Why The Fed Will Hike In September
Sep. 1, 2016 5:24 AM ET

Summary

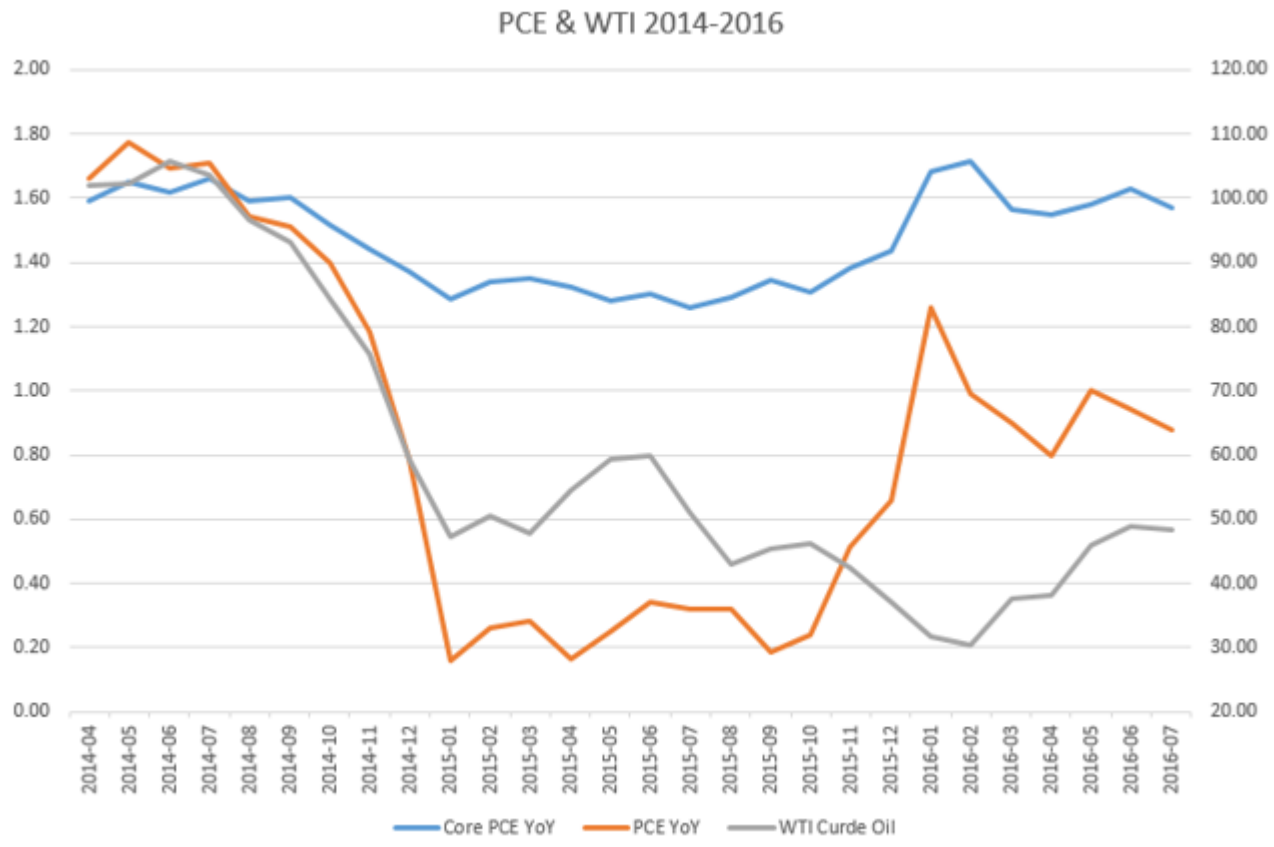
In such a time of low volatility the fed has a good ground to move on.

The fed's checklist for a rate hike gives the green light.

