

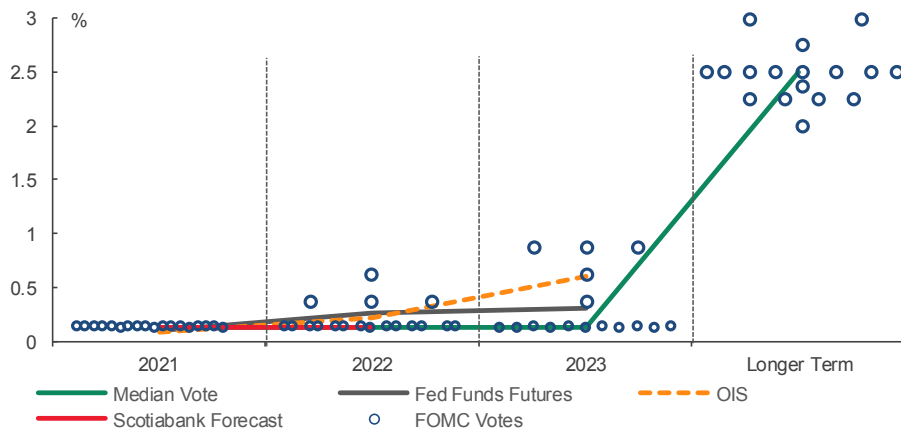
Markets Are Taking The FOMC's Dots Too Literally

- FOMC upgrades macro forecasts...
- ...but still shows no rate hikes for at least three years...
- ...even as some participants break rank...
- ...but markets paid too much attention to dots...
- ...as Powell hinted they could move up if forecasts become reality
- ON RRP limit raised by US\$50 billion
- Ending agency CMBS purchases is of little consequence
- SLR guidance expected in “coming days”
- Bank capital decisions are “a couple of weeks away”
- We continue to expect 2022Q1 taper, 2023 rate hikes

Markets bought the FOMC's act for today, but time will tell if they inappropriately lowered their guard. The US Treasury curve rallied very slightly across maturities by 1–2bps, fed funds futures pushed out rate hike expectations by a few months into 2023, the USD depreciated by about ½% on a DXY basis and the S&P500 rallied by about 0.8% following all communications but mostly on the back of the 2pmET statement and Summary of Economic Projections.

In my view, the only truly meaningful new information you can take to the proverbial bank today had to do with the policy changes announced by the NY Fed, the continued deferral of a decision that is forthcoming over “coming days” on the Supplementary Leverage Ratio exemption of counting Treasuries and reserves in the regulatory rule, and guidance that an announcement affecting decisions surrounding bank capital management issues such as buybacks and dividends is forthcoming in the next two weeks. The SLR matter keeps the suspense alive along with the ongoing debate over what it may mean to markets.

Chart 5
March FOMC Projections for the Federal Funds Target Rate



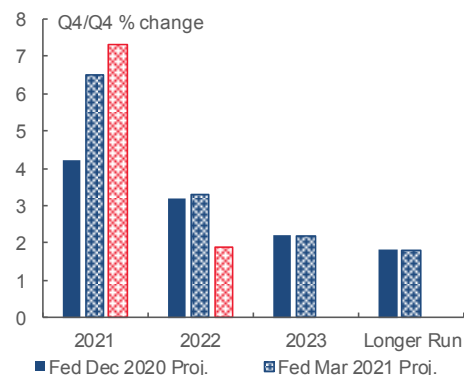
Note: OIS & Fed Fund Futures as of March 17th, 2020.
Sources: Scotiabank Economics, US Federal Reserve.

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Chart 1

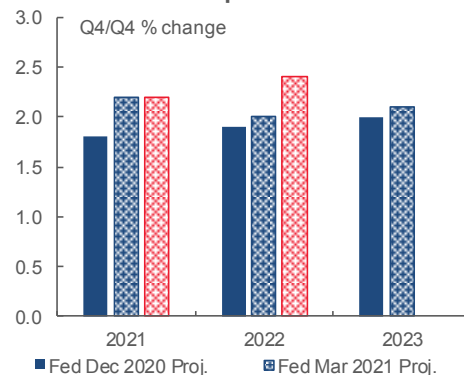
US Real GDP Forecast Comparison



Sources: Scotiabank Economics, Federal Reserve Summary of Economic Proj. (March 17, 2021).

Chart 2

US Core PCE Inflation Forecast Comparison



Sources: Scotiabank Economics, Federal Reserve Summary of Economic Proj. (March 17, 2021).

