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A masterpiece

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The US central bank Fed increased the Fed funds rate last Wednesday. The risky asset markets reacted to the move with an increase. At the same time, the US dollar depreciated. How can that be explained?

Boom and stable markets

- The US economy is currently transitioning from the economic phase of recovery to boom, recording growth rates of above its long-term potential, which is between 1.5% and 2%. The indicators of resource utilisation increasingly suggest full employment. Unemployment has settled at a low 4.7%. The most recent high was set at 10% in 2009.
- The Fed members have prepared the market participants for the rate hike in numerous speeches. In contrast to the previous year, however, the risky asset classes did not react to the speeches with falling prices. We deduce from that the **markets have become more resilient.**

The hawks (fight against inflation)

- The published statement contained a number of hawkish elements, reflecting the fact that the monetary support of the [economy](#) is less important than it used to be. After all, the two goals of the central bank, i.e. full employment and price stability, have almost been achieved.
- In line with this, the Fed increased the bandwidth by 0.25bps to 0.75% - 1.0%. After December 2015 and December 2016, this is the third interest rate hike in this cycle.
- It is worth noting that the interval to the previous hike has shortened from a year to three months.
- The Fed also abandoned an important clause in the statement **the central bank has stopped talking about an excessively low rate of inflation.**

The doves (economic stimulus)

- The suggestions that the central bank would continue to act very cautiously have dominated the statement.
- The median of the expectations of the Fed members with regard to the Fed funds rate still implies only three rate hikes this year. Prior to the interest rate decision there had been speculation about the Fed forecast moving up to a possible

fourth hike.

- The average estimate of the expected Fed funds rate (long-term) remains unchanged at 3%.
- The estimate of the so-called structural unemployment rate was revised downwards by 0.1 percentage point to 4.7%. Thus, the Fed is signalling that the speed limit for the economic growth at which no inflation risk is created has been slightly adjusted upwards.
- As a reminder, the Fed pointed out three already known criteria for estimating inflation:
 - the kind of inflation in question is a sustainable increase towards 2%, i.e. the inflation target.
 - In order to support this, the Fed explicitly talks about the core inflation rate exclusive of food and energy. The underlying inflation is still slightly below 2%.
 - The inflation target was called symmetric. This means that periods of inflation of below 2% followed by rates above 2% (and vice versa) are acceptable.

Neither too loose nor too tight

- The interplay of interest rate and statement was a masterpiece.
- In reaction to the published Fed statement, the yields of US Treasury bonds decreased, with a slightly lower course of interest rate hikes priced in than prior to the interest rate decision.
- Remarkably, the difference between 10Y and 2Y benchmark yields has also declined. From the market's point of view, the Fed is not running the risk of stepping up the inflation risk by tightening the inflation risk only slightly. Rather, the market thinks that the monetary policy is exactly right. **The area of inflation that neither suggests deflation nor excessive inflation generally means a favourable environment for risky asset classes.**
- The risk of a clear de-coupling of the Fed from other central banks has fallen, which has led to a decrease in appreciation pressure on the US dollar. In line with this scenario, the risk of a shrinking scope to manoeuvre for the other central banks has reduced. Therefore, the Brazilian central bank can continue to cut its key-lending rates drastically without the Brazilian real coming under pressure. It is no coincidence that it was mainly the currencies from emerging economies that have appreciated against the US dollar.

Epilogue: the area of conflict between a favourable environment for risky assets (higher growth, supportive central banks), low priced-in volatilities, and increased political risk remains intact.

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