Interest Rate Risk Management Weekly Update

September 15, 2014

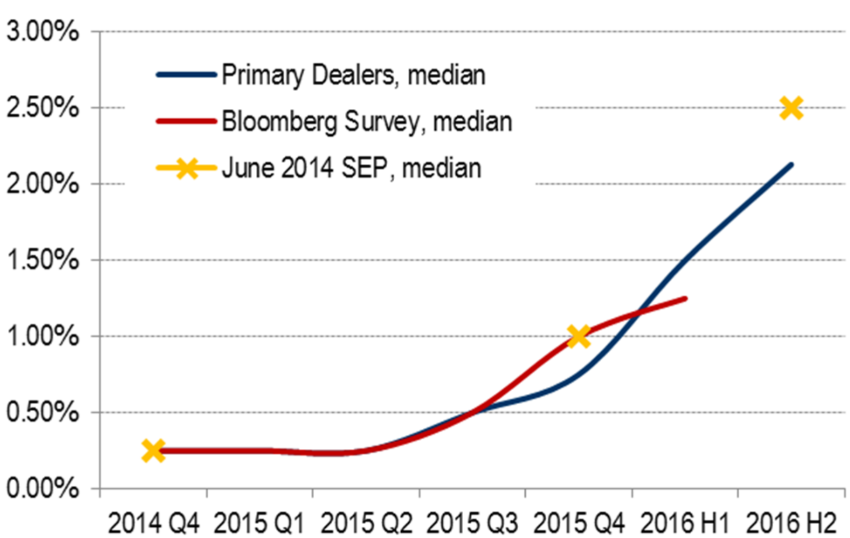
Current Rate Environment

Short Term Rates	Friday	Prior Week	Change
1-Month LIBOR	0.15%	0.15%	0.00%
3-Month LIBOR	0.23%	0.23%	0.00%
Fed Funds	0.25%	0.25%	0.00%
Fed Discount	0.75%	0.75%	0.00%
Prime	3.25%	3.25%	0.00%
US Treasury Yields			
2-year Treasury	0.56%	0.51%	0.05% ↑
5-year Treasury	1.82%	1.69%	0.13% ↑
10-year Treasury	2.61%	2.46%	0.15% ↑
Swaps vs. 3M LIBOR			
2-year	0.85%	0.77%	0.08% ↑
5-year	2.02%	1.87%	0.15% ↑
10-year	2.80%	2.63%	0.17% ↑

Fed Speak & Economic News:

- Once in a while we see a unique event that catches the eyes of market participants. On Monday (September 8) Jens H.E. Christensen and Simon Kwan of the San Francisco Fed released an economic letter titled *Assessing Expectations of Monetary Policy* [1]. This distribution's commentary will borrow ideas from and discuss the findings of the research letter.
- Borrowing from the Federal Reserve's website, "the goals of monetary policy are to promote maximum employment, stable prices and moderate long-term interest rates." One way the Fed can do this is through the use of forward guidance, a tool popularized by Former Fed Chairman Ben Bernanke. He stressed the importance of the Fed's ability to communicate policy to the public; forward guidance has been the tool of choice for the Fed to achieve this. More specifically, forward guidance is used to provide insight into expected future monetary policy in an effort to influence market participants' present behavior.
- But what if the public misunderstood the Fed's messages it tried to communicate? The findings of Christensen and Kwan suggest just that. In the authors' words, "[o]ur analysis shows that, on balance, the public seems to expect more accommodative policy than FOMC participants." Their findings also suggest that the public is more certain about the future course of monetary policy than the Fed. In short, their analysis tells us that the public has misinterpreted how dependent future monetary policy is on the data.
- Why is the public more certain about future monetary policy than the Fed? In addition, why does the public think that future monetary policy will be more dovish than the Fed does? The answer is difficult to determine but probably has to do with the sustained period of low volatility and weaker-than-expected economic growth. Sustained periods of low volatility could be cause for the unusually high level of confidence among market participants. In addition, the economic recovery has been stubbornly slow; and as a result, economic forecasts have consistently overstated the realized economic recovery. Another school of thought believes that market participants are correct in thinking that the Fed will be more accommodative than has been communicated.
- Coincidentally, when the Fed meets this week (Sep 17-18), there is a high likelihood that it revisits the language of forward guidance in light of improved economic data. The Fed will likely focus on the "considerable time" language.

Fed Funds Expectations



Primary dealers are banks and broker-dealers that trade US government securities with the Fed. The Bloomberg survey represents the results of surveying banks and other financial institutions. The June 2014 Staff Economic Projections (SEP) represent the Fed's forecast for the fed funds rate. The median values between the three surveys seem to track one another quite well until 2015. The chart suggests that the Fed forecasts more hawkish policy than primary dealers and the Bloomberg survey.

U.S. Economic Data

- The University of Michigan Confidence index printed at 84.6 vs 83.3 expected and higher than the previous reading of 82.5
- Retail Sales jumped 0.6% in August vs 0.6% expected. The gain was supported by a wide range of sectors, including auto sales, housing-related items, discretionary items, food and clothes

Date	Indicator	For	Forecast	Last
15-Sep	Industrial Production MoM	Aug	0.3%	0.4%
15-Sep	Empire Manufacturing	Sep	16.00	14.69
16-Sep	PPI Final Demand MoM	Aug	0.0%	0.1%
17-Sep	FOMC Rate Decision	17-Sep	0.25%	0.25%
17-Sep	CPI MoM	Aug	0.0%	0.1%
17-Sep	Fed QE3 Pace	Sep	$15B	$25B
18-Sep	Housing Starts	Aug	1040K	1093K
19-Sep	Leading Index	Aug	0.4%	0.9%

Source: Bloomberg [1] http://www.frbsf.org/economic-research/publications/economic-letter/2014/september/assessing-expectations-monetary-policy/

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