What markets rallied on, however, was the impression that the FOMC still has no desire to hike rates throughout its 2021–23 projection horizon. Well, good luck with that, but I'm not inclined to have high trust for that part of the communications. Markets fed on the median rate path provided by FOMC officials as discussed below. Time will tell whether markets should indeed have such faith in the FOMC rate path and whether it is in sync with the rest of the macro projections, but the press conference offered a veiled reason why astute market participants shouldn't take the dots quite so literally. In any event, our curve forecasts embed a loosely pencilled in path containing three rate hikes in 2023.

POLICY ADJUSTMENTS

The New York Federal Reserve issued two statements [here](#) and [here](#) as part of the suite of communications. The first link is the more meaningful adjustment in that it raised the individual counter-party limit on overnight reverse repurchase agreement operations facing the Fed to US\$80 billion from US\$30 billion previously. This had been debated as a policy option into today's communications and it serves the effect of draining some cash from the banking system by potentially swapping cash for more Treasuries. It will help prepare the system for a coming liquidity surge as the Fed continues to buy US\$120 billion of Treasuries and MBS each month and as the US Treasury deploys stimulus by drawing down its account with the Fed to distribute the proceeds. That liquidity surge could continue to put downward pressure upon measures of short-term rates and risk further steps toward negative rates; today's step is one tool to help mitigate that risk.

The second link announced the end of purchases of agency *commercial* mortgage-backed securities due to "the sustained smooth functioning of markets for" CMBS. This announcement carries little effect as the Fed's holdings of agency CMBS in the SOMA account have been roughly flat at under US\$10B for several months now and most of the modest rise to this amount occurred up to June of last year.

FORECASTS—EVERYTHING UPGRADED

The forecast changes ([here](#)) were of two types. One was a necessary reset to catch up with consensus on major developments since the FOMC's last forecasts in December and which showed the generally expected faster growth, lower unemployment and slightly higher inflation. Two was that the median rate projection remained unchanged, but something Powell said in the press conference should have us all fading that guidance that was conveyed in the dot plot.

GDP forecasts (chart 1) were raised from 4.2% in 2021 to 6.5% and remain somewhat below our current forecast but above Bloomberg consensus that anticipates 6% growth this year. The FOMC also revised up 2022 by a tick to 3.3% from 3.2% which is stronger than we forecast and a tick stronger than consensus. The 2023 forecast was revised a touch lower to 2.2% from 2.4%. The message is that over the period during which peak fiscal policy effects on growth begin to dissipate into 2022 the Fed revised up growth and maintained solid growth expectations above the US economy's long-run potential growth rate for at least each of the three years.

The inflation forecasts were also revised up a touch (charts 2, 3). The FOMC projects 2.4% in 2021 (1.8% prior), 2.0% in 2022 (1.9% prior) and 2.1% in 2023 (2.0% prior) for headline PCE. Core inflation forecasts were also revised up four-tenths to 2.2% this year and then by a tick in each of 2022 (2%) and 2023 (2.1%).

Unemployment rate projections were also revised lower (chart 4).

Before getting to what Powell said about the rate projections, what I continue to find befuddling is how a central bank can credibly say that it still thinks it will be providing emergency levels of stimulus ages after the emergency has passed while projecting a move into excess demand, full employment and inflation averaging slightly above 2% over the full forecast horizon. If you believe it, then the Fed isn't showing the requisite willingness to alter its rate guidance in the face of major developments in vaccines and fiscal policy.

Chart 3

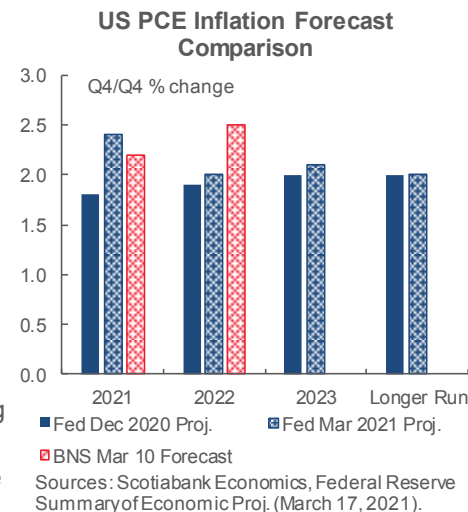
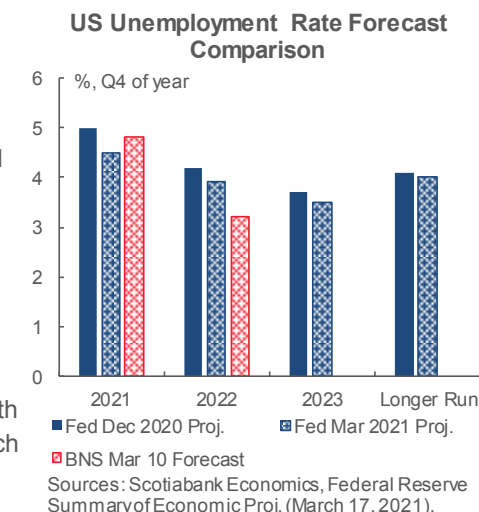


