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Asset management

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Economist Insights

Does the Fed lead the market, or does the market lead the Fed? Who is in charge? The old adage may say never fight the Fed, but the Fed's critics would suggest it may be more a case of the Fed not wishing to fight the market. The Fed would disagree; after all they are both looking at the same data. But neither the Fed nor the market have been that good at forecasting the data in any case.

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Don't fight the Fed. That has been the advice of fixed income traders for decades. Traders who try to take the opposite trade to the direction the Fed is moving tend to lose their shirt. It is hard to fight against the lender of last resort that has a (theoretically) unlimited balance sheet. That makes sense for individual traders. But what about the reverse: should the Fed fight the market?

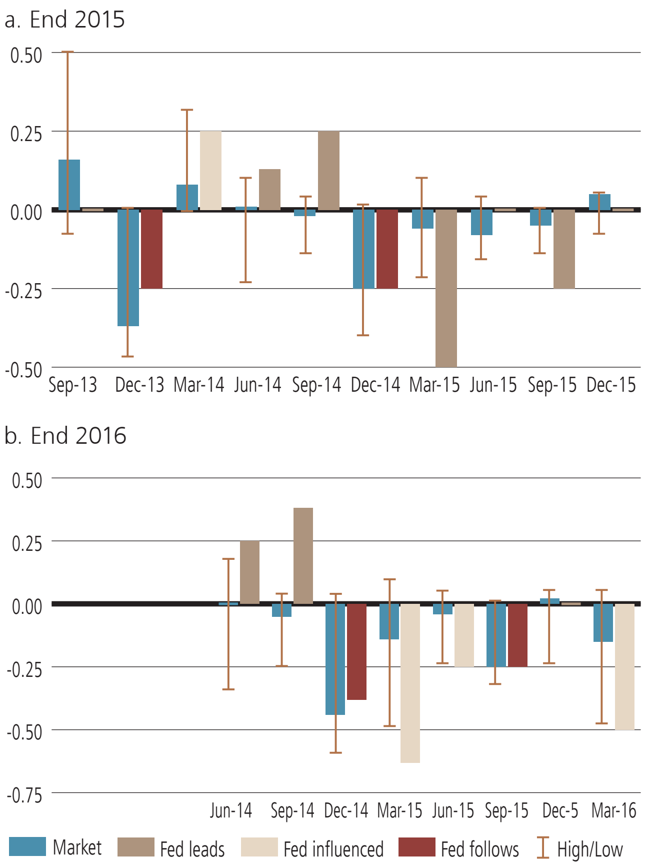
When the market suddenly turns more dovish on the outlook (or rarely, more hawkish), should the Fed ignore that move? In some cases the Fed may well follow the market, simply because the market reacts to the new data day-by-day whereas the Fed reacts to the same data only once a quarter. On other occasions the Fed might want to ignore the data that excites the market and instead focus on the longer term. After all, isn't a central bank meant to have a longer time horizon than the market?

The Fed is sometimes criticised for being afraid of upsetting the market, for being a follower rather than a leader. But how often does the Fed move the way the market does? In recent years the Fed has only changed its interest rate once, but thanks to the publication of its forecasts we can see clearly how FOMC members' expectation for the Fed Funds rate has changed every three months. If the change in the estimate between projections is similar to the change in market pricing, then the Fed is arguably a follower rather than a leader.

The evidence is mixed at best. Sometimes the Fed does follow the market moves, most clearly in December 2013 and December 2014 when it turned more dovish (chart 1). In September last year the Fed also turned more dovish (at the same time that it delayed a rate hike that was widely expected by economists, if not by the market). In contrast, there have been several occasions when the Fed led or was independent of the market, coming out either more hawkish or more dovish than expected.

Chart 1: You first, I insist

Change in median Fed funds projections for end of year between forecast publications, and moves in market pricing for end of year (day after prior meeting to day before)



Source: Federal Reserve, Bloomberg LP. Note: Market pricing is based on Fed Funds Futures contract for following January. Market moves on the day of the FOMC meeting are excluded from the analysis.

