

Special Report

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Fed Guidance Is Not Incompatible With A March Hike

A consensus view is that the conditions likely exist for the Fed to continue to guide rates higher but because it has not signalled a pending hike on March 16th, it may have to go later. That could include teeing up April, or alternatively, because the April meeting does not include forecast updates or a press conference, the Fed may elect to hold off until June before hiking again. **This note counters that argument on two fronts.**

One is that a careful parsing of what the balance of voting Fed officials have said can indeed be referenced by the Fed as having sufficiently laid out the conditions for a hike now. We liken the significance of this episode to being similar to the debate leading up to the September 17th-18th 2013 FOMC meeting when the Fed surprised by not tapering bond purchases and drew the ire of some market participants who complained that the Fed did not signal such a widely priced move. In reality, however, Chairman Bernanke had noted the following in his semi-annual testimony to Congress ([here](#)):

“The risks remain that tight federal fiscal policy will restrain economic growth over the next few quarters by more than we currently expect, or that the debate concerning other fiscal policy issues, such as the status of the debt ceiling, will evolve in a way that could hamper the recovery.”

Then in the press conference following his September 18th post-FOMC press conference, Bernanke followed up this caution (transcript [here](#)):

“But it is the case, I think, that a government shutdown — and perhaps, even more so, a failure to raise the debt limit — could have very serious consequences for the financial markets and for the economy, and the Federal Reserve’s policy is to do whatever we can to keep the economy on course. And so, if these actions led the economy to slow, *then we would have to take that into account, surely. So this is one of the risks that we are looking at as we think about policy.*” [emphasis added].

All signs into the September FOMC were pointed toward the strong risk of a shutdown that did indeed happen from September 30th until October 17th. After that risk eased, the Fed tapered and kept on doing so thereafter. We felt at the time and continue to feel that markets were wrong to blame the Fed and should have read things more clearly. There is the danger once again that markets are misreading recent Federal Reserve communications.

Two is that it isn't even clear to us that the Fed has a duty to have market pricing on side before acting especially if a move is accompanied by dovish guidance like December's milquetoast hike. Sometimes if you have any conviction as a policy maker and markets are deeply off side where you think you would like to take them, then a sharp wake-up rap on the desk has merit to bring them at least back to the halfway point. The purpose of this note is nevertheless not to dwell on the second point; rather, it is to focus upon a careful parsing of Fed speak.

Before diving into such an exercise, a starting point involves recognition of the fact that recent weeks have not offered the most shining examples of consistency or discipline in Fed communications. At times, Fed guidance has appeared overly sensitive to weekly market developments and introduced divisive, tangential and politically charged issues such as breaking up the largest banks. Being in the blackout period ahead of next Wednesday's FOMC meeting therefore leaves limited ability to read a consensus voting tendency. Our attempt to do so is below; it mainly focuses upon voting members not at all because other opinions don't matter at the table but because we need to be practical in weighting the views by the probability of action for or against policy decisions. Then we provide an assessment of alternate and nonvoting members' opinions. On balance, our reading is

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tentatively supportive of a vote in favour of a hike but our conviction is by no means high. Two strong voting doves and two strong voting hawks will cancel out each other in the tails of the debate and the vote should be carried by the top of the house and the moderates that we feel are likely to stay reasonably on course.

1. **Chair Janet Yellen (hawkish moderate):** Yellen has not spoken since February 11th when she delivered the second day of her semi-annual testimony on monetary policy to Congress. Clearly a lot has happened since, and so the significance we would attach to her views now is tempered by how relevant that testimony may be in the here and now. That said, most developments since then have been constructive and particularly a calmer market environment, recent foreign policy gestures, and improved US data. Our assessment of her comments at the time is available [here](#). At the time, Yellen's balanced testimony reinforced a "gradual" message for policy adjustments and noted the caveat referenced below.

"Financial conditions in the United States have recently become less supportive of growth, with declines in broad measures of equity prices, higher borrowing rates for riskier borrowers, and a further appreciation of the dollar. These developments, if they prove persistent, could weigh on the outlook for economic activity and the labor market, although declines in longer-term interest rates and oil prices provide some offset."