Chart 4



DOTS & WHY TO VIEW THEM SKEPTICALLY

The median rate projection remained unchanged at 0.1% but the composition of the dots was altered with more FOMC participants indicating rate hikes as soon as 2022 (chart 5, front page). It's still the case that 14 officials expect no rate change next year, but instead of one forecasting a single hike, three forecast a single hike and one forecasts two hikes next year. For 2023, there are still 11 who forecast no change (down one from previously) but seven who forecast either 1 rate hike (1 participant), two (1), 3 (3) or 4 (2) hikes. The total adds to 18 forecasts, up from 17 the last time.

So what did Chair Powell say in the press conference that should not have markets taking the FOMC's rate projections so literally and as alluded to above? When probed during the presser on whether the FOMC consensus is weakening with more participants showing hikes in 2022 and 2023, Powell said that the bulk of the FOMC is not showing a rate increase during the forecast period and that **"part of that is wanting to see actual data and not just forecasting it."** So more—perhaps many more—participants would shift to hikes if their forecasts became reality? Isn't a forecast supposed to be internally consistent in order to be credible rather than one component fudged? That says to me that the median rate path could well be adjusted higher with more participants showing hikes if the actual growth, inflation and unemployment forecasts turn into reality or if conviction increases over time. This suggests downplaying the significance of the median rate projection as potentially misaligned with the rest of the forecasts.

My belief is that the investors should not discount the possibility that the FOMC's forecasts are less of a reflection of what they actually think will happen to inflation and rates going forward and quite possibly a reflection of the unwillingness to entertain greater risks on both counts *at this stage*. The FOMC is imposing judgement that inflation won't overshoot and will magically hang in at 2% or so throughout the forecast horizon as the US economy moves into excess aggregate demand driven by unprecedented monetary and fiscal stimulus so they don't have to show a median hike. Of course they did; to show, say, sustained 2.2+% inflation throughout that might have been more consistent with the rest of their forecasts for sustained above-potential GDP growth and a return toward a pre-pandemic unemployment rate would have led to aggressive questioning on the credibility of not showing a median hike and markets would have lit up. The Fed has no interest in tossing further fuel on the fire at this juncture.

So, it boils down to whose forecasts do you believe and how will the FOMC policy path change as data evolves and I'm not sure that we're really any further ahead in the wake of these forecasts whatever the market reaction. We're all in monitoring mode, but our bet is that core inflation will rise somewhat more than the FOMC is inking today and with that will come pressure to raise the policy rate into 2023 after beginning to taper purchases early next year and shutting down bond buying by the end of 2022.

STILL NOT FUSSED OVER BOND MARKETS

During the press conference, Powell reaffirmed that he's not fussed by higher bond yields and indirectly rejected the option of altering purchases or engaging in an 'operation twist' of sorts by repeating the line that the FOMC believes the current stance of monetary policy to be appropriate. He continues to say that he *would* be concerned about a disorderly move in bond markets which places any potential for concern in a future tense rather than saying he is already concerned about developments to date. The message is that the FOMC remains quite content to have witnessed curve steepening in a way that continues to look like a whisper taper effect.

FEW STATEMENT CHANGES

Statement changes were relatively minor but somewhat more upbeat. They were all in the second paragraph of the accompanying statement comparison. They struck out how the recovery has moderated in favour of having "turned up recently." They also removed reference to declining oil prices holding down CPI—likely given the speed of ascent by oil prices—and now merely factually state that inflation remains under 2%.

BUBBLES

Powell downplayed concern about financial stability. He did so by saying they look at four things. First, on asset valuations, he said "Some asset valuations are elevated." He did not elaborate, though at another point in the press conference he noted that financial conditions remain broadly stimulative as an offset to higher bond yields. Second and third, he noted that they look at household and business financial conditions and that "nothing in businesses and households really stands out" after taking account of how they entered the crisis and the combination of policy supports, financing activities and cash reserves. Third, on funding, he continues to emphasize that there will remain a focus upon seeking to further strengthen the system in the wake of the pandemic.

