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Fed Thoughts:

Zombie Apocalypse

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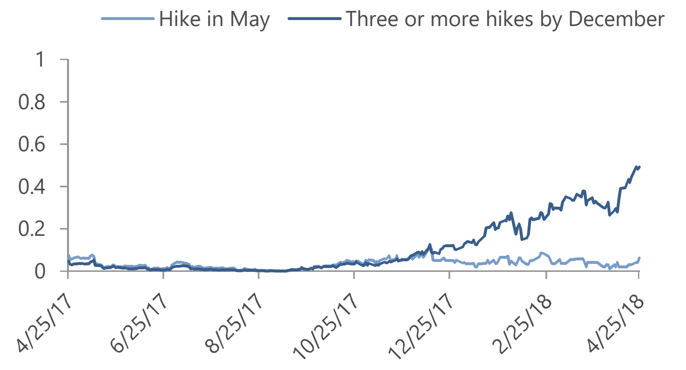
Hunkered in the basement, doors and windows boarded, the sound of their shuffling feet scrapes the floorboards above. Soulless, mindless, rigid in their movements, and relentless in their drive, they move forward, creating an enveloping sense of existential dread for all of us hidden below. In the dark, we are riven by the question: What primeval power pushes them forward?

There is a simple answer. The calendar of the Federal Open Market Committee (FOMC) indicates that there is a meeting in Washington, DC, on May 1 and 2. Governors of the Federal Reserve Board and presidents of the Reserve Banks will show up, even if there is no apparent purpose. As shown in the chart below by the light blue line, inferences from futures prices reveal that the probability of action at this meeting is very low. Indeed, there has been no apparent pulse for a May hike in a very long time. Indeed, some readings from futures markets are below the share of affirmative survey responses on whether there will be a zombie apocalypse in our lifetime.

Probability of FOMC Action



Source: CME FedWatch Tool, at http://www.cmegroup.com/trading/interest-rates/countdown-to-fomc.html and BNY Mellon AMNA calculations.

How respondents in the latter group reach that conclusion is an interesting inquiry into the state of our society. Why no one in the former group worries about the May meeting has a more straightforward solution. The Fed told us not to worry. Indeed, central bank officials have been holding market participants' hands during this entire hiking cycle. The FOMC:

- Only acts at press conference meetings (limiting its opportunity to move to four times a year)
- Signals impending action in the minutes of the meeting prior to the one at which it pulls the trigger (imparting a lag in its responsiveness to data)
- Dutifully pushes back in speeches and interviews if investors drift into error
- Provides a corrective interpretation to the press at the last minute if need be

The May meeting whiffs on all these pitches—no press conference, no message in the minutes, no speeches, and no weekend warning in the *Wall Street Journal* (as of yet).

Anathema regarding surprises is not new to the Fed, as anyone can attest who remembers "the measured pace" language that found its way into 13 FOMC statements. (Yes, I admit that I drafted all of them, but chalk it off as a youthful indiscretion.) The logic is that telegraphing action allows the effect of a policy change to build slowly into market prices, avoids triggering an outsized reaction on FOMC day, and implicitly offers an opportunity to get feedback before the action get carved in stone. Such foreshadowing,

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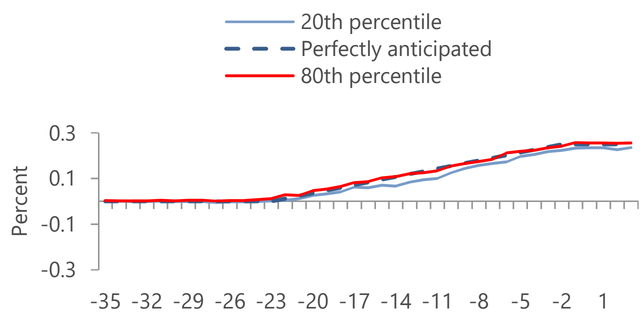
however, makes policy more inertial (by lengthening the runway needed for take-off), is undemocratic in that it speaks to Wall Street in a whisper before issuing a statement for Main Street, and undercuts the promise that "all decisions are data dependent and made meeting by meeting." The latter statement is conditionally true, in the sense that decisions in six months depend on data today and made at earlier meetings.

