Special Report

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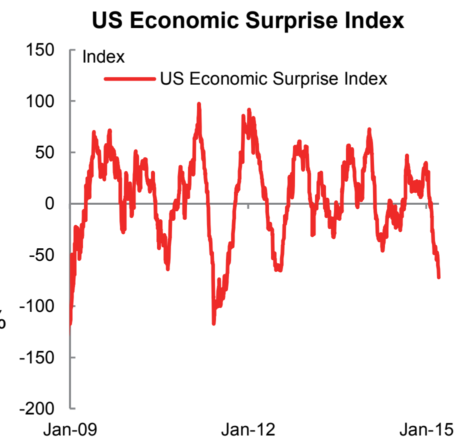
Will The FOMC Look Through Q1 Softness Again?

One of the dividing points within consensus going into tomorrow's FOMC statement and related announcements centers upon the extent to which evidence of a soft Q1 for the US economy could derail plans to begin raising rates into mid-year. The balance of recent economic indicators has surprised to the downside (see chart). In some of the more unflattering accounts of this line of reasoning, proponents of a mid-year lift-off are portrayed as not letting the Q1 data speak for itself in a form of cognitive dissonance. We offer a somewhat different perspective on how possible downside disappointment to Q1 US GDP growth could impact the Federal Reserve.

Transitory Headwinds

The first point is that many of the Q1 headwinds are probably transitory and far-reaching such that delayed economic activity just gets pushed into Q2. These factors include a colder and worse-than-normal winter, a massive strike across dozens of west coast ports that probably affected a broad array of categories from trade figures through to equipment orders and consumer spending, and unusual retooling issues in the auto sector that have affected output and sales (eg. Ford's F150 plants).

Chart 1



Source: Bloomberg, Scotiabank Economics

There are still structural and cyclical reasons to remain bullish about US growth in 2015, and it is reasonable to expect the economy to improve in the quarters ahead. The weakness in Q1 seems to be one part mean reversion and cyclicality after a very strong run in Q2/Q3 2014 (4.6% and 5% q/q SAAR economic growth respectively — numbers that can't be repeated indefinitely), and one part circumstance (a port strike, bad weather, etc.). Overall, the fundamentals for the US economy remain relatively constructive: an ongoing recovery in the labor market from the financial crisis (finally), a structurally improved trade deficit due to the oil boom, lower levels of consumer debt, healthy corporate balance sheets conducive to investment, an end to fiscal drag, etc. **But much like last year, Q1 is unlikely to do the heavy lifting in 2015**.

The Perils Of 'Nowcasting'

Second, what has gotten a fair bit of attention is today's Atlanta Fed 'nowcast' growth estimate for Q1 that currently shows a meagre 0.3% q/q (seasonally adjusted, annualized) tracking in Q1 which is well below the Scotiabank Economics' forecast (go here). This signals very soft to nonexistent growth compared to consensus expectations but is open to caveats on several counts. First, while the 'nowcast' estimate that is released just before the BEA's first GDP estimate may be in roughly the right ballpark, it's still very early in Q1 to be estimating growth. Right now we only have January data for many measures of economic activity and the 'nowcast' could well end the quarter at a very different reading than present. For instance, since the port strike negatively affected trade, the agreement reached on February 20th and the return of workers to the ports this month could lead to a solid snap-back in trade activity within the quarter with spillover effects on other categories of activity. Better weather so far in March could also unleash some of the consumer spending that might have otherwise occurred earlier in Q1 and pose a solid hand-off into Q2.

The FOMC Looked Through It Once Before And Will Probably Do It Again

Third, how will the FOMC look at a potentially soft Q1? The question is whether or not monetary policy officials will feel comfortable raising rates amidst what we think is just a short-term hiccup for a normalizing and growing

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economy — or if they will want to wait for confirmation that Q1's soft data patch is transitory. We think they will probably look through temporary softness. **Indeed, that's exactly what the Fed did throughout Q1 last year.**

Recall that in the March statement last year, the FOMC stated "…growth in economic activity slowed during the winter months, in part reflecting adverse weather conditions." It also went on to flag the role of fiscal headwinds that no longer exist as a drag on quarterly growth. Most important is that the FOMC further tapered MBS and Treasury purchases at the March meeting even amidst what would turn out to be a temporary drag on growth of -2.1% q/q at a seasonally adjusted and annualized rate followed by explosive growth the next quarter. They were right then, and this time we're likely looking at much less Q1 downside. We think they could do the same thing this time and look through Q1 and keep their eyes on the road ahead as opposed to being fooled by temporary distortions to growth.

Indeed, the entire growth and inflation picture is a story of temporary distortions that, given 6-12+ month policy lags on the economy, should be looked through in conducting forward-looking monetary policy. Into year-end and early next year, we think inflation will be moving back toward the FOMC's target on a shift in oil's year-ago base effect influences. By that point, the US is likely to be closer to full employment and facing more intensified financial stability risks in the absence of steps taken beforehand to withdraw some monetary policy stimulus that is unprecedented since the Fed's inception in December 1913. It's our belief that beginning the withdrawal of monetary stimulus well before then is a necessary experiment in favour of mid-year rate hikes as opposed to the folly of waiting for a perpetually uninterrupted string of growth upsides.

Other Expectations

Beyond the issue of how growth distortions may impact FOMC decisions are many other matters to expect in tomorrow's statement as originally noted here. On balance, we expect a marginally less accommodative tone but not all signals will point in this direction as the key will be to retain flexibility to begin raising interest rates at any point from June onward. **We do not expect any specific meeting to be teed up for lift-off just yet.** Watch for the following possibilities:

- Removal of 'patient' in favour of language that connotes flexibility to raise the federal funds target rate at any point from June onward.
- Possible downward revision to the unemployment rate forecast since, at 5.5% in February, the rate is getting closer to the Fed's 5.2-5.3% forecast range and job growth has exceeded expectations.
- Possible upward revision to GDP growth forecast for this year, as the FOMC range (2.6-3.0%) is currently somewhat low relative to the median forecast captured in the Bloomberg consensus (3%). As oil has pushed somewhat lower since the December forecasts, the FOMC could be somewhat more upbeat toward growth prospects.
- Downward revision to prior headline PCE inflation forecast of 1.0-1.6% in 2015 and perhaps to core PCE inflation (1.5-1.8%). Key will be whether next year's inflation forecasts remain unchanged as that would continue to signal that the FOMC is looking through transitory downward influences upon inflation readings. The statement language is likely to remain unchanged via "Inflation has declined further below the Committee's longer-run objective, largely reflecting decline in energy prices."
- It is unclear whether the FOMC acknowledges that market-based inflation expectations have stabilized and by some measures risen somewhat compared to when the FOMC expressed concern about them in the January statement. What complicates this is that market-based measures of inflation expectations — like TIPS breakevens or the Fed's preferred measure of the five year forward inflation swap — have slipped somewhat of late even though they remain higher than at the time of the January meeting and they reflect liquidity and other premia beyond just inflation expectations.
- It is possible that the FOMC alters reference to international risks by somehow acknowledging policy easing across foreign central banks and an improvement in drivers of global growth while indirectly flagging mild concern over the USD. On this latter point, we continue to advise caution on what measure of the currency is used. DXY, Bloomberg's index, and EURUSD are all not the way the Federal Reserve considers currency risk. The inflation adjusted broad dollar index is the way the Fed looks at it and through to the end of this past February this monthly gauge was up by 10% since last summer. Federal Reserve staff research has argued there is a) a modest degree of pass-through into inflation readings via USD-motivated import price changes; and b) that the effects on the broad current account balance of the US economy are spread over about a four year period of time.