Portfolio Manager van Skagen Tellus

**Torgeir Høien**

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# The looming Fed tightening. It's probably going to be a very dovish lift-off, with no "normalization" in sight

The Fed is probably going to tighten monetary policy for the first time since 2006 this fall. Some analysts expect a first move on Thursday. Others expect the Fed to wait until October or November.

I think the important point to keep in mind is that although the Fed might hike already on Thursday, the central bank is in all likelihood going to tighten very carefully over the next years, and there is the possibility that a tightening might be reversed if actual or expected inflation do not speed up to the Fed's 2% target.

The main reason for being careful about tightening is that both actual and expected inflation is below the Fed's inflation target. (See chart below)

Also, tightening will be aborted if the economic expansion comes to an end – it has been a while since the last recession.

So while the policy rate might be hiked a bit this fall, possibly already on Thursday, it's not going to be the first step toward "normalization" of the policy rate.

How will the Fed tighten?

Since December 2008 the target for the federal funds rate has been 0% to 0.25%.

Federal funds are Fed deposits owned by banks, and the federal fund rate is the interest rate on overnight loans of such funds. Since December 2008 the Fed has paid 0.25% in interest on central bank deposits, often misleadingly referred to as "reserves". Due to various technicalities, the federal funds rate has traded a bit below the deposit rate. Thus, the Fed has operated with a targeted interval for the federal funds rate.

Currently the federal funds rate is 0.14%.

The gap between the deposit rate and the federal funds rate is expected to persist as the fed tightens. That is, the federal funds rate is expected to trade about 10 bp lower than the Fed's deposit rate also called interest on reserves.

The Fed will tighten by hiking the deposit rate and by having a higher interval for the federal funds rate. The step need not be 25 bp, as has usually been the case. After almost 7 years with the federal funds rate around 0.15%, and with a very uncertain Fed, it might be that tightening is done in very small steps.

The Fed could for example increase the deposit rate from 0.25% to 0.35% and target a federal funds rate that lies between 0.1% and 0.35%. The federal funds rate would then probably trade around 0.25%.

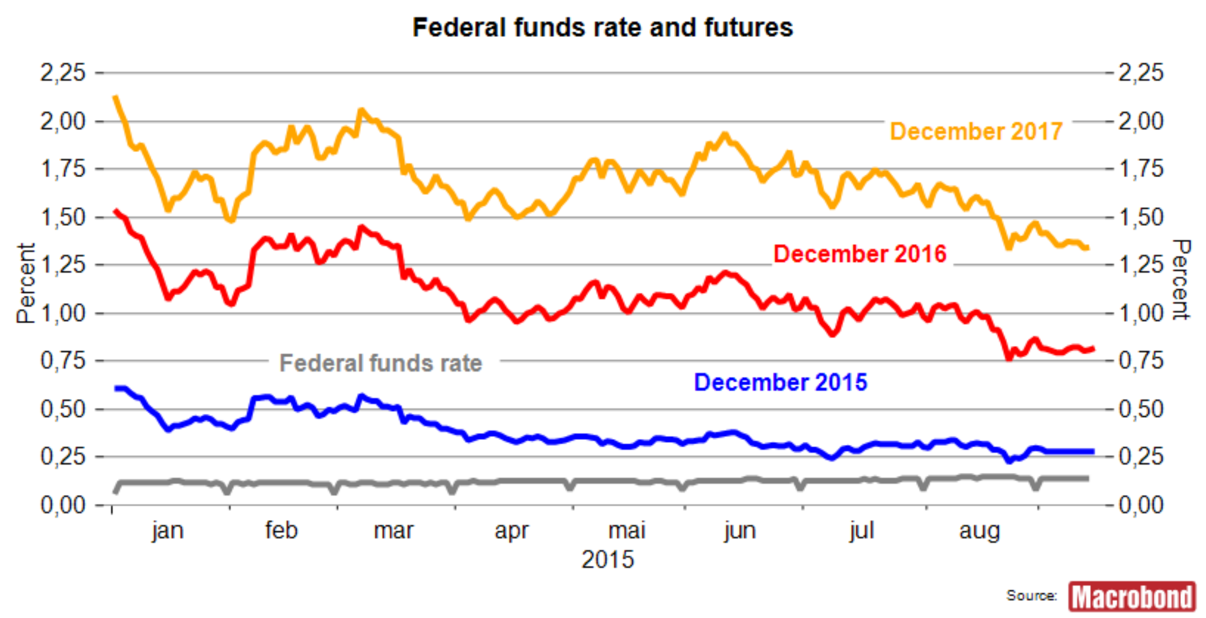
The futures market currently expects such an outcome of this falls Fed meetings. The federal funds rate on the futures contract December is 0.28%

The futures market expects very gradual tightening beyond 2015. The federal funds rate is expected to be 0.82% in December 2016 and 1.34% in December 2017. That is, the market expects the Fed to just tighten by 1.25 percentage points over the next 27 months.  (See chart below)