To re-emphasize, we feel that since that time, the general global market tone has improved and so Yellen could reference what she said on February 11th and say that developments since then have eased some of the concerns she laid out. The S&P500 is now down by just 3% year-to-date and 6% from the early November peak, high yield has recovered much of the weakness earlier this year (chart 1), ditto for market-based inflation expectations (chart 2), and the Fed's preferred trade-weighted broad dollar index is back down to where it was when the Fed hiked in December and guided gradual further hikes (chart 3). On fundamentals, the balance of positive data surprises has climbed to the highest readings since early last year (chart 4). Firmer core inflation and nonfarm payrolls are among such positives that reinforce expectations the US is recovering from transitory headwinds in Q4 alongside modestly building inflation accompanied by a three month moving average pace of wage growth at 2.5% notwithstanding mild give-back of the prior month's strong monthly rise. **One would therefore be on somewhat shaky ground to claim that Yellen provided absolutely no policy guidance in advance if the Fed hikes next week.** The Fed should not be overly sensitive to chasing markets but at a minimum should have comfort that market fears earlier this year have calmed down.

2. **Vice Chairman Stanley Fischer (hawkish moderate):** Fischer's views have been somewhat buffeted by market forces this year which isn't entirely unreasonable given the volatility to date. On January 6th he bluntly stated "We think they're too low" in relation to the market's expectation that the Federal Reserve will only hike twice this year (at the time). We agreed, but it was a fairly strong statement and greater market turmoil lay ahead. Last month on February 23rd he remarked that "It is still early to judge the ramifications of the increased market volatility of the first seven weeks of 2016. But we have seen similar periods of volatility in recent years — including in the second half of 2011 — that have left little visible imprint on the economy." Again, we agreed, and since then the US economy and broad market tone have improved. Our advice to take the opposite side of market pricing for little to no Fed action at all this year has paid off as 2 year yields on Treasuries have risen significantly over the past month and back toward mid-January levels. This past week, Fischer remarked quite strongly that "unemployment is in the vicinity of full employment" and "we may well at present be seeing the first stirrings of an increase in the inflation rate — something that we would like to happen." Fischer

Chart 1 Bloomberg USD Corporate Bond High Yield Index



Chart 2 Markets Changing Their Tune On Inflation Risk?

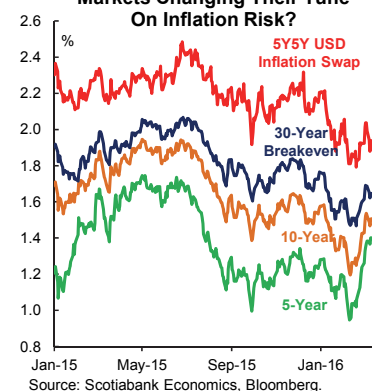


Chart 3 USD Slips From Peak

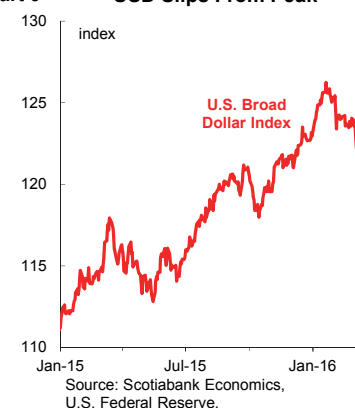
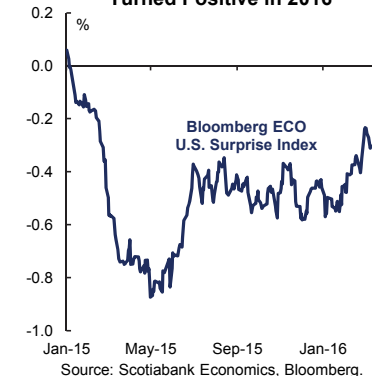


