Here's how the Fed could surprise you

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While markets don't believe the Fed will really raise interest rates this year, it could surprise them with at least one hike later in the year.

The **Federal Reserve** 's road to a rate increase is a tough one, with easy money from other global central banks lining the way with possible hazards.

Fed funds futures imply a 40 percent chance of a rate hike this year, and while some economists do see a rate rise, they don't necessarily agree on the timing. One thing they do agree on though is that the **Fed is taking the summer off** .

The U.S. economy is stronger than others, so why can't the Fed raise rates? One reason is that those central bank easing programs in Europe and Japan work to suppress interest rates and in some cases, intentionally turn them negative.

In response, their currencies should weaken and the dollar strengthen, and the worry is that the greenback has the potential to surge, as it has before, if the Fed moves forward to hike U.S. interest rates.

A stronger dollar has been a problem for the Fed in the past. For instance, it helped trigger China's sudden devaluation last summer. It also has depressed commodities prices in the past, and commodities are important sources of revenue in emerging economies. A strong currency also hurts U.S. exports.

"The market is fickle. If we get a few more good jobs reports, upward pressure on wages and prices in general and the global economy is not very disruptive, the Fed could raise rates … I do think the stars need to be aligned," said Marc Chandler, chief currency strategist at Brown Brothers Harriman. He said the concerns about the dollar have been overstated, especially since on a trade-weighted basis, the greenback is down 7 percent since the end of January.

"The dollar is softer, but in the big picture it's up about 15 percent since it bottomed in the middle of 2014. The key for the Fed is not the level, but the rate of change, and the rate of change is not really accelerating," said Chandler.

The Fed held off from hiking rates in June because of the U.K. Brexit vote that month and the weak U.S. May jobs report, which was found to be even weaker than expected with only 11,000 jobs added. But the recent economic data have presented the Fed with a quandary, suggesting the consumer is strong enough, manufacturing is recovering and employment — with **287,000 jobs in June** — is heading to a level where wage increases could start to generate some inflation.

Yet, some Fed watchers say the central bank could stay sidelined for the rest of this year. Others, however, say it should move forward and hike because the U.S. economy is strong enough, as evidenced in that recent jobs data, unemployment claims, ISM manufacturing surveys and consumption data for April and May.

"The Fed has no domestic excuse. The problem is we live in an international world. I do think the Fed should raise rates," said Diane Swonk, CEO of DS Economics. "I worry about the consequences of not raising rates. I think they're in a box, with worry about the consequences of raising rates globally and the dollar. It affects exports. The labor market in June, even with the bad May employment report shows it was justified. Brexit and China make it worrisome. If you really believe we want to be pre-emptive, we're past the time of raising rates."

Low and negative rates elsewhere in the world have created a great flood of capital into the U.S. financial markets with more attractive U.S. yields driving a surge of buying in U.S. credit markets and Treasurys. The result has been an added easing for U.S. markets, with historic low yields and record-high stocks.

Add to that the low expectations for U.S. rate hikes, and markets have been riding a central bank-inspired buying wave. A report that former Fed Chairman Ben Bernanke spoke to Japanese officials about a "perpetual bond" program added a boost to risk markets Thursday, while there was also optimism that the **Bank of England will add more stimulus** later in the summer, as could the European Central Bank.

The perpetual bond program would be a type of so-called helicopter money, meaning the government could issue some sort of unmarketable bond and use it to provide fiscal stimulus. The bonds could then be bought by the central bank. In Japan's case, its policies have backfired. The Bank of Japan set negative rates, and the yen proceeded to rally, a problem for its export economy.

More extreme policy from overseas is problematic for the Fed, and ironically could force it to hold rates lower for longer so it does not risk tipping the economy.

"We've got synchronous unconventional policy and that gets you in a vicious cycle, as well," said Swonk. "The issue is how far can we go?

Negative rates for the U.S. are a big problem. ... The Fed's trying to cushion the economy. That said, if things go south, they have a problem."

