US stocks, bonds rally as Fed pledges to keep rates low

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US stocks and bonds reversed earlier losses and finished Wednesday's session with gains in response to renewed pledges from the Federal Reserve Board to keep interest rates at historically low levels for the foreseeable future.

The two-day meeting of the Fed's policy-making Federal Open Market Committee (FOMC) attracted a great deal of attention both in the US and internationally, under conditions of mounting signs of global financial instability. The meeting was held in the shadow of a looming default by Greece, with unknown consequences for banks and financial markets around the world.

At the same time, government bond markets in Europe and the US have been in turmoil for months, in part because of the divergence in monetary policy between the European Central Bank, which is continuing its highly stimulative program, and the Fed, which is committed to implementing, as early as September, its first increase in short-term rates in nine years.

The prospect of rising US interest rates, even if in small increments and at a gradual pace, and the consequent rise in the US dollar are sending shudders through financial markets, particularly in the so-called emerging economies. In recent months, they have suffered a severe outflow of capital seeking higher returns in the US, threatening the stability of banks and corporations burdened by dollar-denominated debt.

These warning signs are compounded by the slowdown of the Chinese economy, low growth rates in Europe, and a "recovery" in the US that is, by historical standards, anemic.

Wall Street has lobbied heavily for the Fed to delay any rate increase for as long as possible, including into 2016. The vast profits that have been accumulated by banks, corporations and the wealthy elite who monopolize their stocks and bonds have been dependent on a virtually limitless supply of cheap credit and the inflation of asset values as a result of the Fed's near-zero benchmark interest rate, first imposed at the height of the financial crisis in December of 2008.

That the markets generally liked what they heard from the Fed was reflected in the movement of stocks, bonds and the dollar. At 2 PM, when the FOMC released its official statement, the Dow was down 22 points. Within three minutes, it had risen to plus 11 points. It ended the day up 31 points.

Ten-year Treasury notes also rallied in the aftermath of the FOMC report and Chairwoman Janet Yellen's press conference, ending the day at a higher price and lower yield. The dollar fell against the yen and the euro in anticipation of lower-than-expected US rates in the coming months.

As expected, the Fed decided for the present to keep its federal funds rate at zero-0.25 percent. In its statement, the FOMC said the economy had been expanding "moderately" after contracting (by 0.7 percent) in the first quarter of 2015. It cited job gains and concluded that the labor market was continuing to recover. It reiterated the central bank's intention to begin raising rates "when it has seen further improvement in the labor market and is reasonably confident that inflation will move back to its 2 percent objective over the medium term."

The statement concluded with a paragraph designed to reassure the banks and financial markets that, even after the Fed's targets for employment and inflation had been met, the central bank would continue to hold rates at levels that, by historical standards, are extremely low. "The Committee," the statement read, "currently anticipates that, even after employment and inflation are near mandate-consistent levels, economic conditions may, for some time, warrant keeping the target federal funds rate below levels the Committee views as normal in the longer run."

In her press conference, Chairwoman Yellen repeatedly stressed that the size of rate increases, once begun, would be small and incremental, and that they would be implemented gradually. In her opening statement, she said: “Let me emphasize that the importance of the initial increase should not be overstated: The stance of monetary policy will likely remain highly accommodative for quite some time after the initial increase…”

While reiterating that the consensus of Fed officials was to begin raising rates later this year, meaning in either September or December, she pointed out that FOMC members had lowered their projections for where the federal funds rate would stand at the end of 2016 and 2017 from their previous estimates, made last March. The median projections, she said, were 1.75 percent for 2016 and 2.75 percent for 2017, in both cases a quarter percentage point below the March estimates.

She also reported that the FOMC had downgraded its projection for US economic growth in 2015 by more than half a percentage point from its March estimate. A separate document released by the Fed showed the current projection to be 1.8 percent-2.0 percent, as compared to 2.3 percent-2.7 percent.

In the question-and-answer period, Yellen was asked about the implications of a Greek default for the US economy. The chairwoman replied that while the US had little direct financial exposure to Greece, the impact of such a development on financial markets internationally would likely have a “spillover” effect on the United States.

She was also asked about public statements by International Monetary Fund Managing Director Christine Legarde and other IMF officials urging the Fed to refrain from any rate increase until sometime in 2016. Yellen finessed the question, while making clear that she and the Fed would not be bound by advice from the IMF.