

3 298-98A

Practice Questions - Session 2

Question 1: Non-Farm Payrolls

1. Suppose the economy is expanding and the market expects the economy added 150 000 new jobs last month (NFP consensus). The NFP numbers published show that the economy has actually added 300 000 new jobs. How does this statistic impact the fixed income market, the equity market, and the USD? Explain your reasoning.
2. What if the NFP numbers published showed the economy lost 150 000 jobs? Discuss the impact of this statistic on the fixed income market, the equity market, and the USD.

Question 2: Trump Effect

One of the key-measures discussed by Donald Trump during the presidential race was to revive the American economy through some expansionary fiscal policies (infrastructure spending, tax reforms, etc.)

1. As a Fed economist, how would you have to adjust the monetary policy to deal with those new fiscal policies? Consider the economy is currently expanding.
2. How would the bond market, the equity market and the USD value adjust to this new information? Explain your reasoning.

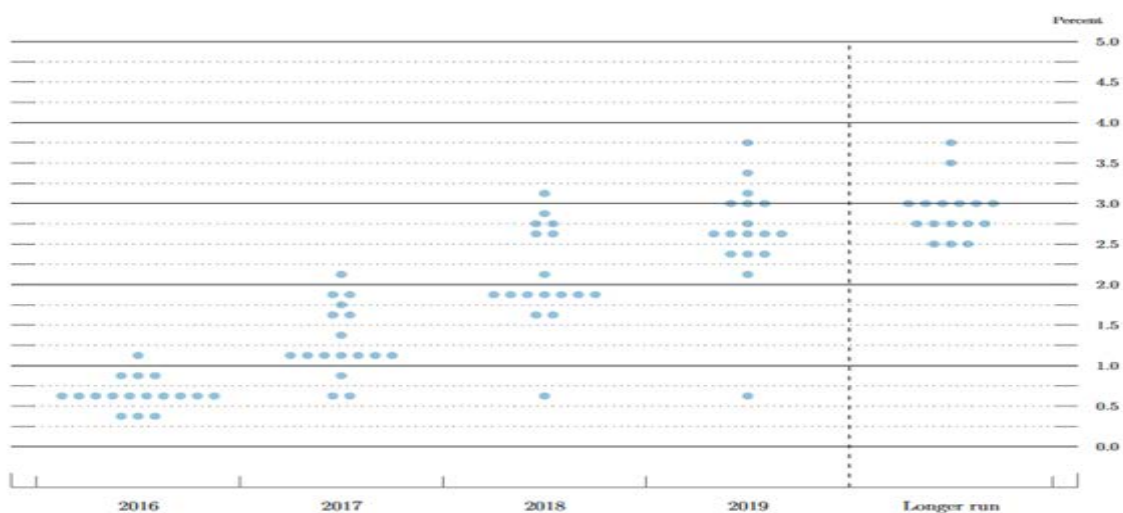
Question 3: Fed Dot plot

One of the most important tool the Fed uses to convey its monetary policy objectives to the market is the dot plot. It is a statistical chart consisting of data points plotted on a simple scale. Each point represents a Fed member's view of the level of the "Fed Funds Rate".

Consider the two following dot plots:

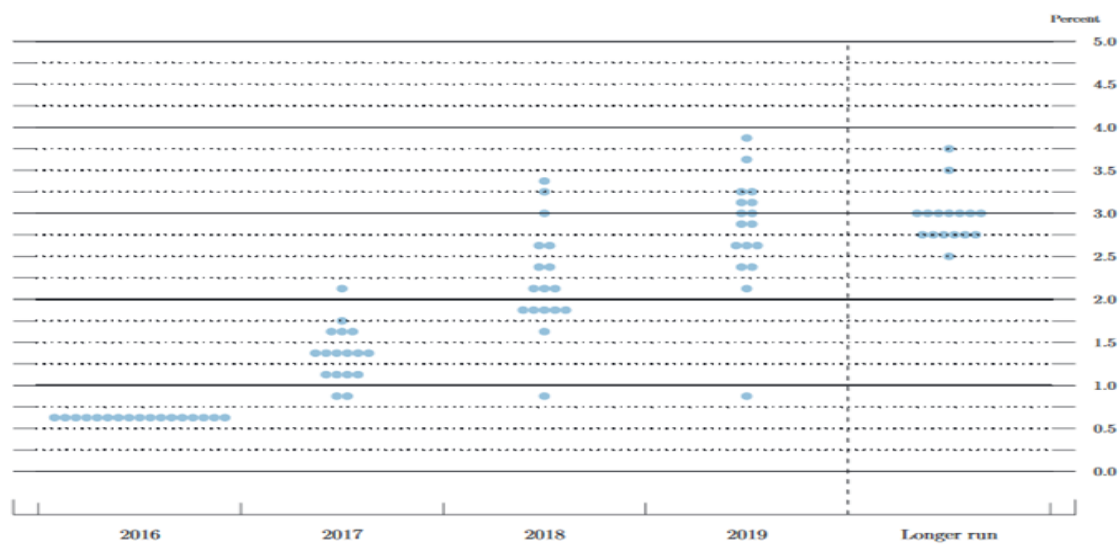
For release at 2:00 p.m., EDT, September 21, 2016