At times the Fed may might have surprised the markets relative to what was priced in the day before the meeting, but it may well have been influenced by the movements of the market up and down in the interim. A good example would be last week's meeting, when the Fed's dovish shift pretty much matched the market's expectations when it was feeling most pessimistic. In one sense the Fed could be said to have been influenced by the market, if not led by it.

If you ignore the critics and instead ask the Fed, the argument would be flipped around. When the market is 'leading' the Fed this is actually just the market being successful at predicting the Fed. When the market is following the Fed it just means the market did a poor job of predicting the Fed. The Fed likes to consider itself independent of the market.

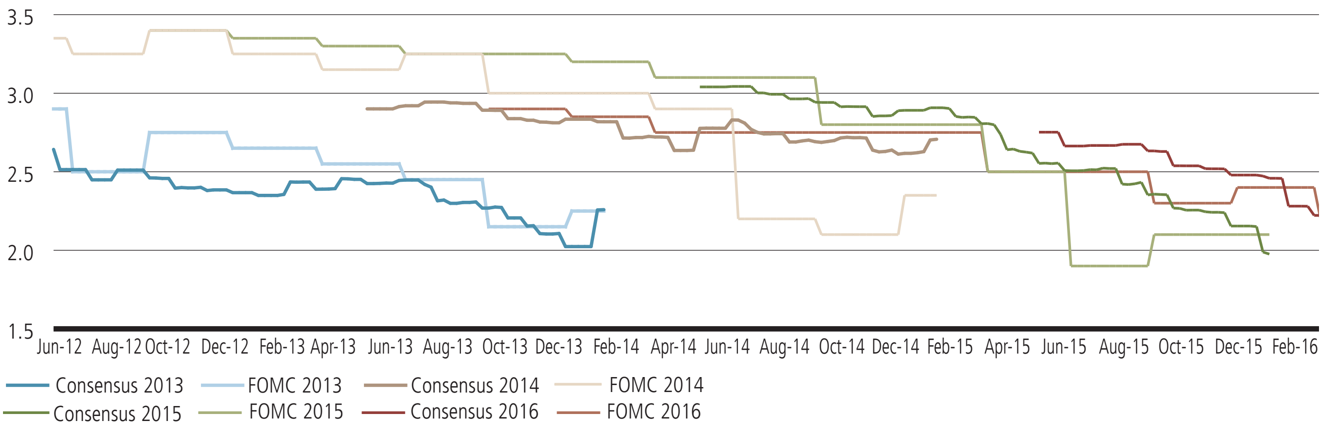
Unfortunately, that leaves us with no clear answer on rates. But how about on the economic outlook? Are market economists better than the Fed at forecasting the growth outlook? Or given the forecasting record of both market economists and the Fed in recent years, is the Fed not as bad at forecasting as market economists?

Unsurprisingly, the results once again are a bit mixed. Both the Fed and the economists in the Bloomberg survey started each year too optimistic and had to revise down their view substantially as time progressed (chart 2). In forecasting 2013 growth, the Fed started out way too optimistic and ended up following the market economists down. When it came to 2014 the story was similar, except that the Fed became over-pessimistic and ended up too low. Last year, on the other hand, it was the Fed that led the market economists, becoming more pessimistic far sooner. And while we do not know the result for this year, so far at least it is the market economists who are once again converging on the Fed.

So are the critics right, and does the Fed follow the market? Or is the Fed independent? With questions like this, it is always useful to apply Occam's razor: the idea that between any equally believable explanations, the simplest is always to be preferred. The simple explanation is that the Fed and the markets both look at the same data, and more often than not they both get it wrong. Given that neither knows where they are going, does it really matter who follows who?

Chart 2: Wrong together

Forecasts of GDP growth (Q4 on Q4 %) by the FOMC and Bloomberg Consensus survey, by year and date of observation



Source: Bloomberg Finance LP, Federal Reserve, UBS Asset Management