Chart 4 U.S. Data Surprises Have Turned Positive in 2016



observed that the soft evidence of an inflation-unemployment relationship may be beginning to mildly assert itself. He also remarked that “At present, it looks likely that the equilibrium interest rate will remain low for the policy-relevant future” which we took as a reference to the medium-term neutral rate and hence more of a comment about the pace of hikes (ie: Fed funds at 1-2% or so remains ‘low’). He did not repeat reference to how it was too early to assess spillover effects from market turmoil but that doesn’t mean he doesn’t still believe this to be the case although cause for doubting as much is reflected in the charts we’ve provided. **On balance we think he would remain cautiously supportive of continued rate hikes.**

3. **Governor Lael Brainard (dove):** She is clearly a committed dove and evidence would include her comments on the wires and in a recent CNBC interview. Brainard referenced core inflation stubbornly stuck at 1.25%. Such a reading is the average 2015Q4 q/q measure from last year. Higher frequency and fresher data shows core PCE inflation at 1.7% y/y as of January 2016 and it hasn’t been at 1.25% since last July. If core price levels remained at January’s seasonally adjusted levels for the rest of Q1, then based on the Q4 hand-off and January 2016 starting point, we’re tracking 1.5% q/q core PCE inflation. To repeat, that assumes flat core prices for the duration of Q1 which we think is unlikely. Core inflation toward 1.75% q/q in Q1 appears more likely to us. Firming commodity prices may also be removing additional downside risk to headline PCE inflation and adding upside so there is danger in clinging to older data. Regardless we think Brainard makes good points of caution and **expect her to lean against hiking at the table though it is not clear whether she would dissent versus insist on very cautious guidance thereafter.** Nevertheless, her remarks contradict Fischer’s somewhat.
4. **Governor Jerome Powell (moderate):** Powell recently lent support to continuing the Fed’s ‘dot plot’ forecast of fed funds target rate projections but has not commented on other monetary policy matters this year. The last time he remarked on conventional monetary policy was on December 18th when he emphasized that “For me, at the top of the list will be continued progress in the labor market, and with it, continued progress on inflation.” He went on to note that managing risks to moving too early or too late require an effort to “start now with a very small increase and then move very gradually.” **He has not dissented in his period with the Fed since 2012 and we expect him to go with Yellen.**
5. **Governor Daniel Tarullo (moderate):** Tarullo has delivered remarks about regulatory matters and as recently as last week on the topic of large banks’ dealings with each other. He has not commented about monetary policy this year and we believe **he is a moderate who supplements his views with Chair Yellen’s steering guidance of the committee.**
6. **NY Fed President William Dudley (hawkish moderate):** Dudley’s speech that he delivered in China early last week was taken by us as a sign that he stands prepared to alter his outlook in a more meaningful manner if downside risks materialize, but he is not there yet. Here are the two most relevant passages.

“Recent economic and financial developments have not yet led me to make a fundamental change in my outlook for U.S. growth in 2016. At this point, I have marked down my growth outlook very modestly. However, financial market conditions have tightened since the start of the year, mostly in response to international developments. If this tightening of financial conditions were to persist, it could potentially lead to a more significant downgrade to my outlook.”

“On inflation, we continue to fall short of our 2 percent objective for the personal consumption expenditure (PCE) deflator. This shortfall looks likely to continue longer than I had earlier anticipated due to the persistent strength of the dollar and weakness in energy prices. However, I continue to expect a gradual return to our 2 percent objective as the transitory factors that have held down inflation dissipate.”

Dudley went on to note that he is “somewhat less confident than I was before” about the inflation outlook but as yet we didn’t read a material shift in his outlook. Also, like the earlier remarks on Yellen, markets may be interpreted by Dudley in a somewhat more constructive manner at this point. To us, his speech reads as more of a cautious tale on the speed of adjustment and the medium-term neutral rate than cause for suspending a hiking campaign. **Dudley is highly likely to vote with Yellen. Not since Paul Volcker has a NY Fed President dissented.**

7. **Boston Fed President Eric Rosengren (dovish moderate):** Rosengren has not spoken since February 17th but at that time noted that “Should these [weaker financial] conditions persist, and slow progress on attaining the Fed’s dual mandate, I believe the normalization of monetary policy should be unhurried, and wait for economic data to improve.” Since then, stronger data has steadily emerged on growth, inflation and jobs and the broad tone across the risk trade has improved so it is not clear where Rosengren would currently stand. **We think he could be swayed by consensus but with a dovish slant.**

