Special Report

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FOMC MEETING PREVIEW

Near-Term Fed Risk Lies In Dissenting Votes

- **One or both of Fisher or Plosser could dissent as soon as tomorrow or by year-end, and we briefly review the literature on how it matters more to equities than fixed income markets.**

The risk to tomorrow's FOMC statement is that Dallas Fed President Richard Fisher dissents. If he does — either now or before year-end, or if Philadelphia Fed President Charles Plosser dissents — then there is the potential for a stock market hit more than an impact on other asset classes if history is any guide. The risk of a dissenting vote or two as 2014H2 unfolded is consistent with the view we've been expressing since the start of the year, but the case for expecting a dissenter has now become somewhat more urgent.

Why Fisher Could Dissent

Fisher's op-ed in the WSJ on Sunday night landed in the middle of the Fed's black-out period which is further evidence that the black-out period no longer means much. Yes it was excerpted from a speech that he delivered last Wednesday but the communications black-out period starts at midnight eastern time 7 days before the beginning of the meeting which, since it starts today, means that it stretches back to last Tuesday at 12am. Fisher's speech therefore landed in the supposed black-out period, just as CNBC appearances by regional Fed Presidents have in the fairly recent past, such that a communications free-for-all makes it no longer realistic to count out Fed speak as a statement approaches. More important is that optically it was opportunistic of Fisher to publish the op-ed just 3 days before the FOMC statement and it may be a red flag that he is preparing to dissent.

Recall this is one of Fisher's last four meetings and there is no August meeting. In an interview at the end of last year he stated that "My full intention is to step down on April 30, 2015." Yes he's 65, and most Fed Presidents have to retire at 65 unless appointed after 55 — as he was — in which case they can retire at 75 or after 10 years of service as long as the local Board of Directors agrees.

So, if I were Fisher and had staked my career at the Fed on being a perennial hawk then I would not want to leave the Fed on a soft note and I might not want to wait until the last possible minute to shift my vote. With FOMC meetings in July, September, October and December his time is running out. I would suggest that the odds of him dissenting are modest tomorrow, highest in September when full forecasts will be updated and Chair Yellen has promised more details on exit policies, modest in October, and high again in December some time after the bond purchase program has ended.

Why Plosser Could Dissent

If Fisher dissents, then the added question is if he is the lone dissenter, or is joined by his traditionally hawkish colleague, the Philly Fed's President Charles Plosser who voted largely in hawkish tandem with Fisher in earlier stages of the crisis. There is also the distinct possibility that Plosser goes it alone and dissents at one of the next few meetings.

Plosser also loses his vote after December of this year and the Philadelphia Fed does not regain a regular vote until 2017. One might argue that Plosser is the more likely of the two to dissent sooner rather than later if the reason for dissenting is the timing of Fed funds hikes. Recall that in a speech at the end of June, Plosser used a variety of policy rate rules to development scenarios and concluded that "...all the rules suggest that liftoff of the fed funds rate from the zero bound should occur next quarter. This is considerably sooner than many seem to be expecting." Thus, Plosser is presumably the 'dot' on the FOMC's rate scenarios chart that advocates a fed funds

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hike this year. Indeed, he has tended to imply that if the balance sheet is not allowed to shrink over time then this should be offset through more aggressive policy rate hikes.

Plosser believes that most of the decline in the labour force participation rate is structural and related to aging demographics. I personally disagree with this and view it as one part demographics and one part the cycle in rough balance to one another such that Fed policy can still exert some influence on labour markets. Regardless, Plosser's dismissal of any cyclical argument behind falling labour force participation rates is a major part of why he thinks the Fed should be raising rates earlier than his colleagues believe in that this view on the participation rate points to less slack in job markets, and the greater threat of ultimate wage and price pressures.

What Would Dissent Look Like?

Where could dissent come from? **There are two main areas in the statement where we can see controversy arising. The first** concerns the FOMC's view "that it likely will be appropriate to maintain the current target range for the federal funds rate for a considerable time after the asset purchase program ends." As noted above, Philly Fed President Plosser has already effectively dissented from that position in his speeches, arguing that various different policy rules would point to a higher Fed funds rate by the end of this year, i.e. not a considerable amount of time after October. Further, some of the hawks think the Fed is too pessimistic on long-term growth and therefore its guidance on the long-term neutral rate is too low.

The second area for controversy among the Fed's hawks — and this seems to be less of an issue at the moment — is the FOMC's policy of "reinvesting principal payments from its holdings of agency debt and agency mortgage-backed securities in agency mortgage-backed securities." There is controversy about the appropriate length of time to continue with this policy. Some of the doves want to see this continue after 'policy lift-off' while the hawks, including Plosser, Fisher, and alternates Lacker and Lockhart (the latter two both vote next year) are open to seeing reinvestment end sooner. It may be early yet for this to arise as the Fed is still buying MBS, but once that stops in October, this could become a touchier subject.

That's not all, of course, with some of the more dovish members wanting more accommodative language inserted into the statement. We would be surprised to see outright dissent against the pace of asset purchases from either the hawks or the doves, all of whom have so-far bought in to the 'tapering' framework, but anything is possible.

Why It Matters To Markets

So what? Fairly recent research on the FOMC announcement effect and specifically on dissenters traces the prospect for abnormal stock market returns based on the results. There is a fairly rich available history of this effect. Recall that individual FOMC votes were made public in the statement only from March 2002 onward. Prior to that, individual votes were made public in the meeting minutes spanning the period of time from February 1992 to January 2002. Prior to 1993 there were neither statements nor minutes published and that was the era in which supposed Fed watchers were more in vogue as Fed communications contrasted to today's tendency to reveal a bit too much. This gives us about a two decade interval of time to evaluate the impact of Fed announcements on markets.

As a first step, a research paper submitted to the respected Journal of Finance (go here), argues that large average excess returns on US equities existed in anticipation of monetary policy decisions. Those returns increased over time, and they account for a substantial share of annual equity returns. Interestingly, the authors did not find such an effect in Treasuries or money market futures. Anecdotally I'd back that up by noting that I often get questions about the Fed from equity-land on the day of the FOMC meeting or after the statement, versus an ongoing dialogue beforehand with institutional fixed income clients. As a second step, another research paper in pre-publication format from March of this year argued that there are abnormal returns around the date of FOMC meetings that directly relate to the disclosure of the voting pattern. Unanimous results lead to stock rallies, while dissenting opinions result in abnormal losses.

Otherwise, Tomorrow's Statement Should Offer More Of The Same

We're not expecting a great deal of additional changes to the economic language in the statement. Aside from noting that growth in H1 2014 has likely been softer than anticipated, the Fed's general view on the economy remains intact. The labour market continues to improve even as there is still considerable slack by some measures. Households look better as do businesses. The recovery in housing is slow. Fiscal drag is fading. Inflation is well behaved, if higher than recent lows. This has been and will likely continue to be the Fed's view. We don't think that a weak H1 will shake it from its current policy course. The FOMC is likely to stick to its view that "there is sufficient underlying strength in the broader economy to support ongoing improvement in labor market conditions" which is the sentence that counts the most.