15 Mar 2017

Viewpoint | US

FOMC delivered as promised!

Economist

Kathy Bostjancic
Head of US Macro Investor Services
646-503-3066

Terry Sheehan,
Economic Analyst SMRA
609-683-5267 ext. 105

- **As widely telegraphed by Fed officials and fully anticipated by financial markets, the Fed lifted the fed funds target range by 25 basis points to 0.75%-1.00%. There were no large surprises in the policy statement, economic and interest rate projections, or in Chair Yellen's press conference. The statement emphasized that there is symmetry surrounding the 2% inflation target – it could go slightly above 2% for a brief period of time.**
- **The Fed median dot plot estimates still signal three rate hikes in 2017, followed by another three in 2018, and now slightly higher 3.5 rate hikes for 2019 (versus three previously). Our OE forecast is largely in line with the Fed's forecast, looking for three rate hikes each year from 2017 – 2019. Markets are in close alignment for 2017, but see at best 2 rate hikes in 2018 and only 1 hike in 2019.**

Fed delivered as telegraphed – no surprises

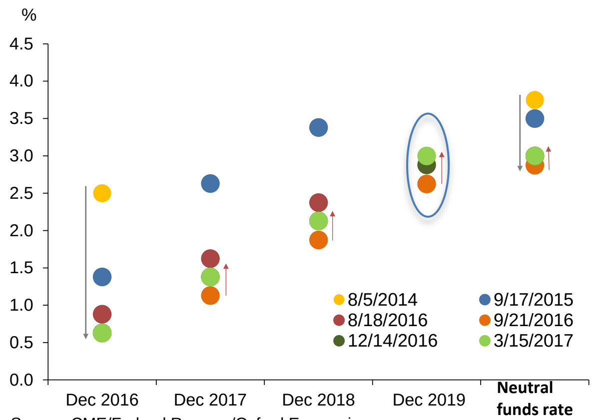
The FOMC delivered in action, forecasts, and guidance as anticipated by the markets. Policy makers lifted the fed funds target range by 25 basis points to 0.75% - 1.00%. There was one dissenting vote by Minneapolis Fed President Neel Kashkari "who preferred at this meeting to maintain the existing target range for the federal funds rate," but as we indicated in our FOMC preview this was a strong possibility. He likely preferred to see more data before hiking rates.

Following the moderate upward move in the median dot plot estimates in December, the median estimates for the fed funds rate were not changed for 2017 or 2018, and moved just slightly higher in 2019 to 3% from 2.88% in December. The consensus for three rate hikes in each of 2017 and 2018 strengthened as the number of policy makers looking for three rate hikes in 2017 increased to 9 from 6 and in 2018 the number of officials rose to 6 from 3. There were 17 individual rate forecasts submitted by policy makers in 2017-2019.

Chart 1

Only slight uptick in dot plot estimate in 2019

US: FOMC median fed funds dot plot estimates



Source: CME/Federal Reserve/Oxford Economics

Modest 0.125% rise in the median dot estimate for 2019 – otherwise no change in dot plot estimates from December.

Contact: Kathy Bostjancic | kathybostjancic@oxfordeconomics.com

FOMC delivered as promised!

Average rate for fed funds rose in 2017 – 2019.

As expected, there was a moderate rise in the average rate for the fed funds rate in 2017 – 2019. In 2017 the average rate ticked up to 1.40% from 1.37%, in 2018 rose to 2.32% from 2.23%, and in 2019 moved up to 2.89% from 2.8 % (table 1).

Table 1

March FOMC forecasts				
Fed funds rate %	2017	2018	2019	Long-run
Range	0.88-2.13	0.88 - 3.38	0.88 - 3.88	2.5 - 3.75
Average	1.40	2.32	2.89	2.97
Median	1.38	2.13	3.00	3.00

As shown in table 2, our projections for future rate increases are very close to the Fed's as we look for three rate hikes per year in 2017-2019. The only difference being policy makers' median estimate signals a 50% chance of four rate hikes in 2019. Similarly, we look for the long-term neutral fed funds rate to be 2.88%, very close to the Fed's 3% projection.