8. **St. Louis Fed President James Bullard (dove):** Bullard's assessment of inflation risks was somewhat mixed but skewed toward a dovish interpretation of market based measures of inflation expectations. On CPI's rise, he said on February 25th: "That's good news in the sense that it fits with the committee's narrative on this." But he then went on to note that "What's got me worried is these inflation expectations have fallen." Bullard noted that it would be "unwise" to raise the fed funds target rate when market based measures of inflation expectations are falling. He has not spoken since but market based measures have modestly risen. We don't judge this to be enough to alter his opinion and **expect Bullard to vote in favour of a pause or, at a minimum, accompany a hike with dovish guidance.** Bullard has already demonstrated willingness to publicly dissent.
9. **Kansas City Fed President Esther George (hawk):** George last spoke on monetary policy matters on February 23rd. In reference to a hike in March, she remarked "It absolutely should be on the table. At this point I would not say that the data have suggested there has been a fundamental shift in the outlook." **We expect George to support a hike in March but perhaps as long as momentum is pointed in direction of a hike it is not clear she would otherwise dissent.**
10. **Cleveland Fed President Loretta Mester (hawk):** Mester noted on February 26th that "March should be on the table" and "Whether we increase in March or not, that's going to depend on the data and other people's views around the table. But my forecasts, and the risks around those forecasts, suggest we still want to see gradually rising interest rates." **We expect Mester to support a hike in March with the same caveat as George.**

In short, a scenario marked by a strong majority in favour of a hike is not the least bit implausible. Beyond the voting FOMC members, other voices will contribute to the dialogue and we offer our assessment of their likely bias.

Chicago Fed President Charles Evans (alternate 2016, voting 2017, dove): Evans has not spoken since a speech he delivered on January 13th but is understood to be a dove. At the time, however, he said he was 'nervous that inflation expectations are not as firmly anchored as we perceived them to be a year ago, that they have drifted down a little bit. I'm not really worried too much, but normally they don't do this, and so it gives one pause when we have been under-running our inflation objective for the last many, many years.' He said he was ok with hiking in December because the Fed had strongly signalled as much but that it would have "pleased" him had the Fed not hiked.

Richmond Fed President Jeffrey Lacker (nonvoting 2016, alternate 2017, hawk): Lacker noted on February 24th that he saw 'no strong evidence' to alter his outlook.

Minneapolis Fed President Neel Kashkari (alternate 2016, voting 2017, dove): Kashkari delivered a speech on February 23rd and noted "I feel pretty good about how the U.S. is positioned, but we have to watch the data." A week before that he caused a stir by advocating the break-up of the largest banks. He also noted on that prior occasion that "There's probably been a little bit more downside" to data following the January FOMC meeting.

San Francisco Fed President John Williams (nonvoting 2016, alternate 2017, hawk): Williams remarked on March 2nd that the FOMC may "slightly" alter its dot plot projections for rates and there could be a 'tweak here or there.' He noted that the economy hadn't been altered by more than "a tenth here or there" now versus at the time of forecasts issued in December and that the Fed remains "on the path to raising rates."

Dallas Fed President Robert Kaplan (alternate 2016, voting 2017, dove): The day before nonfarm payrolls hit the tapes, Kaplan stated "If in doubt, it's better to wait" and went on to note that developments so far this year "call for patience and further diligence."

Atlanta Fed President Dennis Lockhart (nonvoting 2016, alternate 2017, moderate): Lockhart spoke on February 25th and did not comment directly upon near-term monetary policy while confining comments largely to the topic of how rising rates would be challenging for banks by way of managing net interest margins. Back on January 11th, Lockhart stated that the US economy should be positioned "to enjoy enough self-reinforcing momentum to handle gradually higher rates" and that additional rate hikes in 2016 would come to be "justified."

Philadelphia Fed President Patrick Harker (alternate 2016, voting 2017, dove): Harker last spoke on February 16th when he noted that "...it might be prudent to wait until the inflation data are stronger before we undertake a second rate hike. Thus I am approaching near-term policy a bit more cautiously than I did a few months ago."