

FOMC Preview: Which Powell Will Show Up?

- A quarter point reduction is in the bag...
- ...but data dependence may be going against future reductions
- Bonds would be less fussed by another 'mid-cycle' reference...
- ...as markets have reined in rate cut bets
- A step-by-step look at what may change

The two-day FOMC meeting concludes on Wednesday, September 18th when the policy statement and fresh economic projections will be released (2pmET) followed by Chair Powell's press conference (2:30pmET). The primary risk surrounding the communications will likely arise in the press conference. It's somewhat unclear which version of the Chair will show up and good cases can be made for both versions.

Will it be the less dovish version on July 31st when he stated that this was not the beginning of a major easing cycle as opposed to a "mid-cycle" adjustment?

Alternatively, will Chair Powell be somewhat more circumspect this time around and condition everything upon the flow of data and events while committing the Fed to act "as appropriate"? This latter approach was employed at a recent moderated panel discussion in Zurich on September 6th when Powell didn't mention his previous "mid-cycle" references.

A fair amount has changed since that panel appearance, plus it's not clear that the omitted reference within a tamer setting than a post-FOMC press conference was fully intended. Powell might have even preferred to leave such guidance to discussion at the FOMC meeting rather than prejudging the outcome. At this juncture, I would say that **the balance of the evidence suggests that Powell will—and should—adopt the "mid-cycle" tag line once again.**

A quarter point reduction is in the bag. Markets are fully priced for it. Consensus is almost entirely on board. Just last week my NYC cab driver told me the Fed would cut before dropping me off in front of the wrong building. The Fed hasn't wished to negatively surprise markets' expectations for imminent policy changes in a very long time. A half point cut is highly unlikely notwithstanding St. Louis President Bullard's comments on September 3rd, although it's unclear what Bullard thinks in the wake of developments since then.

The market risks to Powell guiding relatively modest further adjustments along an uncertain path are less than they were not long ago. Data and bond markets have done his work for him and the FOMC members—or at least many of them—should have somewhat of a spring in their steps in the face of evidence that leaning against cumulative bond market pricing for monetary easing has come around their way, at least for now. Coming into early September, markets were pricing about five more rate cuts by the end of 2020. As this publication goes to print, fed funds futures have three cuts priced from hereon in and including next week's forecast cut. That's broadly in sync with our own forecast that foresees a pair of further cuts before calling it quits and there remain two-tailed risks to even that outlook. Trump's trade policy is the tail wagging it all.

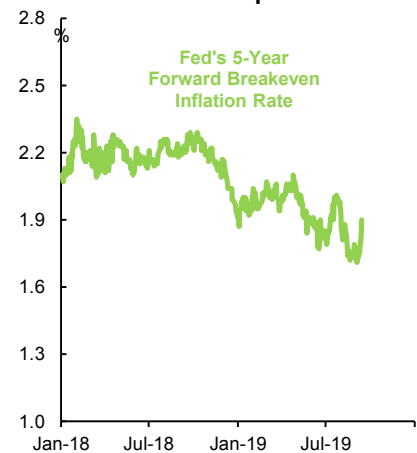
The bigger issue will be the forecast and verbal guidance that may inform the future path for the policy rate. Here are some possible considerations.

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Chart 1

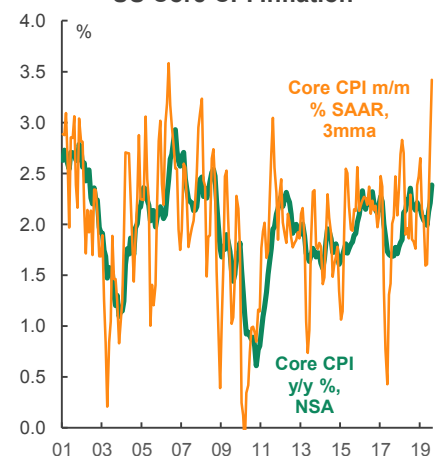
Market Inflation Expectations



Source: Scotiabank Economics, Bloomberg.

Chart 2

US Core CPI Inflation



Sources: Scotiabank Economics, BLS.

Current economic conditions: There could be mixed signals in the statement's opening paragraph. The opening paragraph to the statement may downgrade the reference to how business fixed investment "has been soft" to something harsher given the sharp decline in spending on structures (-9.4% q/q) and flat spending on equipment (+0.7% q/q) in the second quarter. While inflation's depiction as "below 2 percent" remains valid on a PCE and core PCE basis, the latest CPI readings put the risk around potentially softening the inflation wording but I suspect they may wish to see more PCE evidence first. The reference to market-based inflation expectations that "remain low" could be maintained, or slightly dented to acknowledge the very recent improvement (chart 1). Here too, however, the Fed is likely to wish to see more evidence before signalling a bit more encouragement.

