Hawkish FOMC Drives A Flatter Curve

- The FOMC broadly met our expectations for policy changes and in general stuck to its guns with relatively modest tweaking of forecasts and guidance. The broad suite of communications was more hawkish than markets anticipated. Here is a summary of key steps and communications:
  - ◊ The fed funds target rate range was increased by 25bps to 2.25–2.5%;
  - ◊ The IOER rate was raised by only 20bps so the IOER spread to the upper fed funds limit widened to 10bps in order to address the issue flagged in prior writings about short-term interest rate differentials;
  - ◊ Balance sheet plans were left fully intact as expected;
  - ◊ One less hike is projected in 2019. That carries through 2020–2021;
  - ◊ Cumulative rate hikes over the cycle remain more than what markets are pricing;
  - ◊ Reference to 'gradual' hikes was retained versus some risk they might have dropped or replaced 'gradual';
  - ◊ The longer run neutral rate projection was lower by 25bps;
  - ◊ Growth was revised a little lower in 2019 only. Chair Powell stated they have "seen some developments that signal some softening" to merit forecast changes but that "in our view these developments have not fundamentally altered the outlook."
  - ◊ Inflation was revised slightly lower in 2019 only.
  - ◊ Core inflation was revised slightly lower throughout the projection horizon.
  - ◊ See the summary of forecast changes toward the bottom of this note for details.
- Charts 1–4 summarize the main changes to the rate forecasts and their dispersion. The first chart shows the downward 25bps shift in projected rates according to the FOMC consensus throughout the entire forecast horizon. The second chart translates this and the revised inflation outlook into an altered real policy rate projection that came down closer toward the consensus of US primary dealers including Scotia's estimates. The third and fourth charts compared the revised dot plot to the prior rate projections that were offered at the September meeting. In particular, note the tightened distribution in 2019 in addition to the small downward shift. There remains a widely dispersed range of opinions toward where the fed funds target rate will go in 2020 and 2021 and significant variation in the estimates of the longer term neutral rate. I can't resist noting the graphical depiction of the dots in 2020 versus 2021: 2020 appears as an up-arrow versus a down arrow in 2021 that shows up more clearly in the original dots (page 3, here). Clearly the FOMC isn't coordinating its forecasts to a pre-set picture, but the coincidence is at least worth a chuckle.
- **In terms of market reactions,** stocks sold off with the S&P500 swinging from a 1½% rise on the day ahead of the FOMC communications to now being down by 1½% and the Nasdaq off by more than 2%. While there no doubt remains a limit to this argument, clearly stock markets have to learn to live

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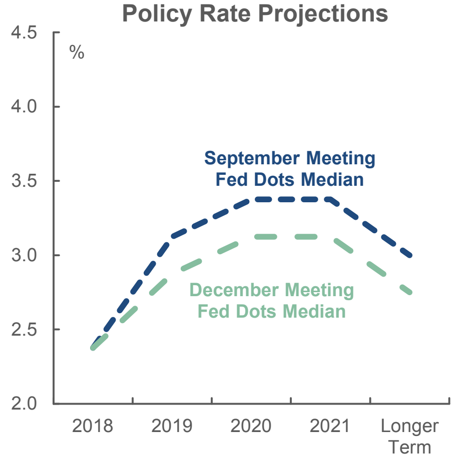
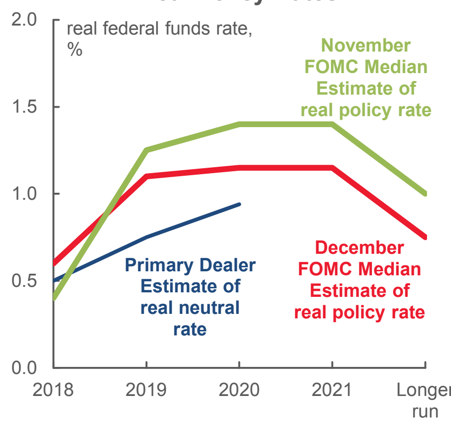
Chart 1 Change In FOMC's Policy Rate Projections



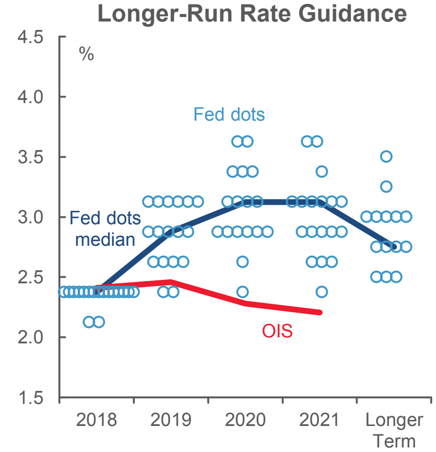
Sources: Scotiabank Economics, Bloomberg.

