FOMC Delivers A Dovish Hold

- The Fed delivered a neutral set of messages…
- ...that ruled out a 1998-style take back of rate cuts…
- ...which markets interpreted as dovish
- The policy range remains unchanged as expected
- Statement changes were not terribly meaningful
- Macro forecasts were largely unchanged…
- ...except for signalling slightly more long-run labour slack
- The FOMC majority still signals a 2020 pause, 2021 hike
- Funding market challenges will be addressed with tweaks…
- ...as a Standing Repo Facility is not in the cards
- The Fed will revise long-run policy goals around mid-2021

A 311 word statement (here), a batch of new forecasts (here) and a lengthy 51 minute press conference that addressed about two dozen questions ultimately left the broad suite of communications little changed. Very little changed, in fact, and markets expressed relief. Short-term rates rallied a touch mainly after the press conference, but probably in no small part as an unwinding of slightly more hawkish positioning yesterday into this morning rather than in response to any great revelations. The USD depreciated slightly and US equities moved a touch higher. The overall tone of communications was about as neutral as one might have expected by pretty forcefully ruling out a replay of the 1998 experience when the Fed quickly took back prior rate cuts. The overall communications were generally in keeping with our expectations that the Fed would not wish to rock the boat at this juncture.

There were few statement changes and none that were of any real consequence. The FOMC could have upgraded its reference to "solid" job gains by noting they are strong, but it did not. If we continue to get nonfarm numbers in keeping with the recent trend, then one should still be on guard for a language shift in subsequent statements.

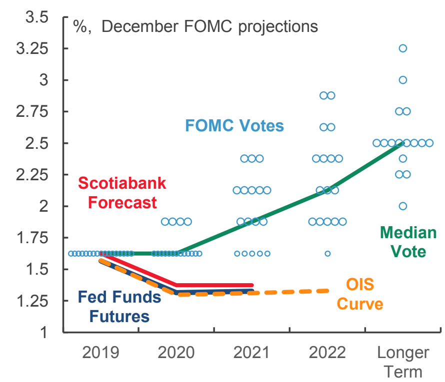
The Fed struck out reference to how "uncertainties about the outlook remain." At first, markets took this as a hawkish signal for a few seconds on the incomplete newswire headlines but then realized this was an oversimplification. Why? Because the Fed changed the context in which it still refers to watching "global developments and muted inflation" but shifted its placement in the second paragraph away from being an explanation for the cut in the October statement toward something they are still monitoring as a bolt-on to forward rate guidance. **Overall this is largely an issue of semantics.** Of course uncertainty still exists! The FOMC is not saying uncertainties have gone away; it shifted where and how they referenced monitoring of those uncertainties.

All forecasts for GDP, PCE and core PCE inflation were left unchanged across all intervals of time other than a rebasing of the 2019 core PCE inflation forecast that was lowered to 1.6% from 1.8% to take into account

CONTACTS

Derek Holt, VP & Head of Capital Markets Economics
416.863.7707
Scotiabank Economics
derek.holt@scotiabank.com

FOMC Federal Funds Target Rates



Note: OIS & Fed Fund Futures as of December 11th, 2019
Sources: Scotiabank Economics, Federal Reserve.

new data since September. Where we differ from the Fed is on 2020 growth as our shop's view expects growth to be almost a half point softer than the FOMC's forecast. And on inflation, tell me what central bank doesn't guide toward achieving their inflation target within the projection horizon despite many years of failure. The inflation forecast is nearly meaningless in my opinion.

The committee lowered the long run unemployment rate forecast a tick to 4.1% which is a slight nod to signalling (again...) that the labour market can run a little hotter over time without sparking concerns about wage growth. That indicates **the committee thinks there is a smidge more labour slack than previously guided.**

The median rate projection was completely unchanged as shown in the accompanying updated chart. The lower numbers for 2019 onward just reflect the fact that they cut by 25bps in October and hadn't shown that in their September dot plot so they had to rebase the entire profile over the forecast horizon, but there is no change to their projected rate path beyond this rebasing effect. **The FOMC still guides toward a 2020 hold** against some unrealistic chatter in advance of the communications that they might have guided toward a hike next year without inflation data to support it and in an election year. The FOMC also still guides toward a 25bps hike in 2021 and an unchanged long run R* at 2.5%.

