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FOMC minutes point to rate hike in December

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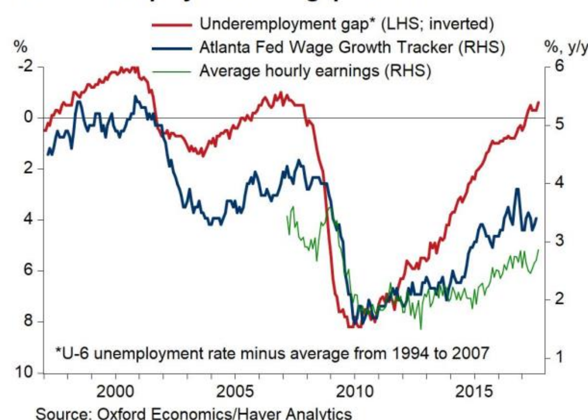
- **The minutes from the September 19-20 FOMC meeting on the whole point to a rate hike in December. However, a few FOMC officials opine that there should be no further rate hikes this year and the forward path for rate increases might be quite shallow due to "persistently" low inflation readings.**

- **Importantly the minutes also revealed that most FOMC participants did not assume fiscal stimulus in their individual forecasts or had lowered the expected magnitude of any stimulus. This presents upside risk for short-term rates for 2018 in the event that a sizeable fiscal package is enacted.**

- **We look for a December rate hike as the consensus on the FOMC is poised to raise rates even though there remains great uncertainty as to why inflation rates continue to undershoot expectations. We believe continued low inflation will temper the pace of rate hikes next year. Currently we forecast just two rate hikes in 2018 (25 basis points each), but if the 10-year fiscal package is significantly larger than our baseline assumption of $500 billion, then the Fed could end up raising the fed funds rate more rapidly next year.**

The minutes depict that Fed officials had a full and robust discussion about the future trajectory of inflation. The more hawkish officials continue to believe in the traditional relationships that dictate that as the labor market continues to tighten and "transitory" factors fade, inflation in the medium-term should rise to the 2% target rate. Within this camp participants also expected wage increases to pick up going forward and some suggested a broader acceleration in wages has already unfolded. In this light, the average hourly earnings data released in the September employment report support this assertion.

Chart 1



Average hourly earnings have re-accelerated back to the late-2016 pace as the labor market looks to be fully employed.

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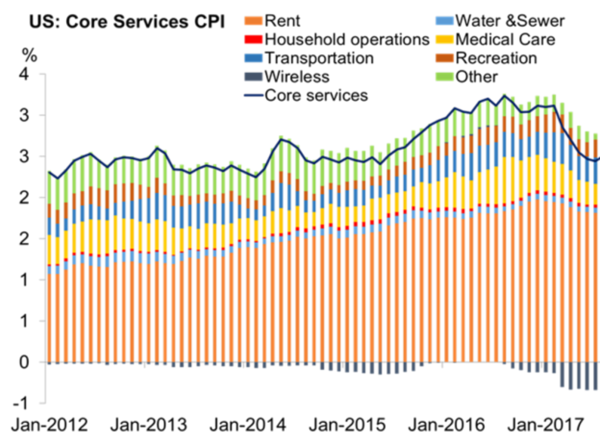
These officials "cautioned that an unduly slow pace in removing policy accommodation could result in an overshoot of the Committee's inflation objective in the medium term that would likely be costly to reverse or could lead to an intensification of financial stability risks or to other imbalances that might prove difficult to unwind."

However, there is a sizeable minority voicing concerns that the equilibrium unemployment rate might be lower than commonly believed and that is why wages continue to lag behind expectations. These policy makers also worry that the downdraft in inflation readings are not "transitory" but "persistent" due to a plethora of structural factors including the impact of technological innovations on "competition and business pricing", demographic issues, slow productivity gains, and global factors as other advanced economies are also experiencing low inflation. Some participants again expressed concern that in a low inflation environment, there is the risk of "a decline in inflation expectations". They feel that an appropriate policy path "should take into account the need to bolster inflation expectations" to reach the 2% target.

Moreover, why the inflation may be temporarily boosted by the recent hurricanes, some officials also see signs that some of the price gains in service categories might continue to be slow. Our analysis also points to a broad-based deceleration in core service prices, outside of the recent hurricane impact.

Chart 2



Our bottom-up analysis of inflation shows that the "core" reasons for the inflation slowdown emanate from the core services categories – with an easing in rental prices as the most important driver.

Further, some members opined that easy "financial market conditions might not deliver much impetus to aggregate demand if they instead reflected a more pessimistic assessment of prospects for longer-run economic growth and, accordingly, a view that the longer-run neutral rate of interest in the United States would remain low."

As expected, the minutes depicted the discussion to start balance sheet normalization. Only the "when" of the start was in question before the meeting. Fed policymakers had a strong consensus going into the meeting that the right time was near, and that its plans had been clearly communicated to avoid market disruptions. A unanimous vote by FOMC members put the final seal on the decision with an October start date.

As for the outlook for economic growth, policy makers remarked that Hurricanes Harvey, Irma, and Maria "would affect economic activity in the near term", but growth should "rebound beginning in the fourth quarter". The storms are "unlikely to materially alter the course of the national economy over the medium term".

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