Figure 2. FOMC participants' assessments of appropriate monetary policy: Midpoint of target range or target level for the federal funds rate



For release at 2:00 p.m., EST, December 14, 2016

Figure 2. FOMC participants' assessments of appropriate monetary policy: Midpoint of target range or target level for the federal funds rate



1. Describe each dot plot.

N.B: the Fed Funds Rate was between 0.25% and 0.5% during the September meeting while it was between 0.5% and 0.75% during the December meeting.

- a. What happened between September 21, 2016 and December 14, 2016?
- b. Based on the December dot plot, how many rate hikes Fed members expect for 2017?
- c. Based on the two dot plots, how did the fixed income market and the USD value change between September 21 and December 14?

Solution

Question 1: Non-Farm Payrolls

1. The economy is expanding and the statistic published is higher than the one expected. Economic agents will start to expect a gradual increase of interest rates and a restrictive monetary policy. Eventually, this will lead to a decrease of bonds prices and to an increase of the USD value. The impact on the equity market is more mitigated: if economic agents expect the economic expansion to have positive impacts on consumers' spending and thus on firms' revenues, stock prices will go up. However, if economic agents expect the restrictive monetary policy to have a slowing impact on the economy, the equity market may see a downwards correction.
2. A statistic equal to – 150 000 means the economy is slowing. Economic agents would expect a more accommodative monetary policy than the one initially thought. This would lead to higher bonds prices (lower interest rates) and to a lower USD value. In this context, an accommodative monetary policy generally has a positive impact on the equity market.

Question 2: Trump Effect

1. Trump's speech may push the America-first agenda via discussion of potential fiscal expansion and tax reform, the by-product of which could encourage additional Fed action. The new fiscal policies would lead to higher growth and to an economic expansion. If the economy is currently expanding, Fed members would have to further tighten the monetary policy (increase the director rate and/or sell government securities to decrease money in circulation).
2. – Higher rates and lower bond prices.
 - Higher USD value. Any signs of Trump boosting US macro outlook would help vindicate a positive USD bias.
 - Higher stock prices considering firms' revenues would improve. An America-first agenda will encourage US equities to outperform peers.

Question 3: Fed Dot plot

1. Dot plot 1:

During the September Fed meeting, Fed members expected a restrictive monetary policy. They expected gradual rates hikes during 2017, 2018 and 2019. 10 members also expected a 25 bps increase of the Fed Funds Rate so that it is between 0.5% and 0.75% at the end of 2016.

Dot plot 2:

During the December Fed meeting, all Fed members thought the Fed Funds Rate would be between 0.5% and 0.75% at the end of 2016.

Generally speaking, Fed members expected a restrictive monetary policy on this temporal horizon.

2. Fed members increased their Fed Funds Rate target and view for 2017 and 2018. This is mainly due to the election of Donald Trump and the possible impact of his fiscal reforms on the economic growth.
3. Assuming a rate hike corresponds to a 25-bps rate hike, Fed members expect between 1 and 6 rate hikes for 2017. By the end of 2017, Fed members think the Fed Funds Rate will be between 0.75% and 1% at the minimum and 2% and 2.25% at the maximum.
4. During this period, a more restrictive monetary policy than initially thought led to higher interest rates (lower bond prices) and a higher USD value.