The dispersion of the dot plot offers useful information. **13 out of 17 FOMC members expect a hold throughout next year** which is fairly high conviction and one can probably guess fairly accurately at least some of the members who probably showed hikes including past dissenters. Maybe the baker's dozen shouted in unison that 2020 is an election year! Especially this election year. 2021 gets more interesting in that five members expect a continued hold, four expect 1 rate hike, five expect two rate hikes and three members expect 3 hikes.

The main takeaways from Chair Powell's press conference include the following points:

- **On assessing next steps in either direction and timing them, Powell indicated that he wants to see the lagging effects of the three rate cuts so far** before potentially reassessing. He generally repeated guidance that a material surprise to their base case outlook is needed to sway the Fed one way or the other. Personally I think that's feasible either in terms of trade policy frictions, persistent undershooting of core inflation and/or global and domestic data.
- **On when to hike, Powell explained that this is not like the 1998 experience** when the Fed took back prior cuts and then some by observing that today's structural drivers of soft inflation lessen any need to take back rate cuts.
- Chair Powell does not support raising rates until there is a "significant and persistent move up in inflation." That would imply that achieving 2% wouldn't be enough in his view.
- **Don't expect material further steps toward addressing repo market funding challenges** such as a Standing Repo Facility. The Fed will adjust details of current tactics as needed.
- Soft wage growth still demonstrates slack in labour markets. **Powell is watching wage growth more closely as a sign of labour market tightness than any other labour market readings** including job growth.
- US-China trade negotiations matter a lot more to the Fed (and markets) than the USMCA agreement.
- **The Fed will issue a revised statement of longer run policy goals around the middle of next year** as part of announcing the results of its policy framework review.

In my personal view, the risks remain more tilted toward easing than hiking in 2020 and not least of which because of the inflation outlook explained here, alongside many of the same uncertainties we've been dealing with for some time.

Please see the accompanying statement comparison.

A rough transcript of Chair Powell's press conference follows. It is not to be treated as a verbatim guide as opposed to a broad guide to the tone of the questions and Powell's answers that is believed to be generally accurate.

Q1. Why do you project falling UR but stable inflation?

A1. The connection has gotten weaker and weaker over the years. It's a very faint connection. That suggests you need to keep policy somewhat accommodative.

Q2: But it looks faint to non-existent. So what do you do to reach your target?

A2: I don't think that's right. There is still a small coefficient between wage growth and inflation and it hasn't gone lower in recent years, it's just still weaker than it was in the past. We do still see some relationship.

Q3: Using the 1998 analogy, the Fed subsequently took back the rate cuts and then some. Is today similar? Or are we at a point where we are at a new steady neutral rate so that you don't need to take those cuts back?

A3: There are similarities and differences between the periods. Back then the economy needed more accommodation but it wasn't the end of the expansion which is similar to today. What's different, however, are the structural characteristics in the economy especially in terms of inflation. The need for rate increases is less. We've learned that unemployment can remain at low levels for extended periods without generating much inflation.

Q4: The BIS report pointed to structural and regulatory issues driving funding problems. Will you be pursuing more measures? Will we see more disruptions? Are you doing enough? Do you have any plans to buy coupon bonds?

A4: These are important operational matters but not macroeconomic issues. The purpose of these tools is not to eliminate all volatility in the repo markets. Markets are functioning. Temporary upward pressures on short-term money market rates are not unusual around year-end. Our measures are oriented toward mitigating the effects. The key to our strategy has been to supply reserves through overnight and term repo and bill purchases and a willingness to adapt our strategy. We're not in that place (ie: not in our current plans) but if needed we can buy coupon but we don't anticipate doing so.

Q5: Where are you on the Standing Repo Facility?

A5: It will take some time to evaluate and create the parameters. At the moment we're focused on year-end. As the underlying level of reserves moves up because of bill purchases, there will be a time when overnight and term repo will decline.

Q6: A number of your colleagues don't think you should raise until core PCE materially rises. Where do you stand?