Swonk said negative yields would be more disruptive in the U.S., for one, because they would hurt the value of the large amount of capital held in U.S. money market accounts.

Chris Rupkey, chief financial economist at MUFG, said the talk of more Japanese easing is a sign that the central banks are doing too much stimulus, and the Fed should start talking about the improvement in the U.S. economy.

"What that tells me is they're at the end of the line, these central banks. They're seeing their power severely weakened and they're contemplating unusual steps that are going to be difficult to sell what they're doing to the public. It's not easily understandable. Nonmarketable perpetual debt. That's printing money."

Rupkey said the Fed could signal that it is ready to start hiking in September, when it meets in July.

"It sounds like we're done with this experiment of low rates. It's no longer necessary. The jobs report came back. The stock market is at an all-time high. There's not a sign of Brexit fear or potential contagion in financial markets around the world. All those fears are gone by the wayside. I think we're going to hear more about September. We're going to have to go through several more jobs reports. There's always something," Rupkey said.

"But textbook economic theory says an economy at full employment needs normal rates," he said.

Goldman Sachs economists also said in note this week that the Fed could change its tune and start preparing markets for a rate rise again. One point they make is that hiking would not hurt financial conditions, which include credit spreads and stock prices, among other factors.

"On the positive side, our financial conditions index has now moved to its easiest level since July 2015. This is important because we estimate that the earlier tightening in financial conditions subtracted more than 1 percentage point from U.S. growth over the past year. The current FCI level suggests that this drag will give way to a slight positive impulse over the next year," they wrote.

Goldman economists also make the point that the Brexit vote did not have a serious impact on markets and that the stronger June jobs report shows that the labor market is tightening. The economists say there's a two-thirds chance of a hike this year, with a 25 percent possibility in September and a 40 percent chance in December.

"This could imply a period similar to that seen in May, when the committee actively signaled its disagreement with the very flat path priced into the fed funds futures. The most obvious opportunity for such a reset would be the July 27 FOMC statement or minutes, as well as policymaker speeches in the weeks after the meeting," they wrote.

The market has been scratching for information about the Fed's intentions, amid a flurry of Fed speakers this week. However, they pointed to no new direction by the central bank. Philadelphia Fed President Patrick Harker said he still sees two hikes this year as a possibility.

Kansas City Fed President Esther George, a hawkish member, reiterated her view that the current interest rate level is too low. She said the economy has been resilient and the economic troubles earlier this year were just a "bump in the road."

Fed watchers say if the central bank does move, December is a more likely time than September. But Jefferies strategists see the message from the Fed as currently too unclear to make a call for this year.

"We're loathe to be vague about our call but right now it doesn't makes sense to make a specific call because right now the Fed doesn't know how things are going to play out or what they're going to do in response," said Tom Simons, money market economist at Jefferies.

Joseph LaVorgna, chief U.S. economist at Deutsche Bank, said the Fed could hike in December.

"The only way the market will be surprised by Fed tightening is if the data is unexpectedly strong. I don't believe the Fed will be able to convince the market it will raise rates (without that). There's only so much the Fed can do to get the market to price a move," he said.

BlackRock's Rick Rieder believes the Fed should have raised more aggressively in the past and said the central bank now has to worry about what impact its actions could have on the rest of the world.

"I'm going to hold to the case that this Fed is going to have a hard time moving this year. That being said, I think the Fed would like to get a rate hike in and the question is are you going to get the opportunity to do it, but I think the dynamics made it significantly more difficult," said Rieder, chief investment officer of global fixed income at BlackRock..

"Fifty-five to 60 percent of growth is coming from emerging markets. If the dollar was going to rise significantly, it could impact that growth," he said. At the same time, a slowdown in the emerging world could hurt the U.S.

If the Fed does hike this year, it would more likely be in December, rather than at its September meeting, he said. But Rieder said this would mean Europe would have to settle down and China look more stable.

"I think they could go in front of the [U.S.] election. That said, the bar is very high, and not because of the election," he said.

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