FOREX TRADING

TRADE THE FED'S HIKING CYCLE

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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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THE FED: TRADING THE HIKING CYCLE

FOREWORD

Monetary policy changes from central banks can have big implications for the currency markets.

One monetary policy programme which is currently drawing the attention of traders and investors comes from the Federal Reserve. The US central bank is currently in a hiking cycle.

In this eBook, we look at what higher interest rates mean for the US economy and USD. We also explore what traders can expect from the Federal Reserve in the coming months.

Patrick Latchford
CEO, Blackwell Global Investments (UK) Limited

THE ROLE OF CENTRAL BANKS

CONTROLLING MONETARY POLICY

Every major economy has a central bank which is separate from government. The purpose of these institutions is to control something known as monetary policy. As a Forex trader, you need to be aware that monetary policy is used to control the flow of capital within an economy.

The reasons for controlling the flow of capital are actually quite simple. By encouraging or discouraging spending, central banks can help foster economic growth and employment, while maintaining the rate of inflation at a sustainable level. Clearly, this is an extremely important portfolio, as central banks play a key role in maintaining the economic health of their respective countries/ regions.

When central banks pursue a particular monetary policy, it can affect the value of their sovereign currency. The mechanics behind why this happens are quite simple. Currencies which are in

demand appreciate in value, while those that have an oversupply depreciate. So when a central bank loosens or tightens monetary policy, it impacts the supply and demand dynamics for that currency.

MONETARY POLICY TOOLS

To control the flow of capital, central banks tend to employ two primary monetary policy tools. You may have come across these terms before - but we'll explain why they matter from a trading perspective.

INTEREST RATES

One monetary policy tool is interest rates. A central bank has the ability to change base interest rates within their country. Think of interest rates as the cost of borrowing money. In most modern economies, central banks lend money to private banks. By adjusting their interest rates, central banks are essentially changing the cost of private banks borrowing money. Clearly, this can have a direct impact on the amount of capital that is distributed within an economy.

Higher interest rates encourage private banks (and therefore consumers and businesses) to hold onto their capital and save. This tool is often employed if a central bank is concerned about high inflation (the increase in the cost of goods and services) - which is driven by high levels of consumer and business spending. Higher interest rates tend to increase the value of a currency over the long-term. This happens because of two reasons. Firstly, higher interest rates taper the supply of that currency. Secondly, foreign

investors tend to move their capital to countries with higher interest rates - as they can yield larger saving returns.

Lower interest have the opposite effect. They encourage private banks to lend more money to consumers and businesses. The intended impact here is to boost job creation, and therefore economic growth. When an economy is struggling to grow, or has a problem with unemployment, central banks usually implement low interest rates. Currencies depreciate in value under low interest rates - primarily because it increases the supply of that currency.

QUANTITATIVE EASING

Another monetary policy tool used by central banks is something called quantitative easing. This is where the central bank deliberately injects more capital into the private banking system (typically by buying private bonds). When this happens, private banks have more capital to lend to consumers and businesses. Again, this monetary policy tool is used when an economy needs a kickstart.

MONETARY & FISCAL POLICY

At this point, it's important to distinguish monetary policy and fiscal policy. Monetary policy is controlled by the central banks. Fiscal policy is controlled by elected governments - and usually involves specific plans for taxation and spending. Both play a key role in maintaining economic growth.

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THE FEDERAL RESERVE

HIKING INTEREST RATES

The Federal Reserve is the central bank of the United States of America. Currently, it's the only major central bank to be in a hiking cycle. This means the bank is in a period of increasing its interest rates.

First, let's get some context. Since 2008 and the global financial crisis, most major central banks have had interest rates close to zero. This was because most economies needed substantial help to return to growth.

The US was the first bank to break this trend when they increased interest rates from 0.25% to 0.5% in December 2016. Alongside this increase in interest rates, the Federal Reserve also stated that it expected three further rate rises in 2017. In March 2017, the Federal Reserve hiked its rate again - from 0.5% to 0.75%.

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WHY IS THE FED HIKING RATES?

The Federal Reserve entered a hiking cycle primarily because of two factors. The first was the overall health of the US economy (GDP growth and unemployment data were consistently strong). The second was the prospect of rising inflation. The Federal Reserve reached a judgement that the US economy was strong enough to continue to grow with a slightly higher interest rate.

YELLEN'S TESTIMONY

So as recently as March - the market was expecting two further interest rate rises for 2017. However, the rate of inflation has remained unexpectedly low (under the Federal Reserve's target of 2%).

Federal Reserve chair - Janet Yellen - recently appeared (July 2017) before congress to testify about the US economy and future monetary policy. During her testimony, Yellen commented that the Federal Reserve was open to changing its monetary policy plans if inflation continued to undershoot its 2% target.

Despite these comments, we still expect the Federal Reserve to finish its cycle of hiking rates. Depending on future inflation (CPI) data, we could see the cycle slowed - but the US economy is still fundamentally strong.

PROSPECTS FOR THE US DOLLAR

The Federal Reserve's current monetary policy suggests long-term strength for the dollar. However, there are multiple factors at play.

Firstly, there are doubts about whether President Trump's fiscal plans can secure support from Congress and the Senate. The current President has promised to slash corporate tax rates and embark on a $1 trillion spending plan. These plans would put upward pressure on inflation. However, all of President Trump's plans have faced fierce political opposition.

Secondly, the current administration could be damaged by the ongoing Russia investigations. Members of Trump's campaign are under investigation for alleged collusion with Russia in an attempt to influence the 2016 election. This clearly has the potential to disrupt the current administration. Such disruption could cause further political deadlock - potentially derailing the implementation of fiscal plans.

Lastly, it's unlikely that Janet Yellen will remain as the chair of the Federal Reserve beyond February 2018. President Trump is apparently open to replacing her with an appointment of his own.

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