

FOMC Minutes — The Door Remains Open To Hikes

- **Minutes to the January 30th–31st FOMC meeting ([here](#)) left the door open to a resumption of rate hikes while signalling that the Fed will stop unwinding its QE programs toward year-end—but not yet as more dovish voices in the markets had thought possible.** Markets reacted by putting mild upward pressure on short-term Treasury yields in a slight 2s10s flattener. US equities are largely flat and the dollar strengthened slightly on a DXY basis. Overall, the minutes were very close to being a non-event in the markets. The Fed remains in watch mode until clarity on the key sources of uncertainty has been provided.

1. On the policy rate

They are not necessarily done with rate hikes if specific forms of uncertainty lift but there is no nod to the risk of rate cuts. Consider this quote:

"Many participants observed that if uncertainty abated, the Committee would need to reassess the characterization of monetary policy as "patient" and might then use different statement language."

2. On balance sheet unwinding

They will probably announce as soon as at the March 20th FOMC that they are ending balance sheet unwinding by year-end. At the present rate of run-off and subject to available securities for reinvestment, this would set the floor on the SOMA portfolio at around US\$3¼ trillion in assets from about US\$3.8T at present. That is considerably higher than prior Fed guidance. This reflects their focus upon an increased buffer of reserves above the minimum that they think will be necessary in order to have a safety buffer against being wrong on the optimal size of the balance sheet.

"Almost all participants thought that it would be desirable to announce before too long a plan to stop reducing the Federal Reserve's asset holdings later this year"

3. On blaming the Fed's balance sheet unwind for market turbulence

Curiously, while signalling an end to unwinding the balance sheet, they also note that the FOMC members don't blame balance sheet unwinding for market turmoil but suggest that the actions of a few might have been responsible.

"... they generally placed little weight on balance sheet reduction as a prime factor spurring the deterioration in risk sentiment over that period."

"However, some other investors reportedly held firmly to the belief that the runoff of the Federal Reserve's securities holdings was a factor putting significant downward pressure on risky asset prices, and the investment decisions of these investors, particularly in thin market conditions around the year-end, might have had an outsized effect on market prices for a time."

"Participants discussed market commentary that suggested that the process of balance sheet normalization might be influencing financial markets. Participants noted that the ongoing reduction in the Federal Reserve's asset holdings had proceeded smoothly for more than a year, with no significant effects on financial markets. The gradual reduction in

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securities holdings had been announced well in advance and, as intended, was proceeding largely in the background, with the federal funds rate remaining the Committee's primary tool for adjusting the stance of policy. Nonetheless, some investors might have interpreted previous communications as indicating that a very high threshold would have to be met before the Committee would be willing to adjust its balance sheet normalization plans. Participants observed that, although the target range for the federal funds rate was the Committee's primary means of adjusting the stance of policy, the balance sheet normalization process should proceed in a way that supports the achievement of the Federal Reserve's dual-mandate goals of maximum employment and stable prices. Consistent with this principle, participants agreed that it was important to be flexible in managing the process of balance sheet normalization, and that it would be appropriate to adjust the details of balance sheet normalization plans in light of economic and financial developments if necessary to achieve the Committee's macroeconomic objectives."

4. Reinvestment composition

The Fed will reinvest most principal received from agency MBS into Treasuries after unwinding is done.

"Participants commented that, in light of the Committee's longstanding plan to hold primarily Treasury securities in the long run, it would be appropriate once asset redemptions end to reinvest most, if not all, principal payments received from agency MBS in Treasury securities."

5. Risks

They are at least as concerned about political dysfunction (trade, shutdowns etc) as they are about the global economy while still generally upbeat on the US. Consider the two following quotes:

"Participants generally expected economic activity to continue expanding at a solid pace in the period ahead, with strong labor market conditions and inflation near 2 percent."

"Concerns about the economic outlook were variously attributed to uncertainty or worries about slowing global economic growth, including in Europe and China; trade policy; waning fiscal policy stimulus; and the partial government shutdown."

"An increase in some foreign and domestic government policy uncertainties, including those associated with Brexit, an escalation in international trade policy tensions, and the potential for additional extended federal government shutdowns were also cited as downside risks. "

6. What's not in the minutes

- No time line was attached to 'patient' other than 'for a time' and made dependent upon data;
- There was no further discussion on the neutral rate so they are not weighing in on whether they're at it or how far to go yet; Artificially precise point estimates have no place in this debate of course, and so all they say is that they are at the bottom end of the neutral rate range that the Fed estimates as 2.5–3.5%.
- There is zero reference to 'recession' in any way which isn't surprising but the case for such risks is not addressed even indirectly versus just vague references to downside risks.

What follows is a summary of opinions expressed in terms of the language used by the Fed to connote frequency of opinion cited.

All

None.

'Generally Agreed' or 'In General'

"Participants generally expected economic activity to continue expanding at a solid pace in the period ahead, with strong labor market conditions and inflation near 2 percent."

"Participants generally continued to expect the growth rate of real GDP in 2019 to step down somewhat from the pace seen over 2018 to a rate closer to their estimates of longer-run growth."

Nearly All

None.

