

FOMC expected to hold policy steady Tuesday

The FOMC will hold a one-day policy meeting on Tuesday, March 16th. This will be the first scheduled single day policy meeting for the Federal Reserve since the start of the financial crisis in September 2008. In February the Fed raised the discount rate 50bps to 0.75% and stated that the discount rate hike was not a signal of tightening of monetary policy. According to the Fed the discount rate hike will encourage financial institutions to rely more on money markets than on the Fed for short-term borrowing. The discount rate hike has encouraged speculation over whether the Fed is nearing the end of its accommodative monetary policy. Investors want to know if the Fed will soon hint that the end of easy money is near.

The key focus of Tuesday's FOMC meeting is whether Fed maintains in its policy statement the language, keeping interest rates at exceptionally low level for an "extended period". Recent statements from Fed officials suggest that the weak labor market, uncertainty about the sustainability of the US recovery and subdued inflation will encourage the Fed to hold policy steady at Tuesday's meeting. Divisions on the Federal Reserve Board however have emerged with a minority of the board members seeking a change in the language of the Fed policy statement to prepare for an eventual rate hike. The Fed's Hoenig says that economic conditions have improved and he argued at the February policy meeting that a change in the Fed's policy statement would allow the Fed greater flexibility and be a necessary first step to a future rate hike. He went on to say that zero interest rates are not sustainable and the Fed must be prepared to raise rates with the jobless rate still high. Hoenig also wants the Fed to begin sales of assets to reduce the Fed's balance sheet because he fears that the Fed's asset purchases increase the risk of inflation. Hoenig is in the minority with most Fed officials concerned that the economy is too weak to signal a policy change at this time. The appointment last week of Janet Yellen by President Obama as the vice chair for the Fed may also reduce the odds of a change in Fed policy anytime soon. Yellen has stated that the economy is too weak to withstand rising interest rates and that she would favor negative interest rates if that would be a positive for the US economy. Yellen is a policy dove.

Recent US economic data suggest that the US recovery remains tentative and uneven. The recovery in the housing market appears to have slowed and consumer sentiment has weakened, but there is optimism that the US labor market may soon begin to create jobs and the industrial sector is expanding. Last month the US posted an unexpected rise in retail sales despite two major snowstorms that blanketed the nation during February. If the recovery in retail sales and industrial sector continues and we get positive employment growth next month the Fed may become more confident in the recovery. As the Fed becomes more confident in the recovery the more likely the Fed will consider a change in the extended period language and set the stage for a rate hike.

Fed fund futures are forecasting a 60% chance of a rate hike by December but limited chance of a change in policy at the March meeting. Investors will be looking to see whether the Fed changes the policy statement language in a way that begins to prepare the markets for this future rate hike. If the Fed were to substitute a change in the "extended period" language in its policy statement it would be a signal of the beginning of a shift in Fed policy. According to a Bloomberg survey of 88 economists all 88 are forecasting that the Fed will keep the target lending rate at a record low at the March meeting and that the Fed will allow the purchase of mortgage-backed securities to lapse at the end of March. Investors will be looking to see whether the Fed keeps the door open for future purchase of bonds if the pace of the US recovery slows. Because recent US economic data has been mixed investors will also be looking to see if the Fed makes any change in its relatively upbeat outlook for the US recovery.

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