Chart 2 Real Policy Rates



Sources: Scotiabank Economics, New York Federal Reserve, Federal Reserve Bank.

Chart 3 Markets Hair-Cutting the Fed's Longer-Run Rate Guidance

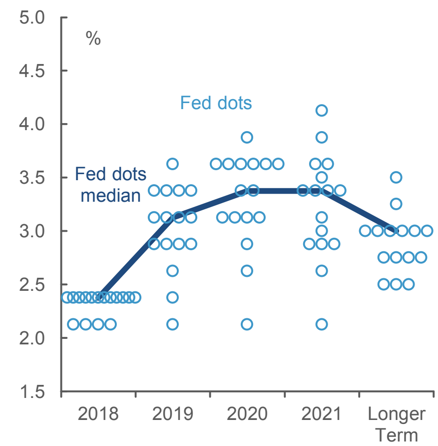


Sources: Scotiabank Economics, Bloomberg.

without their blankie a little more often here. Asian equities will sell off into the overnight session with ripple effects across EMs. The 2s10s Treasury curve flattened with the 2 year yield down about 2bps so far but the 10s yield fell by about 7bps. For the day as a whole, the 2s10s curve is now about 5–6 bps flatter and 10s30s flattened by about 2–3bps. The 2s10s spread is now at just 11bps. The USD appreciated on a DXY basis by about ½%.

Chart 4

September's Dots



Sources: Scotiabank Economics, Bloomberg.

- **On the issue of whether to judge this as hawkish or dovish or neutral, clearly markets have spoken, but it also depends upon your point of reference so I'd say the following:**
    - It is clearly a **more dovish set of overall communications than last time**, but in line with our expectations;
    - It was a **more hawkish set of overall communications than markets were pricing**. The 2s10s curve flattened further, stocks sold off and the USD appreciated on a broad DXY basis.
    - It was certainly a **more hawkish set of communications than they could have gone**. They could have done a full statement re-write including signalling more concern about inflation and inflation expectations but they did not.
    - It was also certainly **more hawkish than the banal view that had crept in over recent days that the Fed should slam on the brakes and do nothing with either conventional or unconventional policy instruments.**
- **Language changes were relatively minor** in nature when they could have been much more significant. The attached statement comparison points out the following changes:
    - The main change is the extension to the end of the second paragraph where the committee flags they are monitoring "global economic and financial developments" while nevertheless viewing **risks as still roughly balanced**. This **suggests caution in the face of recent developments but not enough yet to tip the balance in either direction.**
    - The UR "has remained low" which is a downgrade from "has declined"
    - "Judges" instead of "expects" that "some" further gradual increases are merited is a tad more dovish in that it signals more uncertainty and few additional hikes ahead.
    - Instead of risks "appear" to be roughly balanced, they "are" roughly balanced which sounds stronger.
- **On the issue of balance sheet management, Powell noted during the press conference that their prior work in 2013–14 guided that the best balance sheet strategy was to put it on "automatic pilot."** I would also once again flag his speech in June of last year (here) that stated unwinding "should continue as planned as long as there is no material deterioration in the economic outlook" and they did not signal such a deterioration. The Fed has been clear and consistent on balance sheet management plans and it's a mystery why there was so much debate over this into the statement. Powell noted that the prior guidance has stated they will use conventional monetary policy to adjust to twists and turns in the narrative but that unconventional policy doesn't adjust. Powell also noted he thinks that balance sheet tightening has been a case of "pretty small run-off so far" and has entailed a "small adjustment in economic growth and real outcomes."
- **On the matter of guidance to inform market distribution of the two projected rate hikes in 2019, Powell would only say that they are data dependent.** They will use speeches and press conferences after every meeting to guide toward potential policy changes in advance without major surprises. Powell said in the press conference that "I will be looking to incoming data to tell us that we are on that path in line with expectations" and "we've reached the bottom end of the range of committee estimates of neutral" and "we'll be letting the data inform our view on the appropriateness of policy." Ergo, at a minimum they cannot witness material further downside surprises in order to hike next and they are likely to have the luxury of time to assess developments between now and the second meeting from now in March with no reason for any action in January. Key risks along that path to inform the March call will include US-China trade negotiations, Brexit risks, and the possible resurrection of a binding debt ceiling constraint just as a renewed funding tiff may resurface into February. These are in addition to monitoring the fundamentals and sundry risks facing the stability of the Trump administration.
- **Further on the topic of balance sheet management, I would look to the minutes three weeks from now for further discussion since this was the meeting at which a deeper dive was supposed to have occurred.**