A6: I want to see a significant and persistent move up in inflation before acting in my view. That's my view.

Q7: It looks like inflation is never overshooting the inflation target yet rates are increasing in 2021. How do we square the circle that you wouldn't hike until you see persistent and significant inflation before hiking but you signal 2021 hikes?

A7: In terms of those outer year rate increases, people will have their own explanations, but none of us have much of a sense of how things will look in 2021. I think that if people think the policy rate has to rise to neutral eventually then they start to show it in 2021. A number of officials think that inflation needs to overshoot before raising and that it will do so but you can’t tell that in the published forecasts (ed note: monitor this in the FOMC minutes in three weeks). There is more humility than confidence when it comes to forecasting inflation.

Q8: About the framework review and allowing an overshoot of the 2% target. Is merely saying you want to allow an overshoot enough? Would a more formal change in the framework be required?

A8: I think you have to back that up with policy to support the outcome. The changes we are looking at in the framework are designed to strengthen the credibility of the inflation target but only if followed by policy. Inflation expectations will take time to turn around.

Q9: Regarding uncertainty, with the NAFTA/USMCA/CUSMA moving ahead, how does that net out as an influence on business investment versus the US-China trade tensions? Is one uncertainty bigger than the other?

A9: If a NAFTA deal were to be enacted it would be positive. Same thing for US-China negotiations which haven't reached that point. We've been hearing through businesses that trade policy uncertainty is weighing on the outlook. Removal of uncertainty on that would be a positive. You can see in the markets that what's moving markets is US-China, not NAFTA.

Q10: Is the Review looking at the employment side of the mandate as well?

A10: We've seen we can maintain much lower levels of unemployment than once thought. The Fed Listens events are about inflation to a much lesser extent than full employment. The discussion is much more around what's happening in low to moderate income communities. That these communities still have slack is very telling.

Q11: Are you currently telling examiners not to preserve reserves over Treasuries for supervisory purposes? On the Standing Repo Facility are you inclined to do it but need to figure out details or what?

A11: On Treasuries versus reserves, we've done lots of work, and it's not obvious there is one thing happening there. We are more focused upon what we are doing now toward year-end and the review of supervisory and regulatory issues that we are digging into than we are on a facility. The liquidity is already there but what can be done to make it flow more smoothly.

Q12: You seem confident that uncertainties have gone away. What caused you to reach this conclusion?

A12: If you look at the statement, we did call out "global developments and muted inflation pressures" later in the statement. We don't think those things have gone away. But to change our monetary policy stance we want to see a material reassessment of the outlook.

Q13: Have you set the bar too high for cuts next year? Do you need to see data worsen? Can you still act pre-emptively?

A13: We've cut 3 times since July. We believe monetary policy operates with long and variable lags. It will take some time to see the effects which is one reason to hold back and wait. If you look more broadly at the Treasury curve it has moved more than 75bps so there is more accommodation. There isn't any single factor that will influence our future policy choices.

Q14: Was the Fed too quick to attack inflation when you raised rates?

A14: Look back at the start of 2018. We had GDP growth at 3% and inflation at 2% and $1T of stimulus coming and the policy rate was very low. We never got to the neutral rate (ed. In 2018, the Fed's peak long-run R* rate was 3%) and we were trying to get near neutral. We were meaningfully below the neutral rate so we still had accommodation. Then shocks emerged and the trade situation was just beginning in the middle of 2018 but it has had a meaningful effect on output through the uncertainty factor.

Q15: What would be the effect if negotiations with China fell apart and how would you react?

A15: We look at a range of factors. We try to look through the volatility in trade headlines. Monetary policy is not the right tool for that. But I don't want to get into hypothetical outcomes.

Q16: Did you mention anything on uncertainty to Trump in your private meeting?

A16: I do not comment on private meetings with elected officials.

Q17: Does the Fed's dot plot still serve a useful purpose?

A17: Properly understood it can still be useful. It is an expression of the thinking of individual committee members. We don't discuss or negotiate it at the meeting. It gets submitted beforehand. Policy is always going to depend upon emerging conditions and the dots won't constrain us against doing the right thing. If you focus too much on the dots you can miss the broader picture.

