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The confrontation of the doves

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The most important central bank in the world, i.e. the US Fed, made an announcement yesterday that attracted a large deal of attention from investors. The bank withdrew its assurance to remain “patient” before the Fed funds rate would be increased. This paved the way for a possible abandonment of the zero interest rate policy, if economic need be. The new formula goes like this: the Fed funds rate will be raised once the labour market has improved more and the FOMC is optimistic about inflation rising towards the medium-term target of two percent.

At the same time the chairperson of the FOMC, Janet Yellen, managed to dampen the market expectations for the future Fed funds rates. This was mainly achieved by the downward revision of the projections for the Fed funds rate by the central bank. The expected value of the estimates by the members of the FOMC for the Fed funds rate at the end of 2015 is now 0.63% (formerly 1.13%). The market prices in 0.44%.

The central bank’s premise hinges on the assumption that the US economy, at an unemployment rate lower than previously expected, can grow without an increase in inflation pressure (5.0-5.2% in contrast to the previously expected 5.2-5.5%). The February unemployment rate amounted to 5.5%.

The actions taken by the US central bank are motivated by the increase of the excessively low inflation and the support of the economy. This means the doves are in control rather than the hawks. The latter focus on the fight against inflation. This goes in tandem with keeping the own currency from appreciating too much. The US dollar has indeed appreciated considerably relative to other currencies in the past months. This dampens inflation and economic output. The monetary strategy is currently similar across numerous countries. The confrontation of the central banks is prolonged. Those currencies whose central banks are taking the most active steps harbour the biggest potential for depreciation. While the US Fed has kept the expectations of the future Fed funds rates low, the ECB has the upper hand in the long run. It will be engaging in a negative interest rate policy in the foreseeable future and thus massively expand the money supply.

The indications given by the US Fed of only cautious raises of the Fed funds rate maintain the US Treasury yields on low levels and keep a lid on the appreciation pressure on the US dollar. Ceteris paribus, this supports US equities and US dollar bonds issued by emerging countries.

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