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The Fed Doesn't Like Surprises

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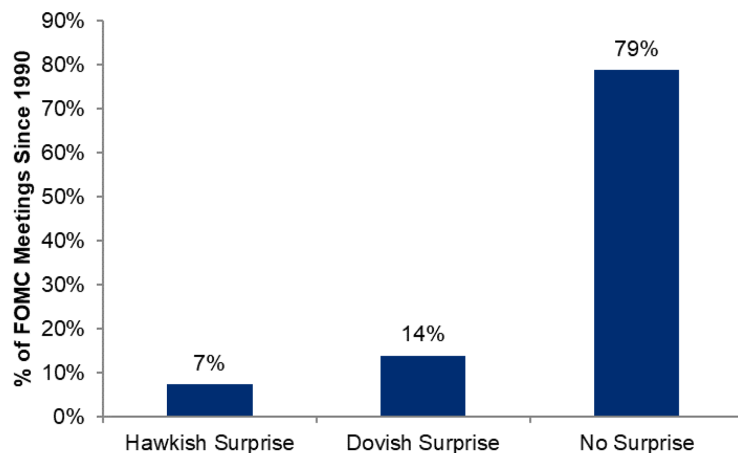
- The vast majority of Fed meetings avoid surprising markets, with just 21% of rate decisions since 1990 setting rates more than 5 bps from market pricing.
- When the Fed has surprised markets, it has delivered dovish surprises twice as often as hawkish shocks.
- A 25 bps rate surprise corresponds to around 1% change in the S&P 500 on the day of the Fed's announcement. Hawkish rate shocks tend to drive stronger S&P 500 selloffs than comparable dovish rallies.
- If fed funds futures remain near current levels, a no-cut July would be the largest hawkish surprise on record.
- Fed members will be wary of the risks around surprising the market in the coming weeks, and are likely to communicate the central bank's evolving thinking as we get news from the G20 and as the economic situation evolves.

At his press conference following the Fed's June meeting, Chair Powell was asked if the Fed was inclined to act more aggressively with a 50bps cut as soon as July. The Fed Chair cited academic research indicating that Fed surprises can provide a useful jolt to the economy, especially with policy rates so close to zero. However, with rates already near historic lows, a Fed "insurance" cut today could make future crisis fighting more difficult. While we acknowledge that the Fed has other tools like forward guidance and quantitative easing at its disposal once interest rates reach the effective lower bound, we focus this analysis on interest rate policy as it is likely to be the first line of defense ahead of a potential easing cycle.

Markets have gone well ahead of the Fed in pricing rate cuts, with nearly 75bps of cuts priced in through year-end. Many market participants now assume that a July hike is a given, with much of the debate centering around whether the Fed will cut by 25 or 50 bps. While Fed officials won't admit it, the market puts the central bank in a difficult spot with just a month until the next FOMC meeting.

The Fed has avoided surprising the market very often, with nearly four fifths of meetings since 1990 setting a fed funds rate within 5 basis points of market pricing (Figure 1). When the central bank does choose to veer from market expectations, it has been more likely to deliver a "dovish" interest rate surprise than a "hawkish" one. The Fed has surprised the market by setting interest rates at least 5 basis points lower than expected 14% of the time in the last 3 decades. By contrast, it has only delivered comparable hawkish surprises at 7% of meetings over this period. While more frequent, dovish surprises also tend to be larger in magnitude. The average dovish surprise between 1990 and 2018 was 17 basis points, vs just 10 basis points for hawkish shocks, with many of these instances occurring during the more opaque Greenspan era. Since the financial crisis, the Fed has made a concerted effort to better communicate its policies to the market and the broader public. The addition of a Fed statement in 1994, chairman's press conference in 2011, and the unleashing of individual Fed members to provide regular public commentary are all an effort to avoid surprising economic actors around the central bank's reaction function.