Q18: Will the framework you are working on be less rather than more?

A18: We're just at the stage where we've had a really interesting discussion on the framework and Fed listens events. We're just getting to the stage at which we are looking at conclusions. Many of these will translate into changes in the statement of longer run goals around the middle of next year. I wouldn't pre-judge. I believe we'll make meaningful improvements. It's premature to say this exercise isn't going anywhere. That said, just saying words is not credible. You can't just say we're going to target, say, 4% inflation if you can't realistically achieve it. Is it even in our legal mandate? I'd like to see meaningful improvements to our policy framework but in an evolutionary sense. We'll do it again in future years in incremental fashion.

Q19: What would you have done differently this year? Are there any particular surprises you saw?

A19: My focus is forward looking. I like the stance we have now. There is a lot of learning. I don't think anyone saw the challenges we faced. Toward the end of 2018 no one expected these challenges. I'm pleased we moved to support the economy the way we did. We're in a good place now.

Q20: Why aren't we seeing stronger wage gains?

A20: Wage gains have moved up a bit over the past 3–4 years. Why aren't they growing faster? One reason is low productivity growth. Globalization is another restraint on the wage setting process everywhere. Also the labour market might not be as tight as we thought it was. Non-supervisory workers are seeing faster wage growth of 3.7% y/y than the average.

Q21: Are there still more people on the sidelines who could join the workforce?

A21: Yes. Higher participation is a signal. It provides more labour supply so it's a less tight labour market.

Q22: What do you need to see to call the labour market hot?

A22: Faster wage growth. The labour market is strong, not tight. Not tight because you aren't seeing higher wage increases.

RELEASE DATE: DECEMBER 11, 2019

Information received since the Federal Open Market Committee met in October indicates that the labor market remains strong and that economic activity has been rising at a moderate rate. Job gains have been solid, on average, in recent months, and the unemployment rate has remained low. Although household spending has been rising at a strong pace, business fixed investment and exports remain weak. On a 12-month basis, overall inflation and inflation for items other than food and energy are running below 2 percent. Market-based measures of inflation compensation remain low; survey-based measures of longer-term inflation expectations are little changed.

Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. The Committee decided to maintain the target range for the federal funds rate at 1-1/2 to 1-3/4 percent. **The Committee judges that *the current stance of monetary policy is appropriate*** to support sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2 percent objective. The Committee will continue to monitor the implications of incoming information for the economic outlook, ***including global developments and muted inflation pressures***, as it assesses the appropriate path of the target range for the federal funds rate.

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 monetary policy action were Jerome H. Powell, Chair; John C. Williams, Vice Chair; Michelle W. Bowman; Lael Brainard; James Bullard; Richard H. Clarida; Charles L. Evans; Esther L. George; Randal K. Quarles; and Eric S. Rosengren.

RELEASE DATE: OCTOBER 30, 2019

Information received since the Federal Open Market Committee met in September indicates that the labor market remains strong and that economic activity has been rising at a moderate rate. Job gains have been solid, on average, in recent months, and the unemployment rate has remained low. Although household spending has been rising at a strong pace, business fixed investment and exports remain weak. On a 12-month basis, overall inflation and inflation for items other than food and energy are running below 2 percent. Market-based measures of inflation compensation remain low; survey-based measures of longer-term inflation expectations are little changed.

Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. ~~In light of the implications of global developments for the economic outlook as well as muted inflation pressures,~~ the Committee decided to lower the target range for the federal funds rate to 1-1/2 to 1-3/4 percent. ~~This action supports 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 Committee will continue to monitor the implications of incoming information for the economic outlook as it assesses the appropriate path of the target range for the federal funds rate.

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 monetary policy action were Jerome H. Powell, Chair; John C. Williams, Vice Chair; Michelle W. Bowman; Lael Brainard; James Bullard; Richard H. Clarida; Charles L. Evans; and Randal K. Quarles. ~~Voting against this action were: Esther L. George and Eric S. Rosengren, who preferred at this meeting to maintain the target range at 1-3/4 percent to 2 percent.~~