Growth Forecasts: The Summary of Economic Projections has not been revised since it was published way back on June 19th. A lot has changed since then and so there may well be material forecast revisions and primarily so in terms of growth. On GDP growth, 2019 may be left little changed at 2.1% y/y using the Fed's fourth-over-fourth quarter forecast approach, but 2020 is likely to be revised down from 2.0% y/y (consensus 1.8%) as increased uncertainty and trade tensions since the June forecasts weigh upon the outlook. That said, 2019Q3 growth tracking looks to be resilient and thanks again to consumer spending (recap [here](#)). Continued strength in macroeconomic data might have the Fed taking a step in the direction of consensus but not toward the lower bound of the range of views.

Inflation Forecasts: The June projections for core PCE inflation at 1.8% this year, 1.9% in 2020 and 2.0% in 2021 are in the ballpark of consensus expectations and Scotia's with minimal need for revision. This would be one way in which the FOMC pushes back on market expectations for cumulative rate cuts. The message would be that inflation remains on track to return to target within the projection horizon while nevertheless emphasizing that the target is symmetrical and thus implying tolerance toward a mild overshoot.

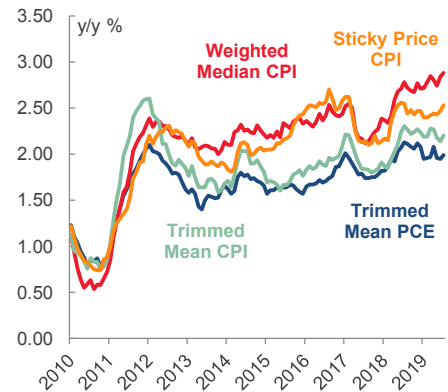
Nevertheless, the freshest information may suggest that transitory factors that were previously weighing down inflation are rapidly lifting. The August CPI report surprised higher and probably invigorated more hawkish FOMC members (recap [here](#)). Recall that core CPI hit an eleven year high in year-ago terms and the three month moving average for seasonally adjusted and annualized monthly core CPI changes hit the highest since 2006 (chart 2). Central tendency measures of CPI produced by the regional Feds held firm in the 2.2–2.9% y/y range during August (chart 3). Translating CPI into PCE is fraught with multiple considerations (see reconciliation methodology [here](#)). Nevertheless, as the spread between core CPI and core PCE readings widens toward historic highs (chart 4), it may only be a matter of time before core PCE inflation begins to accelerate and catch up to core CPI.

Forecast guidance: The verbiage employed in the statement to describe the base case macro outlook is likely to be unchanged or to be left very similar to what was used in June. Specifically, look for a repeat of "the Committee's view that sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2 percent objective are the most likely outcomes, but uncertainties about this outlook remain." The latter part is the insurance cut spin on the base case, but done so in the context of a solid base case outlook that rejects recession talk.

Dot plot: Get out the crayons! The usefulness of the dot plot has been superseded by market actions as the Fed catches up to the effects of the Trump administration's erratic trade policies and the effects upon global growth. Chair Powell is likely to continue to downplay the dot plot as largely something that reflects FOMC guesswork. Nevertheless, the prior dot plot (chart 5) is likely to see the median

Chart 3

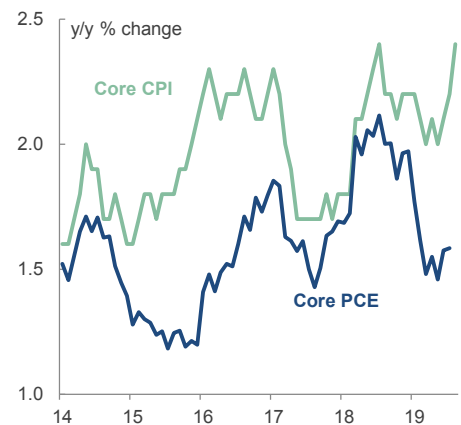
A Comparison of Alternative Federal Reserve Inflation Measures



Sources: Scotiabank Economics, FRB Dallas, FRB Cleveland, FRB Atlanta.