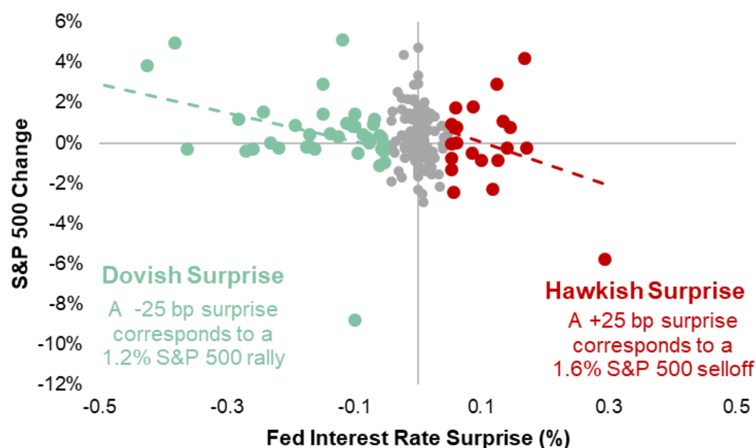
Figure 1 – The Fed doesn't like surprises



Source: Citi Private Bank, Haver, and Factset as of June 28, 2019

The Fed's gradual "opening up" has been employed for a reason. Systematically reducing uncertainty allows businesses and investors to better plan for the medium and longer-term. Additionally, rate surprises have implications for asset prices over the short term, which can feed through to tighter financial conditions. **Our analysis shows that all else equal, a 25 basis point fed funds shock in either direction is consistent with a 1% move in the S&P 500 on the day of the announcement.** Isolating just dovish or hawkish surprises uncovers some asymmetry in this finding. Hawkish shocks tend to drive stronger S&P 500 selloffs than a comparable dovish rally (See Figure 2). Either extreme scenario could drive an equity melt up or melt down.

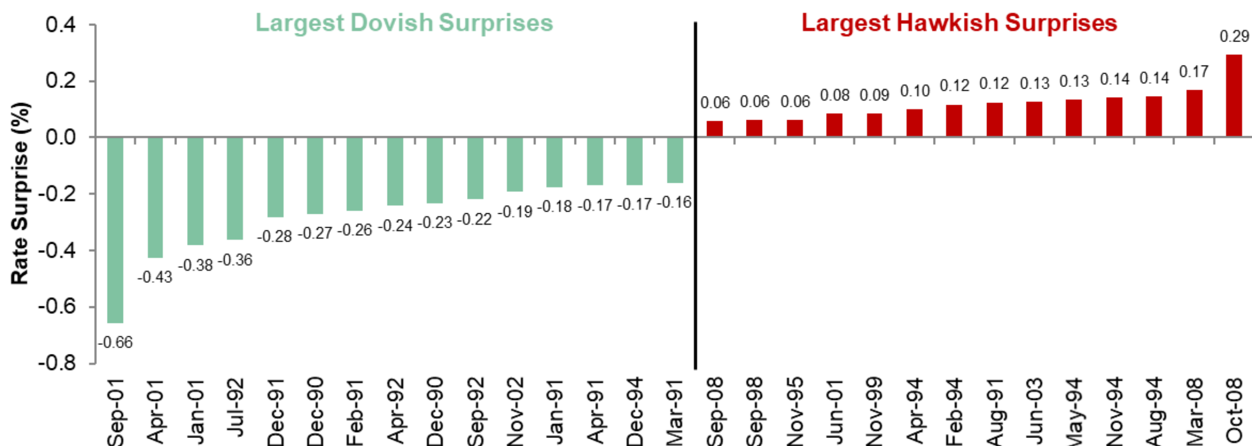
Figure 2 – Equity reactions to Fed Surprises (dovish and hawkish)



Source: Citi Private Bank, Haver, and Factset as of June 28, 2019
Note: We use the *Gurkaynak, Sack, and Swanson 2004* methodology for measuring Fed rate surprises by identifying the scaled change in current month fed funds futures on the day of each Fed announcement since 1990.

Looking ahead to the July Fed meeting, fed funds futures are currently pricing roughly 33 bps of cuts. If this pricing holds, only a 50 basis point cut would be considered a dovish surprise. A 25 bp cut could lead to a positive rate shock of 8 basis points at the very short end of the curve, while no cut would jolt short-term forwards as much as 0.33% higher. In fact, a no-hike July with market pricing near current levels would be the largest hawkish surprise on record (Figure 3), surpassing the 29bp surprise following the "underwhelming" 50bp cut in October 2008. On that day, amid the height of the global financial crisis, US equity markets closed 5.7% lower. **Fed members will be wary of the risks around hawkish surprises in the coming weeks, and are likely to communicate the central bank's evolving thinking as we get news from the G20 and as the economic situation evolves.**

Figure 3 – Most extreme hawkish and dovish surprises since 1990



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