ECONOMIC NEWS

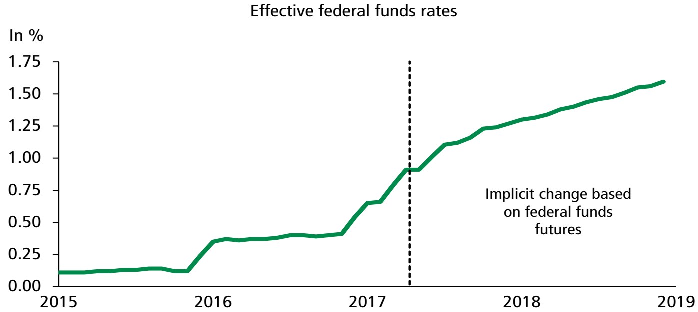
Our Take on Markets' Expectations for U.S. Monetary Policy

There were few surprises from the May 3 Federal Reserve (Fed) meeting. After raising its key rates in March, the Fed stood pat and did not send a clear signal regarding the important June meeting. The fact that it sees the U.S. economy's weakness early in the year as transitory and that it is maintaining a fairly positive tone, however, confirmed that we should expect the Fed to keep gradually tightening its monetary policy in the coming quarters.

This Fed's stance and April's good labour market results seem to pave the way for another U.S. key rate hike in June. At some points in recent days, the probability of firming calculated by Bloomberg even hit 100%. However, this calculation seems to overestimate the actual expectations. In our view, the futures price, which reflects an increase of about 20 basis points in the federal funds rate by July, is more consistent with an implicit probability of about 80% for 0.25% in monetary firming on June 14. This probability still seems high, as a lot could happen in the next five weeks. We agree, though, that monetary tightening in June is now the most likely scenario.

Although market expectations for a June increase seem a little high to us, the expectations regarding what happens next seem much too low. The futures suggest the federal funds rate will hit 1.40% only in May 2018—50 points higher than it is now—and end 2018 near 1.65%. After tightening its policy in June, the Fed would thus suddenly slow the pace on monetary firming. For our part, we instead expect the effective federal funds rate to go to 1.40% as of next fall, as a June increase could be followed by further tightening at the September meeting. We anticipate that federal funds could end 2018 at around 2.15%.

GRAPH
The markets expect U.S. monetary firming in June, but few rate hikes after that



Sources: Datastream, Bloomberg and Desjardins, Economic Studies

IMPLICATIONS

As the jobless rate is already below where Fed leaders had expected it to be at the end of 2018, and everything suggests the U.S. economy rebounded after a tough start to the year, there is nothing to suggest the Fed will put the brakes on its monetary firming. Market expectations regarding the movement of federal funds in coming quarters should adjust shortly to reflect ongoing monetary firming, which should put upside pressure on the entire yield curve.

Mathieu D'Anjou, CFA, Senior Economist

François Dupuis, Vice-President and Chief Economist • Mathieu D'Anjou, Senior Economist
Benoit P. Durocher, Senior Economist • Francis Généreux, Senior Economist • Jimmy Jean, Senior Economist • Hendrix Vachon, Senior Economist
Desjardins, Economic Studies: 514-281-2336 or 1 866-866-7000, ext. 5552336 • desjardins.economics@desjardins.com • desjardins.com/economics