Almost all

“Almost all participants thought that it would be desirable to announce before too long a plan to stop reducing the Federal Reserve’s asset holdings later this year. Such an announcement would provide more certainty about the process for completing the normalization of the size of the Federal Reserve’s balance sheet.”

All but one

None.

Majority

“A substantial majority expected that when asset redemptions ended, **the level of reserves would likely be somewhat larger than necessary for efficient and effective implementation of monetary policy**; if so, many suggested that some further very gradual decline in the average level of reserves, reflecting the trend growth of other liabilities such as Federal Reserve notes in circulation, could be appropriate.”

Most

None.

Many

“**Many participants commented that upward pressures on inflation appeared to be more muted than they appeared to be last year** despite strengthening labor market conditions and rising input costs for some industries.”

“Many participants suggested that it was not yet clear what adjustments to the target range for the federal funds rate may be appropriate later this year.”

“Many participants observed that if uncertainty abated, the Committee would need to reassess the characterization of monetary policy as “patient” and might then use different statement language.”

More than half

None.

Fewer than half

None.

Several

“Several participants commented that **they had nudged down their outlooks for output growth** since the December meeting, citing a softening in consumer or business sentiment, a reduction in the outlook for foreign economic growth, or the tightening in financial conditions that had occurred in recent months.”

“Several participants noted solid rates of hiring or other indicators of tight labor market conditions in their Districts.”

“**Several participants judged that risks that could lead to higher-than-expected inflation had diminished relative to downside risks.**”

“Several participants also noted that the slope of the Treasury yield curve was unusually flat by historical standards, which in the past had often been associated with a deterioration in future macroeconomic performance.”

“Several of these participants argued that rate increases might prove necessary only if inflation outcomes were higher than in their baseline outlook.”

“Several other participants indicated that, if the economy evolved as they expected, they would view it as appropriate to raise the target range for the federal funds rate later this year.”

A number

“Among those participants who commented on financial stability, a number expressed concerns about the elevated financial market volatility and the apparent decline in investors’ willingness to bear risk that occurred toward the end of last year.”

Some

“Some thought that continuing to reinvest agency MBS principal payments in excess of \$20 billion per month in agency MBS, as under the current balance sheet normalization plan, would simplify communications or provide a helpful backstop against scenarios in which large declines in long-term interest rates caused agency MBS prepayment speeds to increase sharply.”

“However, some others judged that retaining the cap on agency MBS redemptions was unnecessary at this stage in the normalization process.”

“Some participants noted the recent softening in surveys of consumer sentiment.”

“Some participants highlighted that recent surveys of business sentiment or District contacts had indicated some weakening in optimism or confidence about the economic outlook, though available indicators suggested that the level of business sentiment had remained high.”

“Some participants commented on recent indicators at the national or District levels as suggesting a pickup in wage growth.”

“Participants noted that some risks to the downside had increased, including the possibilities of a sharper-than-expected slowdown in global economic growth, particularly in China and Europe, a rapid waning of fiscal policy stimulus, or a further tightening of financial market conditions.”

“Some participants noted that, while global economic and financial developments had been important factors leading to a patient monetary policy posture, those developments mattered because they affected assessments of the policy rate path most consistent with achievement of the Committee’s dualmandate goals of maximum employment and price stability.”

“However, some other participants noted that the policy rate projections in the SEP are a valuable component of the overall information provided about the monetary policy outlook.”

A few

“A few participants judged that there would be little benefit to allowing reserves to continue to fall after the end of redemptions or that this approach could have costs, such as an undue risk of volatility in short-term interest rates, that would exceed its benefits.”

“... with a few participants commenting that waning fiscal stimulus was expected to contribute to the step-down.”

“A few participants also pointed to continued weakness in the housing sector, which was attributed in part to concerns about affordability among potential homebuyers.”

“A few participants observed that conditions in the agricultural sector remained difficult, citing large inventories of agricultural commodities, uncertainty about international trade policies, and concerns regarding low prices of commodities and farmland.”

“However, a few participants commented that business optimism had increased among contacts in their Districts, or that they were planning new capital expenditures.”

“A few participants expressed concern that longerrun inflation expectations may be lower than levels consistent with the Committee’s 2 percent inflation objective.”

“A few participants highlighted the importance of ensuring that financial institutions were able to withstand adverse financial market events—for instance, by maintaining adequate levels of capital.”

“A few participants expressed concerns that in the current environment of increased uncertainty, the policy rate projections prepared as part of the Summary of Economic Projections (SEP) do not accurately convey the Committee’s policy outlook.”

A couple

“A couple of participants suggested that a ceiling facility to mitigate temporary unexpected pressures in reserve markets could play a useful role in supporting policy implementation at lower levels of reserves.”

“A couple of participants commented that contacts in their Districts remained optimistic about consumer spending.”

“A couple of participants noted that the rise in credit spreads over recent months, if it were to persist, could restrain future economic activity.”

“Although these conditions had eased somewhat in recent weeks, a couple of participants noted that the strain in financial markets might have persisted or spread if it had occurred during a period of less favorable macroeconomic conditions.”

“A couple of participants highlighted the role that decreased liquidity at the end of the year appeared to play in exacerbating changes in financial market conditions.”

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