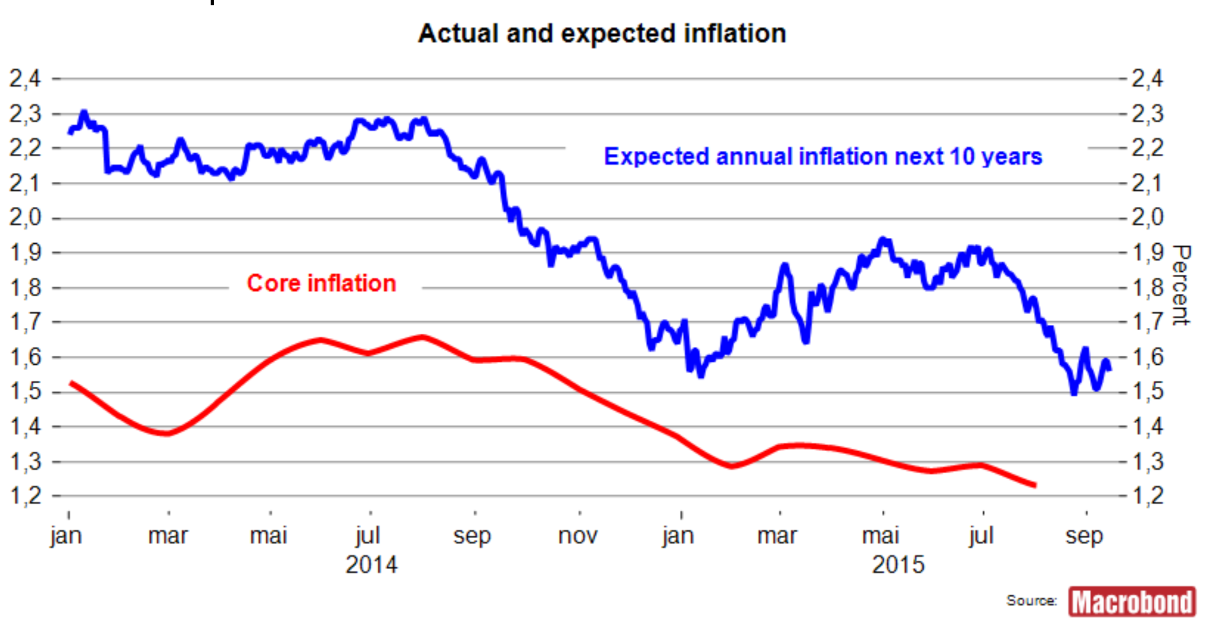
I agree with the futures market. The Fed's tightening cycle is going to a very muted one, and most likely aborted well before the federal funds rate approach a historical normal of about 4%. (See chart below)

*"This is his first Fed tightening."*

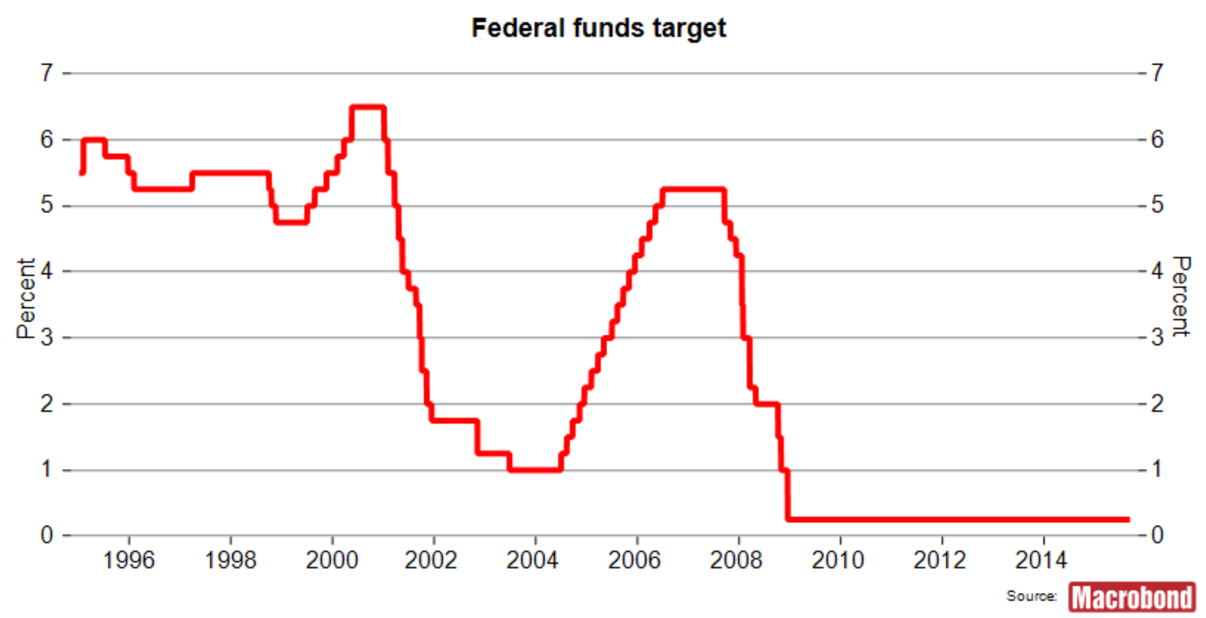
The federal funds rate:




Actual and expected inflation:



The federal funds rate over the longer run:




*Hoien is a portfolio manager with Skagen Funds in Stavanger, Norway and was on the executive board of the Norwegian central bank from 1998-2002.*