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Fed Chair Yellen bit more cautious on inflation outlook

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- **FOMC Chair Yellen's semi-annual monetary policy testimony overall was in line with our expectation. Importantly she revealed a bit more caution on the inflation outlook than she conveyed at the June FOMC meeting and the FOMC detailed in the Monetary Policy Report released last Friday. This lends support to our call that the FOMC will forgo additional rate hikes this.**

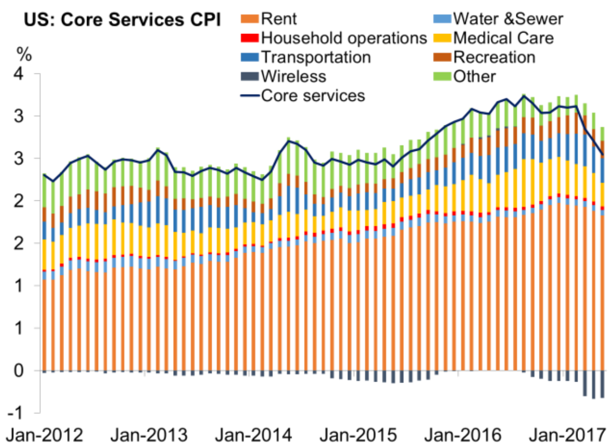
- **Yellen's comments underscore that the start of the balance sheet reduction is on course for this year. We anticipate that the FOMC will announce at the September 19-20 policy meeting that a reduction in the balance sheet will commence in October.**

Yellen presents a slightly more cautious view on inflation

Chair Yellen's semi-annual monetary policy testimony overall was in line with our expectations. She indicated that gradual rate hikes are likely over the next several years and that balance sheet reduction is on course for this year. Importantly, she also struck a slightly more cautious tone on the inflation outlook. While she continued to expect that further tightening in the labor market will lead to upward pressures on wages and prices, and asserted that "recent lower readings on inflation are partly the result of a few unusual reductions in certain categories of prices", she acknowledged that there is "uncertainty about when – and how much – inflation will respond to tightening resource utilization." This added caveat reflects that Yellen and other Fed officials are becoming less confident that inflation will reach the 2% target in the medium-term as the FOMC currently projects.

Our recent bottom-up analysis shows that there is a broader set of categories that are suppressing inflation. Of these categories, slower residential rental price gains are the most important and indications are the pace of increase in rental prices will continue to cool. This represents a large hurdle for inflation to reach its 2% target rate.

Chart 1



Source : Oxford Economics/Haver Analytics

We forecast that the PCE price index will register a 1.7% annual rate and core PCI prices advance at just 1.6% for this year. For 2018, we see inflation accelerating only modestly to 1.8% at the headline and core levels.

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Yellen’s shift to a more guarded view on inflation and our recent analysis on inflation developments support our expectation that below-target inflation readings will lead Fed officials to keep the fed funds rate target unchanged for the remainder of this year. For next year we forecast the FOMC will raise rates only twice (total 50 basis points).

That said, we look for the FOMC to move forward this year with balance sheet normalization since this is not the Fed’s primary policy tool and the FOMC likely wants to implement its balance sheet plans before Yellen’s term as Chair ends in February 2018. We anticipate that the FOMC will announce at the September 19-20 policy meeting that a reduction in the balance sheet will commence in October.

Risks are balanced surrounding the economic outlook – changes to fiscal policy represent uncertainty.

On the economic growth front, Yellen said that after a sub-par 1.4% growth rate in Q1, economic activity has rebounded in Q2 on the back of firmer consumer spending, improved global economic growth, and an ongoing recovery in oil drilling activity. We estimate that Q2 GDP growth is running around 3% annualized rate. She reiterated that there is “roughly equal odds that the US economy's performance will be somewhat stronger or somewhat less strong.” She did note that possible changes in fiscal and government policies are a source of uncertainty.

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