The Eurodollar future curve rallied today, lowering moderately the expected rate path. The Eurodollar futures market now suggests two rate hikes, with a near 60% probability of a third rate hike. In 2018 the bond market at best looks for two rate hikes and only one hike in 2019. The movement in the short-term bond market echoed moves in the broader bond market and this likely reflects in part relief that the tone of the FOMC policy statement and press conference were not overly hawkish. It could also reflect that fact that Q1 GDP growth is looking disappointing at around a sluggish 1% annual rate.

Table 2

Expectations of Fed funds rate (%)			
Month	Market implied rate Eurodollar futures yield* as of March 15, 2017	Fed Dot Plot median rate forecasts as of March -2017	Oxford Economics forecast as of March-2017
Dec. 2017	1.22	1.38	1.38
Dec. 2018	1.65	2.13	2.13
Dec. 2019	1.93	3.00	2.88
Dec. 2020	2.10	3.00	2.88
Long-Term	---	3.00	2.88

Source: CME group, Federal Reserve, Oxford Economics

*Adjusted for estimated risk and term premiums

Forward guidance still for "gradual" future pace of rate hikes

The economic assessment within the policy statement continued to reflect the ongoing tightening in the labor market and the return of inflation towards the Fed's 2% objective. Reflective of that, the language in the policy statement now focuses on inflation "stabilizing" at the 2% target rate as oppose to "rising" to the target (see last page for word-for-word changes in the policy statement). Further, the statement emphasized that the Fed see symmetry around its 2% inflation target. Meaning that after undershooting the target for a very long period of time, it would not be worrisome or surprising to see it overshoot the 2% target slightly for some period of time. With the swing in energy prices,

Contact: Kathy Bostjancic | kathybostjancic@oxfordeconomics.com

FOMC delivered as promised!

Policy statement emphasized inflation target is symmetric

no doubt Fed officials doing the arithmetic can see the possibility headline PCE price index could move above 2%, but they do not want the markets to interpret that as meaning they will abandon their pledge to "gradually" raise interest rates.

No change yet to the Fed's balance sheet

As expected, there was no mention of possible changes to the management of the Fed's balance sheet in the policy statement. Chair Yellen reiterated that the subject is under discussion, but that policy makers intend to "gradually and predictably" shrink the balance sheet by allowing debt securities to mature and roll-off the balance sheet. When questioned, she again commented that short-term interest rates will be the main instrument of monetary policy. For more specific details on the balance sheet discussion we look forward to the release of the meeting's minutes on April 5. Our view remains that the FOMC is likely to announce by the end of this year that starting in 2018 they will start to taper the size of its balance sheet through a "passive and predictable" manner.

No clarity on fiscal policy front

Chair Yellen commented that Fed officials are still awaiting clarity on prospective changes to economic policies. She also opined there was time to assess such future changes, and for the Fed to react appropriately.

The FOMC made modest updates to its GDP, inflation and unemployment rate forecasts (table 3). The changes are highlighted in yellow. Real GDP growth was raised slightly to 2.1% from 2% in 2018. Core inflation forecast was lifted a bit to 1.9% from 1.8% in 2017 and the long-run unemployment rate projection declined to 4.7% from 4.8%.

Table 3

FOMC's median forecasts vs OE forecasts

Summary of Economics Projections	2017		2018		2019		Long run	
%	FOMC	OE	FOMC	OE	FOMC	OE	FOMC	OE
GDP Q4/Q4								
Mar-17	2.1	2.2	2.1	2.3	1.9	1.6	1.8	1.5
Dec-16	*2.1*	*2.3*	*2.0*	*2.3*	*1.9*	*1.6*	*1.8*	*1.5*
Sep-16	*2.0*	*2.2*	*2.0*	*2.0*	*1.8*	*1.9*	*1.8*	*1.5*
Jun-16	*2.0*	*2.3*	*2.0*	*2.2*			*2.0*	*1.8*
Unemployment rate Q4								
Mar-17	4.5	4.6	4.5	4.6	4.5	4.7	4.7	4.8
Dec-16	*4.5*	*4.6*	*4.5*	*4.6*	*4.5*	*4.7*	*4.8*	*4.7*
Sep-16	*4.6*	*4.6*	*4.5*	*4.7*	*4.6*	*4.7*	*4.8*	*4.7*
Jun-16	*4.6*	*4.6*	*4.6*	*4.7*			*4.8*	*4.8*
PCE Inflation Q4/Q4								
Mar-17	1.9	2.1	2.0	2.1	2.0	1.7	2.0	2.0
Dec-16	*1.9*	*2.0*	*2.0*	*2.1*	*2.0*	*1.8*	*2.0*	*2.0*
Sep-16	*1.9*	*2.1*	*2.0*	*1.9*	*2.0*	*1.9*	*2.0*	*2.0*
Jun-16	*1.9*	*2.0*	*2.0*	*2.0*			*2.0*	*2.0*
Core PCE inflation Q4/Q4								
Mar-17	*1.9*	*1.9*	*2.0*	*2.0*	2.0	*1.7*		*2.0*
Dec-16	*1.8*	*2.1*	*2.0*	*2.0*	*2.0*	*1.7*		*2.0*
Sep-16	*1.8*	*2.0*	*2.0*	*1.8*	*2.0*	*1.8*		*2.0*
Jun-16	*1.9*	*2.0*	*2.0*	*1.8*				*2.0*