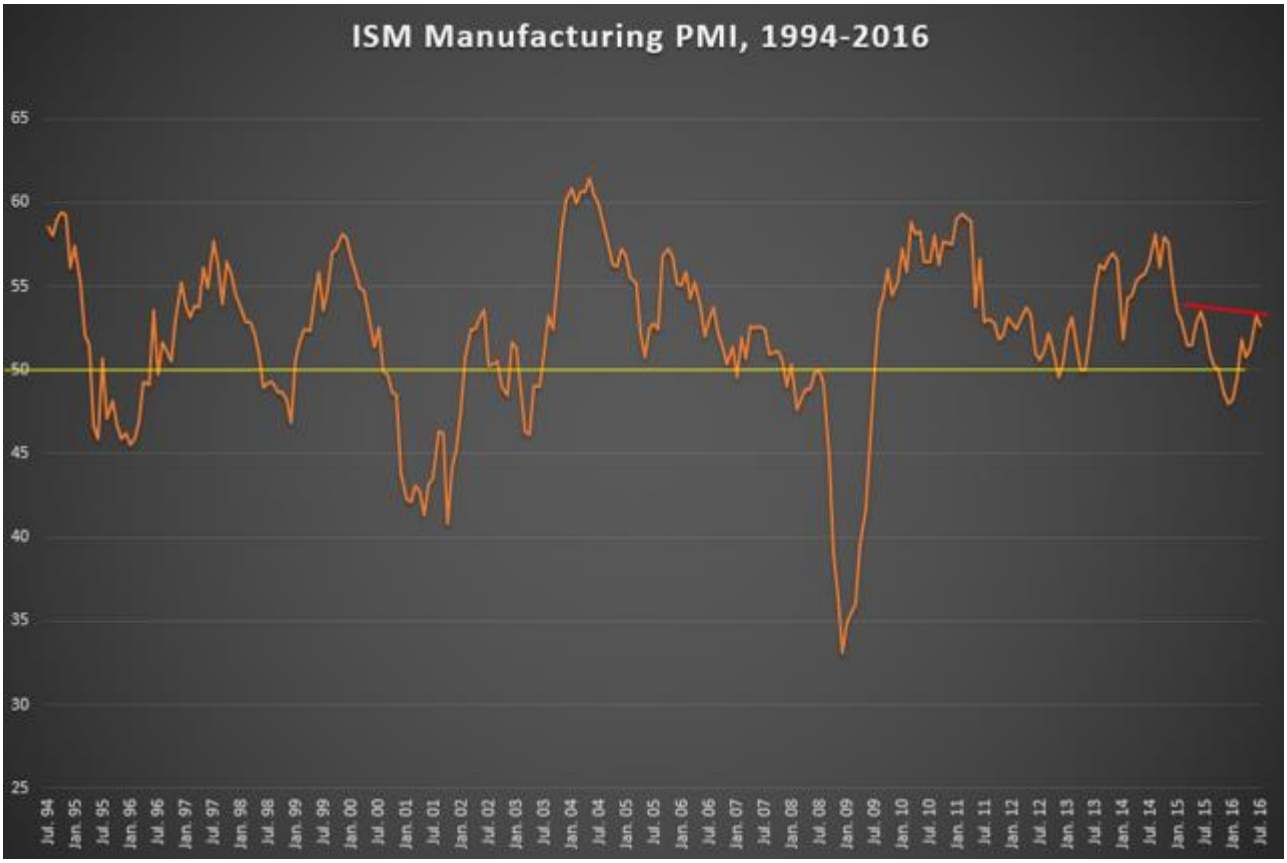
Momentum in fixed income futures point to higher rates.

According to their own rulebook, fed policy makers have enough reasons to hike in September. The volatility in the beginning of 2016 and uncertainty about market's reaction to a Brexit forced the fed not to do so earlier. As long as the market keeps calm the fed has a good ground to move on. I don't want to say that the U.S. economy is in good shape - these are just the numbers the fed wants to be in a certain range. So what does the fed's checklist for a rate hike say?

- **Unemployment:** Average monthly job growth has been 190,000 over the past three months. The unemployment rate at 4.9% couldn't be much better.
- **Inflation:** The drag from the low oil price is fading. The core PCE seems to stabilize - approaching the 2%-target.



- **GDP:** The GDPNow model forecast for real GDP growth (seasonally adjusted annual rate) in the third quarter of 2016 is 3.5% on August 29. That makes up some ground for the weak number of 1.2% q/q AR in Q2 and leaves the average for the two quarters at 2.3%.
- **Manufacturing:** Whether it was due to the dovish tone in early 2016 or not, the ISM Manufacturing PMI has recovered from its low and indicates expansion.



- **Global risks:** Emerging markets are rebounding and there's no more shocking news coming from China. In addition to that, a Brexit seems to have lost its intimidating power.

However, I would like to get more signaling from Fed officials as the fed has never acted against what was expected to happen. They still have a few weeks left to prepare the markets. Hopefully, then they won't scare the market into so much volatility that they have to step back - resulting in a loss of trust.

Momentum in eurodollar futures

The price of the eurodollar index reflects the interest rate you get on U.S. Dollar denominated deposits held in banks outside the United States (100 - future price = implied yield). Since July, the index has been trending lower.

2-year U.S. treasury yields have gained last Friday on Yellen's speech. However, expectations are still quite low for a September hike. Stable job data on Friday could be the trigger for the market to turn these probabilities towards 50%.

Target Rate (bps)	Current Probability %	Previous Day Probability %
25-50	73.0	76.0
50-75	27.0	24.0

Trade ideas

Obviously, there can be derived quite a few trade ideas from earlier than expected rate hikes. Without knowing about the outcome of the next fed meeting yet, I would consider option strategies: Going long volatility and buying put options on the S&P500 and the euro.

Disclosure: I/we have no positions in any stocks mentioned, and no plans to initiate any positions within the next 72 hours.