Chart 4

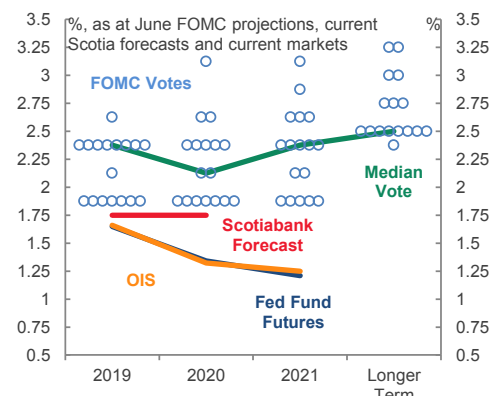
A Nearly-Record Divergence



Sources: Scotiabank Economics, BLS, BEA.

Chart 5

FOMC Fed Funds Target Rates



Sources: Scotiabank Economics, Federal Reserve System.

projection for the fed funds target rate bump lower, but not as far as markets have priced. Some of that is out of necessity, the often welcome and sometimes feared mother of all invention. Recall that the median June projections included no rate cut this year which clearly must be revised either to show two including next week or perhaps guidance for another by year-end. The median forecast showed only one cumulative rate cut in 2020 and then a hike in 2021 that I would think may be revised to show 2–3 rate cuts cumulatively before then flat-lining. The longer-run neutral rate is likely to be left unchanged at 2.5% after it was revised down by ¼ percentage point in June. By inference, the dots would then imply a significantly accommodative stance with the actual policy rate foreseen to be around 75bps below the neutral rate. Around this base case expectation, the risks are probably more skewed toward fewer rather than more rate reductions shown in the dots.

Rate guidance: Aside from the dots, the statement is likely to repeat reference to how the FOMC “will act as appropriate to sustain the expansion” as a data-conditioned nod to possible future policy changes that the rest of the guidance is expected to reinforce.

Balance sheet policy: No further changes are expected after the March and July FOMC meetings reset nonconventional monetary policy to flat line the SOMA portfolio and thereby bring balance sheet unwinding to an end amidst a projected significant rise in the share of the portfolio going toward Treasuries.

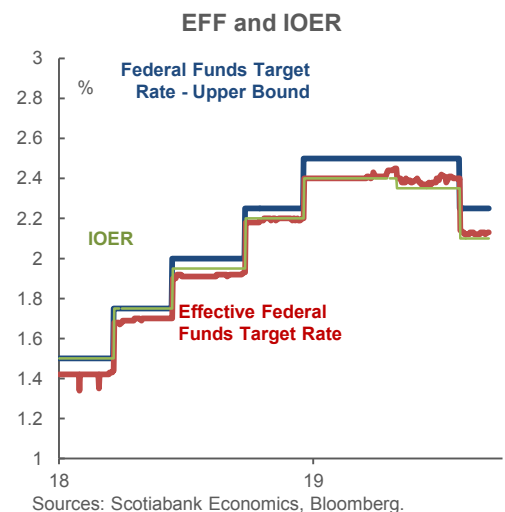
Dissenters: The ECB might make the Fed look good here! Recall that there were two relatively hawkish-leaning dissenters at the last meeting in July who preferred to keep the policy rate unchanged (Rosengren and George). There could be two or perhaps three dissenters this time, albeit for possibly somewhat altered reasons. St. Louis Fed President Bullard has indicated he would like a 50bps reduction at this coming meeting, while Rosengren and George have continued to indicate they don’t see a need for rate cuts. Still, that would be less disharmony during highly uncertain and tumultuous times than the push-back that ECB President Draghi got.

Returning to the ECB, the belly flop that followed in markets after the latest ECB policy announcements probably lessened some of the pressure upon the Fed to ease. The spillover effects via the bond market selloff that preceded and followed the ECB have driven the 2s10s US Treasury spread back toward being modestly positive after escalating trade tensions drove it negative in August.

IOER: The spread between short-term market and policy rates is generally behaving better than at other times when the Fed adjusted the spread between the upper bound of the fed funds target range and interest on excess reserves rate (chart 6). No policy spread adjustment is expected.

Chair Powell’s press conference: The remarks that were delivered by Powell on Friday September 6th during a moderated panel discussion are likely to be repeated almost verbatim but potentially combined with his remarks on July 31st. Powell is likely to continue to describe the economy as being on solid foundations and indicate that Fed policy will act “as appropriate” while steering largely clear of debating the merits of the Trump administration’s trade policies and Trump’s pointed criticisms of the Fed. Still, I wouldn’t be the least surprised to hear him offer—or be invited to do so—a repeated remark regarding a mid-cycle adjustment versus a more material series of steps back down toward the lower bound.

Chart 6



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