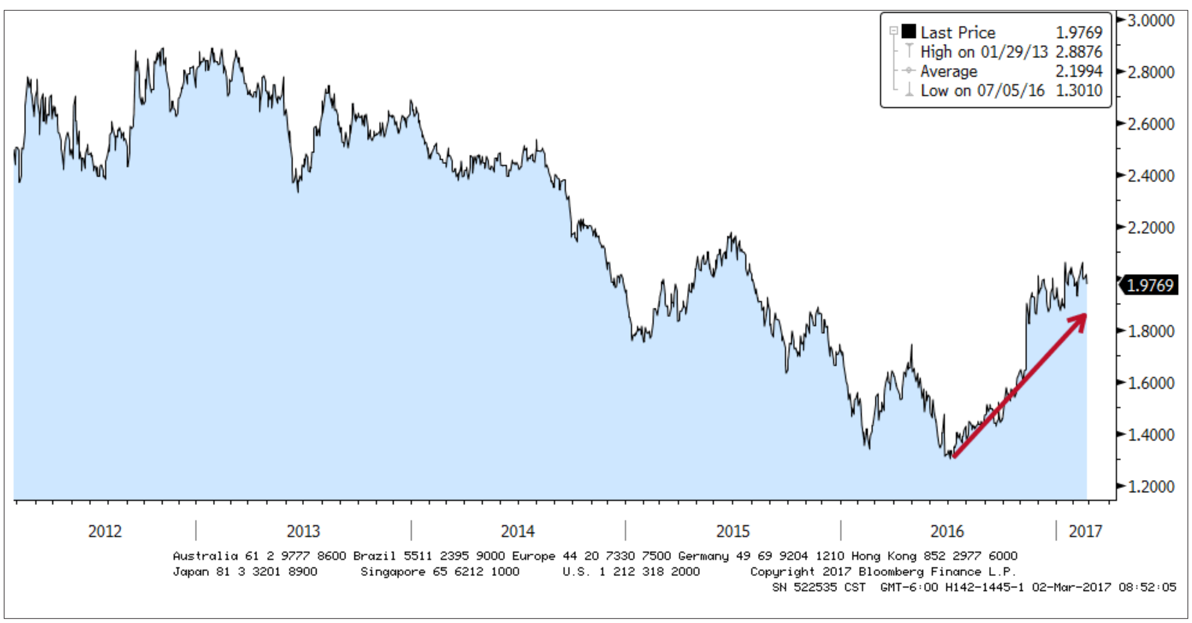
Exhibit 3: 1994 - Today: Core CPI (black) vs. Core PCE (orange) vs. Dallas Fed Trimmed Mean (green)



Long-Term Inflation Expectations Are At The Fed's State Goal of 2%

Market based inflation expectations has risen sharply since last summer, especially following the election. The market is pricing in faster economic growth, more deficit spending and the potential for trade barriers that could raise prices. After years of abnormally low rates and knowing that monetary policy works with a lag, some members of the Fed may be worried about the risk of following behind the curve on fighting inflation.

Exhibit 4: Fed's 5-Year Forward Inflation Rate Since 2012



Fed Officials Are Telegraphing A Rate Move Is Coming Soon

In just the last week, we have heard from a slew of Fed Presidents that a rate hike is expected soon and a move in March is getting "serious consideration". We will hear from several more Fed Officials including Chairwoman Yellen on Friday (along with the February Employment Report) so stay tuned.

William Dudley - New York, Vice Chairman

- Case for tightening has become a lot more compelling
- Animal spirits have been unleashed post-election

John Williams - San Francisco

- March rate hike getting serious consideration
- Fed is very close to achieving dual mandate

Robert Kaplan - Dallas

- We should move sooner rather than later

Dennis Lockhart - Atlanta

- March is a live meeting for FOMC and rate hike gets serious consideration

James Bullard - St. Louis

- Fed closer to goals today than any time in the last 60 years
- Fed has essentially achieved its dual mandate

February 1 FOMC Minutes

- "Many participants expressed the view that it might be appropriate to raise the Federal Funds Rate fairly soon"
- "Continuing to remove policy accommodation in a timely manner, potentially at an upcoming meeting, would allow the committee greater flexibility"

The FOMC May Want To Raise Rates When They Hold A Press Conference

The only 2 rate hikes in the last decade occurred in December 2015 and December 2016 and both of these hikes coincided with a scheduled Fed press conference. The Fed holds a press conference every other meeting near the end of the quarter (March, June, September & December). It is likely the Fed wants to hike rates at a meeting with a schedule press conference so they will have the ability to further explain their actions beyond the normal policy statement.

2017 FOMC Meetings

Jan/Feb	31-1	Statement: PDF | HTML Implementation Note	Minutes: PDF | HTML (Released February 22, 2017)
March	14-15*		
May	2-3		
June	13-14*		
July	25-26		
September	19-20*		
Oct/Nov	31-1		
December	12-13*		

* Meeting associated with a Summary of Economic Projections and a press conference by the Chair.

While a rate hike in March is not a certainty, the futures market has already priced in an 88% chance and the bond market is anticipating a move so the Fed would be unwise to wait at this point. Tomorrow we will get additional comments from several Fed officials (including Chairwoman Yellen) and the February Employment Report, but as of now institutions should be prepared for another 25bp hike in 2 weeks.