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Interest Rate Outlook

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The probability of the federal funds rate (FFR) staying at 5.25% remained consistent with expectations from previous weeks. The testimony from Federal Reserve Chairman Ben Bernanke still received weight from the markets this week even with higher than expected. The core CPI for January experienced a 0.3% increase, higher than the CPI overall. One high reading is not enough to unnerve the Fed, or shake the market and their expectations of future FFR changes. However, further high readings coming in later months will not be ignored. The FOMC minutes released this week confirm this. All FOMC participants discussed the possibility of changing the bias the Fed maintained about future rate actions. Chicago Fed President Michael Moskow, in a talk last week, mentioned that inflation was too high.

While the CPI numbers and the Employment Cost Index (ECI) released by the Bureau of Labor Statistics (BLS) both indicate some price pressures currently, other data sources are indicative of the moderation the Fed hopes becomes more prevalent in the coming weeks and months. There is no sector evidencing weakness more than housing. Toll Brothers reported a 67% fall in fiscal first quarter profits. The problems are not just present for homebuilders though as more banks experience rising defaults on mortgage loans, particularly those active in the sub-prime market. One area to watch in the coming weeks is jobless claims. This weeks number was lower than last week, but higher than the median forecast. This will likely be a key gauge going forward, examined to see whether the labor market situation provides a consistent, clear picture about future labor costs.

The FFR implied by the futures markets are still predicting no change as the most likely scenario for the next three meetings. However, at the May and June meetings a rate cut of 25 basis points (bp) has taken over as the second most likely, albeit remote, outcome.