A GUIDE TO

THE FED'S INTEREST RATE DECISION

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Founded in 2010, we now have global presence in over 90 countries, with main offices in the separately regulated markets of Australia, Cyprus, New Zealand and the United Kingdom.

We believe that sound investment and trading decisions begin with a strong grounding in financial education. Our goal is to make this available to everyone - and this free eBook is part of that commitment.

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A NEW CYCLE

FOREWORD

The Federal Reserve has increased its benchmark interest rate to 1% - a rise of 0,25% since December's last hike.

This is an important moment for Forex traders. We're now in a hiking cycle for the first time in almost a decade.

The goal of this eBook is to explain why this interest rate hike happened - and the impact it will have on the US dollar and wider US economy.

Patrick Latchford
CEO, Blackwell Global Investments (UK) Limited

WHY INTEREST RATES MATTER

WHAT FOREX TRADERS NEED TO KNOW

Before we explore the Federal Reserve's decision, it's important to clarify why monitoring interest rate changes from any central bank are important to Forex traders.

Interest rates can be described as the cost of borrowing money in a country or economic bloc. Interest rates are set by central banks - independent bodies that are responsible for an economy's monetary policy. If you're not familiar with monetary policy, this is simply the means by which a central bank controls the flow of money within its economy.

Interest rates are one of a series of monetary policy tools that a central bank can use to control the flow of capital.

By keeping interest rates low, a central bank encourages foreign investors, business enterprises and the public to spend more money. This is usually done to spark economic growth in regards to employment and consumer spending. Low-interest rates can act to weaken an economy's currency - because foreign investors typically move their capital to places with a higher interest rate.

Conversely, higher interest rates encourage foreign investors, business enterprises and the public to save their money. Central banks often employ interest rate hikes to control the rate of inflation - which is the rate at which the price of domestic services and goods increase. High-interest rates strengthen an economy's currency - as foreign investors often move their capital to places where they can maximise their returns.

THE FED'S DECISION

IT'S ALL ABOUT INFLATON

Now we understand the basics behind interest rates and why they are important to Forex traders, let's explore the Federal Reserve's decision to hike its benchmark rate.

In short, the reason why the Federal Reserve increased its rate is to control inflation, which has started to creep above the central bank's target of 2% in recent months. US inflation for the month of February 2017 was 2.7% (meaning consumer prices have risen 2.7% over the past 12 months).

So why is inflation increasing? Well, it's simply because the US is going through a period of strong economic growth. The population of a strong economy typically has more money to spend - both in a consumer or business context. The more money that is spent on domestic services and goods, the faster their prices increase. It's a simple example of supply and demand.

Another contributing factor to the Federal Reserve's concern over inflation is the new administration of President Trump. Specifically, Trump's fiscal plans are inflationary in nature. Let's explore two examples. Firstly, President Trump has promised to implement an infrastructure stimulus plan of approximately $1 trillion. The goal of this plan is to boost job creation and attract businesses to invest within the United States. A plan of this size would push inflation higher, as it encourages states and businesses to spend money.

Secondly, we need to look at President Trump's approach to corporate tax. The former real-estate businessman is in favour of dramatically reducing the US corporate tax rate. The intention here is to make the US one of the world's most attractive places for big businesses to invest, hire and manufacture goods. Again this is a recipe for inflationary business and consumer spending.

It's clear to see that the Federal Reserve is attempting to pre-empt any inflationary pressure that could arise in the near future.


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THE MARKET'S FOCUS

LOOKING TO FUTURE DECISIONS

Interestingly, an interest rate hike was anticipated by most market participants. For that reason, the focus of the Federal Reserve's interest rate announcement concerned further rate hikes for 2017.

Back in December 2016, the Federal Reserve predicted that there would be three interest rate hikes in 2017. In the lead up to March's FOMC meeting, there was some expectation that this number could be revised upwards, considering the strong recent economic data for job creation, along with higher inflation.

It transpired that the Federal Reserve stood by its original forecast of three interest rate hikes in 2017. This disappointed the markets slightly - and actually saw the US dollar fall against its major peers immediately after the announcement.

It illustrates the importance of being in tune with how the market is 'feeling' in the lead up to any important announcement or data release. Doing this isn't difficult - there are a number of reliable financial news outlets that report on market sentiment. There are also a number of free tools that you can use to keep track of when these important events are scheduled to happen, such as Blackwell Global's free economic calendar.

PROSPECTS FOR THE US DOLLAR

EXPECT STRENGTH IN 2017

You might be wondering what the Federal Reserve's decision means for the US dollar over the long-term. What's clear is that we are now in what can be described a 'hiking cycle' for the first time in a decade.

After the financial crisis of 2008, central banks across the globe adopted close to zero interest rates in an effort to kickstart economic growth. In fact, some central banks, such as the European Central Bank and the Bank of Japan, are still continuing with this approach today.

The US is out of this phase - and as such, traders can expect continued long-term strength for the US economy and US dollar, certainly for 2017.

However, there are a number of factors which could change this scenario. Firstly, the implementation of Trump's fiscal plans could affect the timing of further interest rate hikes. Secondly, the markets remain attuned to the more controversial aspects of President Trump's administration. This includes future trade agreements with other countries and geopolitical confrontations.

Our advice to Forex traders is to monitor current news events for developments from the White House. Remember, the market is a living organism and has a herd mentality.


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CALENDAR
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Founded in 2010, Blackwell Global was established to offer brokerage solutions for private and institutional clients. Blackwell Global is a Straight Through Processing or STP broker who provide their clients with superior liquidity and price feeds from top international banks. These are offered alongside 24-hour technical support, market research tools, educational materials, professional partnership programmes and fully integrated trading platforms.

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