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YES, AND NO

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KEY TAKEAWAYS

In the wake of last week's FOMC decision not to raise rates, markets focused more on the FOMC statement and press conference than the dovish tone the decision may have suggested.

In addition to inflation data, the Fed may be looking back at historical effects of Fed tightening during international turmoil.

We continue to expect the Fed to hike in coming months, likely in December 2015.

The title of this commentary is our answer to the question: Does the Fed know something we don't know? Many market participants and pundits were asking this question late last week after the Federal Reserve's (Fed) policymaking arm, the Federal Open Market Committee (FOMC), decided not to raise interest rates at the conclusion of its two-day policy meeting on Thursday, September 17, 2015. Market participants were asking the question although they had priced in just a 30% chance of a rate hike prior to the meeting.

On the surface, the Fed's decision to defer raising interest rates until at least the next FOMC meeting in October 2015 should have been viewed by the market as dovish. Indeed, the FOMC's new forecast for gross domestic product (GDP), the unemployment rate, inflation, the appropriate timing of the first rate hike, and the so-called "dot plot" (the appropriate level for the fed funds rate at year-end in 2015, 2016, 2017, 2018, and in the "longer run") generally lowered the FOMC's view of the economy and inflation, as well as the trajectory of the path of the fed funds rate in the coming years. In the past, when the market has seen these kinds of changes to the Fed's own forecasts, it has viewed them as a sign that the Fed won't be raising rates anytime soon, generally allowing equity investors to breathe a sigh of relief, and putting downward pressure on bond yields.

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A CLOSER LOOK AT THE FED'S WORDS

But the market reaction in the wake of last week's meeting suggested the usual pattern wasn't playing out. Markets (correctly, in our view) focused on the words used in the FOMC statement and by Fed Chair Janet Yellen in her post-meeting statement and press conference. Specifically, the FOMC statement noted that "recent global economic and financial developments may restrain economic activity somewhat and are likely to put further downward pressure on inflation in the near term," and "the Committee continues to see the risks to the outlook for economic activity and the labor market as nearly balanced but is monitoring developments abroad." In addition, the Fed added "readings on financial and international developments" to the list of items it is watching as it assesses whether the economy is tracking toward full employment and 2% inflation. These remarks are somewhat unusual, as in the past the Fed has not cited international developments in its policy statements.

Adding to the international theme, in her prepared remarks at the start of her post meeting press conference, Fed Chair Yellen noted:

"The outlook abroad appears to have become more uncertain of late, and heightened concerns about growth in China and other emerging market economies have led to notable volatility in financial markets. Developments since our July meeting, including the drop in equity prices, the further appreciation of the dollar, and a widening in risk spreads, have tightened overall financial conditions to some extent. These developments may restrain U.S. economic activity somewhat and are likely to put further downward pressure on inflation in the near term. Given the significant economic and financial interconnections between the United States and the rest of the world, the situation abroad bears close watching."

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Later, during the Q&A portion of her press conference, Yellen mentioned China five times, most notably by highlighting that "a lot of our focus has been on risks around China but not just China, emerging markets, more generally in how they may spill over to the United States."

WHAT DOES THE FED KNOW?

Thus, the market's concern, as expressed by the question, "Does the Fed know something that we don't know?" is really about China, and in particular the Chinese economy and financial system.

We believe the Fed would like to raise rates this year, and our view remains that this will occur, most likely at the December 2015 meeting, as we wrote in last week's *Weekly Economic Commentary, "How Much, How Far, How Fast, Not When?"* Also, had the data—especially the inflation data—supported a rate hike at last week's meeting, the Fed likely would not have let the recent turmoil in global financial markets around the Chinese equity markets and economy stand in the way. We noted last week that recent tightening in financial conditions, which remain at their worst levels since before the Fed announced its third quantitative easing program in September 2012, largely because of equity, currency, and debt market-related disruptions associated with China, argued against a hike. In effect, the market tightened on behalf of the Fed in the past four weeks.

What the Fed may know that the market may not (or at least not remember) is that Fed tightening during prior periods of international turmoil, such as the Mexican peso crisis in 1994, the Asian financial crisis in the late 1990s, and the Argentine debt crisis in the early 2000s, made the situation worse, not better. The increased international turmoil, in general, drove the value of the dollar higher, putting downward pressure on U.S. inflation as import prices fell. In those prior episodes, the U.S. was not flirting with deflation. Today, the Fed is more concerned with deflation—falling wages and prices—than inflation, and Fed members likely believe that tightening policy now could lead to still lower inflation. In addition, China today—like Mexico in the mid-1990s—is a major trading partner to the U.S., and a further slowdown in China may further impact U.S. economic growth, and more importantly readings on U.S. inflation.

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So does the Fed know something the market doesn't? In our view, probably not. It may, however, have a better sense of history and more institutional memory than "the market" does; factoring in an additional lens on history seems prudent right now, as the Fed prepares markets for the first launch of a rate tightening cycle in 11 years. ■

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