- **On the question of what to do with the dot plot, Powell advised he thinks it provides useful info and is "sometimes more useful than others".** He did not indicate any desire to do away with it. He went on to note that there will be an academic conference in June in Chicago that will consider new and old ideas to assess whether there are better ways to do things. He advised that we may be in a world where the Fed will have less policy space to react to downturns and they want to have better tools, but that they are not looking at changes to the inflation target rather than better ways to achieve that goal.
- **On countercyclical capital buffers** and whether to change them to address stability considerations, Powell said "I'm absolutely willing to use" them when the test of financial stability issues merits doing so and advised that they meet regularly on this topic but that he believes financial stability vulnerabilities are at a moderate level. That indicates no preference by the Chair to change them any time soon, but he deferred to future discussions with the BoG.
- There were no dissenters. **This is a unified Fed in the face of criticism from the Trump administration and some Fed observers.**
- **Forecast revisions are detailed below.**
  - **Fed funds rate:**
    - 2018: 2.4 (prior 2.4)
    - 2019: 2.9 (prior 3.1, 3 hikes)
    - 2020: 3.1 (prior 3.4, 1 hike)
    - 2021: 3.1 (prior 3.4 no change)
    - Longer run: 2.8 (prior 3.0)
  - **GDP:**
    - 2018: 3.0 (prior 3.1)
    - 2019: 2.3 (prior 2.5)
    - 2020: 2.0 (prior 2.0)
    - 2021: 1.8 (prior 1.8)
    - Longer run: 1.9 (prior 1.8)
  - **Unemployment rate:**
    - 2018: 3.7 (prior 3.7)
    - 2019: 3.5 (prior 3.5)
    - 2020: 3.6 (prior 3.5)
    - 2021: 3.8 (prior 3.7)
    - Longer run: 4.4 (prior 4.5)
  - **PCE:**
    - 2018: 1.9 (prior 2.1)
    - 2019: 1.9 (prior 2.0)
    - 2020: 2.1 (prior 2.1)
    - 2021: 2.1 (prior 2.1)
    - Longer run: 2.0 (prior 2.0)
  - **Core PCE:**
    - 2018: 1.9 (prior 2.0)
    - 2019: 2.0 (prior 2.1)
    - 2020: 2.0 (prior 2.1)
    - 2021: 2.0 (prior 2.1)
    - Longer run: n/a
  - The next FOMC decision will arrive on January 30th. It will be a statement followed by Chair Powell's press conference. The next meeting on March 19–20th will be accompanied by another forecast round.

RELEASE DATE: DECEMBER 19, 2018

Information received since the Federal Open Market Committee met in November indicates that the labor market has continued to strengthen and that economic activity has been rising at a strong rate. Job gains have been strong, on average, in recent months, and the unemployment rate ***has remained low***. Household spending has continued to grow strongly, while growth of business fixed investment has moderated from its rapid pace earlier in the year. On a 12-month basis, both overall inflation and inflation for items other than food and energy remain near 2 percent. Indicators 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 ***judges*** that ***some*** further gradual increases in the target range for the federal funds rate will be consistent with sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2 percent objective over the medium term. The Committee judges that risks to the economic outlook ***are*** roughly balanced, ***but will continue to monitor global economic and financial developments and assess their implications for the economic outlook.***

In view of realized and expected labor market conditions and inflation, the Committee decided to raise the target range for the federal funds rate to 2-1/4 to 2-1/2 percent.

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 maximum employment objective and its symmetric 2 percent inflation objective. 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.

Voting for the FOMC monetary policy action were: Jerome H. Powell, Chairman; John C. Williams, Vice Chairman; Thomas I. Barkin; Raphael W. Bostic; Michelle W. Bowman; Lael Brainard; Richard H. Clarida; Mary C. Daly; Loretta J. Mester; and Randal K. Quarles.

RELEASE DATE: NOVEMBER 8, 2018

Information received since the Federal Open Market Committee met in September indicates that the labor market has continued to strengthen and that economic activity has been rising at a strong rate. Job gains have been strong, on average, in recent months, and the unemployment rate ***has declined***. Household spending has continued to grow strongly, while growth of business fixed investment has moderated from its rapid pace earlier in the year. On a 12-month basis, both overall inflation and inflation for items other than food and energy remain near 2 percent. Indicators 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 further gradual increases in the target range for the federal funds rate will be consistent with sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2 percent objective over the medium term. Risks to the economic outlook ***appear*** roughly balanced.

In view of realized and expected labor market conditions and inflation, the Committee decided to maintain the target range for the federal funds rate at 2 to 2-1/4 percent.

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 maximum employment objective and its symmetric 2 percent inflation objective. 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.

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