Source: Federal Reserve, Oxford Economics (OE)

Contact: Kathy Bostjancic | kathybostjancic@oxfordeconomics.com

FOMC delivered as promised!

Changes to the FOMC policy statement

Release Date: ~~February 1~~March 15, 2017

Information received since the Federal Open Market Committee met in ~~December~~February indicates that the labor market has continued to strengthen and that economic activity has continued to expand at a moderate pace. Job gains remained solid and the unemployment rate ~~stayed near its~~was little changed in recent ~~low~~months. Household spending has continued to rise moderately while business fixed investment ~~has remained soft. Measures of consumer and business sentiment~~appears to have ~~improved of late.~~firmed somewhat. Inflation has increased in recent quarters ~~but is still below~~, moving close to the Committee's 2 percent longer-run objective~~.~~; excluding energy and food prices, inflation was little changed and continued to run somewhat below 2 percent. Market-based measures of inflation compensation remain low; ~~most~~ survey-based measures of longer-term inflation expectations are little changed, on balance.

Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. The Committee expects that, with gradual adjustments in the stance of monetary policy, economic activity will expand at a moderate pace, labor market conditions will strengthen somewhat further, and inflation will ~~rise to~~stabilize around 2 percent over the medium term. Near-term risks to the economic outlook appear roughly balanced. The Committee continues to closely monitor inflation indicators and global economic and financial developments.

In view of realized and expected labor market conditions and inflation, the Committee decided to ~~maintain~~raise the target range for the federal funds rate ~~at 1/2~~ to 3/4 to 1 percent. The stance of monetary policy remains accommodative, thereby supporting some further strengthening in labor market conditions and a sustained return to 2 percent inflation.

In determining the timing and size of future adjustments to the target range for the federal funds rate, the Committee will assess realized and expected economic conditions relative to its objectives of maximum employment and 2 percent inflation. This assessment will take into account a wide range of information, including measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial and international developments. ~~In light of the current shortfall of inflation from 2 percent, the~~The Committee will carefully monitor actual and expected ~~progress toward~~inflation developments relative to its symmetric inflation goal. The Committee expects that economic conditions will evolve in a manner that will warrant ~~only~~ gradual increases in the federal funds rate; the federal funds rate is likely to remain, for some time, below levels that are expected to prevail in the longer run. However, the actual path of the federal funds rate will depend on the economic outlook as informed by incoming data.

The Committee is maintaining its existing policy of reinvesting principal payments from its holdings of agency debt and agency mortgage-backed securities in agency mortgage-backed securities and of rolling over maturing Treasury securities at auction, and it anticipates doing so until normalization of the level of the federal funds rate is well under way. This policy, by keeping the Committee's holdings of longer-term securities at sizable levels, should help maintain accommodative financial conditions.

Voting for the FOMC monetary policy action were: Janet L. Yellen, Chair; William C. Dudley, Vice Chairman; Lael Brainard; Charles L. Evans; Stanley Fischer; Patrick Harker; Robert S. Kaplan; ~~Neel Kashkari;~~ Jerome H. Powell; and Daniel K. Tarullo. Voting against the action was Neel Kashkari, who preferred at this meeting to maintain the existing target range for the federal funds rate.

Contact: Kathy Bostjancic | kathybostjancic@oxfordeconomics.com