RELEASE DATE: MARCH 17, 2021

The Federal Reserve is committed to using its full range of tools to support the U.S. economy in this challenging time, thereby promoting its maximum employment and price stability goals.

The COVID-19 pandemic is causing tremendous human and economic hardship across the United States and around the world. ***Following a moderation in the pace of the recovery, indicators of economic activity and employment have turned up recently,*** although the sectors most adversely affected by the pandemic remain weak. ***Inflation continues to run below 2 percent.*** Overall financial conditions remain accommodative, in part reflecting policy measures to support the economy and the flow of credit to U.S. households and businesses.

The path of the economy will depend significantly on the course of the virus, including progress on vaccinations. The ongoing public health crisis continues to weigh on economic activity, employment, and inflation, and poses considerable risks to the economic outlook.

The Committee seeks to achieve maximum employment and inflation at the rate of 2 percent over the longer run. With inflation running persistently below this longer-run goal, the Committee will aim to achieve inflation moderately above 2 percent for some time so that inflation averages 2 percent over time and longer-term inflation expectations remain well anchored at 2 percent. The Committee expects to maintain an accommodative stance of monetary policy until these outcomes are achieved. The Committee decided to keep the target range for the federal funds rate at 0 to 1/4 percent and expects it will be appropriate to maintain this target range until labor market conditions have reached levels consistent with the Committee's assessments of maximum employment and inflation has risen to 2 percent and is on track to moderately exceed 2 percent for some time. In addition, the Federal Reserve will continue to increase its holdings of Treasury securities by at least \$80 billion per month and of agency mortgage-backed securities by at least \$40 billion per month until substantial further progress has been made toward the Committee's maximum employment and price stability goals. These asset purchases help foster smooth market functioning and accommodative financial conditions, thereby supporting the flow of credit to households and businesses.

In assessing the appropriate stance of monetary policy, the Committee will continue to monitor the implications of incoming information for the economic outlook. The Committee would be prepared to adjust the stance of monetary policy as appropriate if risks emerge that could impede the attainment of the Committee's goals. The Committee's assessments will take into account a wide range of information, including readings on public health, labor market conditions, inflation pressures and inflation expectations, and financial and international developments.

Voting for the monetary policy action were Jerome H. Powell, Chair; John C. Williams, Vice Chair; Thomas I. Barkin; Raphael W. Bostic; Michelle W. Bowman; Lael Brainard; Richard H. Clarida; Mary C. Daly; Charles L. Evans; Randal K. Quarles; and Christopher J. Waller.

RELEASE DATE: JANUARY 27, 2021

The Federal Reserve is committed to using its full range of tools to support the U.S. economy in this challenging time, thereby promoting its maximum employment and price stability goals.

The COVID-19 pandemic is causing tremendous human and economic hardship across the United States and around the world. ***The pace of the recovery in economic activity and employment has moderated in recent months,*** with weakness concentrated in the sectors most adversely affected by the pandemic. ***Weaker demand and earlier declines in oil prices have been holding down consumer price inflation.*** Overall financial conditions remain accommodative, in part reflecting policy measures to support the economy and the flow of credit to U.S. households and businesses.

The path of the economy will depend significantly on the course of the virus, including progress on vaccinations. The ongoing public health crisis continues to weigh on economic activity, employment, and inflation, and poses considerable risks to the economic outlook.

The Committee seeks to achieve maximum employment and inflation at the rate of 2 percent over the longer run. With inflation running persistently below this longer-run goal, the Committee will aim to achieve inflation moderately above 2 percent for some time so that inflation averages 2 percent over time and longer-term inflation expectations remain well anchored at 2 percent. The Committee expects to maintain an accommodative stance of monetary policy until these outcomes are achieved. The Committee decided to keep the target range for the federal funds rate at 0 to 1/4 percent and expects it will be appropriate to maintain this target range until labor market conditions have reached levels consistent with the Committee's assessments of maximum employment and inflation has risen to 2 percent and is on track to moderately exceed 2 percent for some time. In addition, the Federal Reserve will continue to increase its holdings of Treasury securities by at least \$80 billion per month and of agency mortgage-backed securities by at least \$40 billion per month until substantial further progress has been made toward the Committee's maximum employment and price stability goals. These asset purchases help foster smooth market functioning and accommodative financial conditions, thereby supporting the flow of credit to households and businesses.

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