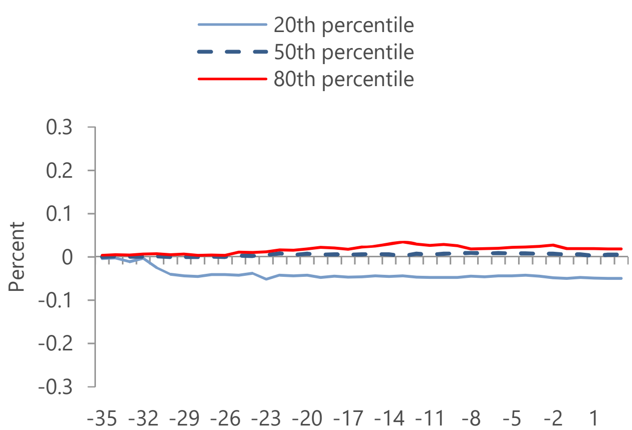
The chart below provides some sense of the strictness of Fed guidance. Daily data on 30-day interest-rate swaps (OIS) since 2015 were sorted into 40-business-day windows around the 27 FOMC meetings held over the period. (These are based on swaps settling on the average overnight rate over the term of the contract.) Each segment is normalized by the level of the OIS rate 35 days before the FOMC announcement, implying that the term of the contract did not yet cross into the Fed event so that the quoted rate did not embed the expected outcome. The upper panel provides a summary of the movements around the six meetings when the policy rate was increased 25 basis points; the bottom panel shows the remainder when the funds rate was kept on hold. The blue and red lines in both give the 20th and 80th percentile levels across the two samples, respectively, of the normalized rate.

30-day Overnight Interest Swap Rate

...in Advance of FOMC Action



...in Advance of FOMC Inaction



Source: Bloomberg, accessed 4/26/18, and BNY Mellon AMNA calculations.

The dashed line in the upper panel considers the hypothetical case where the 25-basis-point hike was perfectly anticipated. By the arithmetic of term contracts, more and more of the stated rate would incorporate a higher overnight rate as pricing walked closer and closer to Fed action. This is why the dashed line slopes gradually up to kiss 25 basis points on FOMC day. Actually, there is not much hypothetical about this, as the outcomes hug the perfectly predicted prediction. Market prices correctly built in the six policy actions.

The bottom panel repeats the exercise for the larger sample of no-action meetings, recognizing that the perfectly predicted hypothetical is the horizontal axis. The median outcome, the dashed line, is added, and it clings to the axis closely. Market participants understood no action as equally well as action.

If the goal of Fed officials is never to surprise markets, then mission accomplished. We got the message.

It is proper and fitting to expect an unchanged policy rate at the conclusion of the May FOMC meeting. Three weeks later, we will read in the minutes that the Committee contracted to move at its next meeting, scheduled for June 12 to 13. The economy seems to have momentum; cost pressures are on the rise and, with the unemployment rate headed toward 3½ percent, poised to show up in inflation. By June, the FOMC will be halfway done for the year.

Halfway done? Another line in the first chart is comforting to our 2018 policy call that the Fed will hike the funds rate at all four press-conference meetings. Market participants are also coming around to this view. The probability that the funds rate target will be at least one percentage point higher at the end of 2017 is now about 50-50 according to futures prices.

Why does this seem right? Beyond the economic outlook, which justifies at least that much action, the Fed should legitimately be unsure how to engineer a pause, even if desired. Market participants will assume that policymakers packed their bags and left the tightening cycle behind at the first press-conference meeting where there is no policy change. Because a cold reboot is worrisome to them, a Fed body in motion stays in motion.

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