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Special Report

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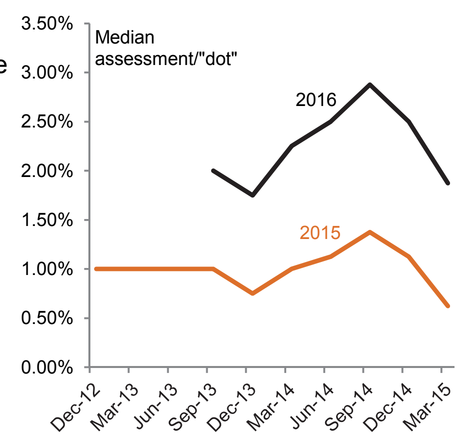
Five Key Questions For The FOMC

Taken at unquestioned face value, the FOMC's dovish surprise yesterday confirmed the expectations of those who think rates should rise by less and later. Maybe that will ultimately prove to be correct. **We're less convinced of this and believe that the FOMC will return to raising the 'dot plot' projections as the rest of the year unfolds into next and turn more hawkish in the process.**

This has already happened before in the very limited history of 'dot plot' projections (chart 1) as the Fed's forward guidance has proven itself to be somewhat volatile. Indeed, the FOMC consensus spent all of last year raising its projections for the fed funds target rate at the end of 2015 and 2016 after just previously lowering them in late-2013. It's possible that the FOMC is doing it all over again and that the median forecast endpoints for this year and next will be upwardly revised over coming meetings.

Chart 1

Appropriate Pace of Policy Firming



Source: Scotiabank Economics, Bloomberg

That's particularly possible since two of the most hawkish FOMC officials — Richard Fisher who retired on March 19th but did not attend the meeting, and Charles Plosser who retired on March 1st — were replaced in the voting by the Philly Fed's acting President Blake Prichard and the First Vice President at the Dallas Fed. Fisher and Plosser were toward the hawkish top of the dot plot for rate hike projections and we simply don't know if the subs voted differently than their exiting bosses and thus partly skewed the dot plot sample to the downside. If so, it's not clear whether that could be a temporary phenomenon until Patrick Harker takes the reins at the Philly Fed in time for the July meeting and perhaps reveals his bias, and when an as-yet unannounced successor to Fisher does likewise sometime in the future.

In driving toward this conclusion, at least five questions need to be addressed and yet none of them were broached yesterday. It's our duty to ask these questions and not simply roll over in the face of an abrupt shift in policy guidance. The subtext is that the bigger risk facing the Fed is not a replay of the premature policy tightening in 1937, but rather the risk of having perhaps gone too dovish this month only to take a decidedly more hawkish turn later.

Q1. Why were transitory factors recently influencing US growth not acknowledged?

There was zero reference to strikes that crippled ports along the western seaboard as an explanation of trade weakness that cut across many industries including retailers, nor were weather effects on housing starts and retail sales acknowledged, nor auto sector retooling challenges such as F150 retooling at two major plants, or refinery strikes. A year ago the FOMC looked through 2014Q1 growth softness and dismissed it as transitory and significantly due to weather effects while it continued tapering. **Why is it making no attempt to do likewise this time?**

To that effect, it's especially worth focusing upon the port strikes. The impact has been very significant. Chart 2 shows the data on port import volumes that was released on Tuesday evening just after the end of the first day of the two day FOMC meeting and may have indeed gone unnoticed. West Coast port volumes utterly tanked in January and February with deep double digit declines. In total, all west coast ports combined saw trade

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volumes down by a whopping 24% from December through February. Some of that may be seasonal, but it was far, far larger for the west coast ports and very different from the same two months in prior years. East Coast ports were also down but by much less, and so were volumes out of gulf ports. The strike ended on February 21 and crews began to be cut in early January such that the strike brought down trade volumes for two-thirds of the quarter. March trade volumes will probably skyrocket as the workers return and so will April's. Trade could therefore surprise the Fed to the upside into Q2 and lead them to revisit their assumptions. It's difficult at this point to evaluate the net trade impact in volume terms but both export and import volumes are likely to rebound smartly. Thus, we think we have serious reason to question the Fed's apparent assumption that softness abroad and the USD are sideswiping the trade account versus putting the emphasis upon large and temporary effects of the port strikes that had sweeping effects on multiple sectors including probably reducing stocking efforts at retailers and thus putting downside to retail sales.

Q2. What is the Fed's preferred measure of the USD?

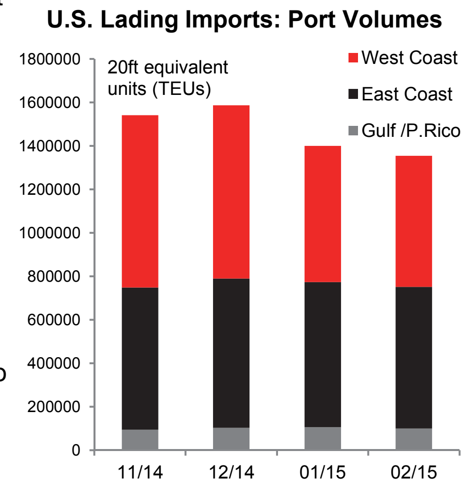
We used to think that what mattered were the nominal and more importantly the real broad dollar index that the Fed itself calculates as this was the measure referenced in various studies of the impact of currency movements on broad current account balances (like this one) and past speeches by former Chairman Ben Bernanke (like this one) but now we're not so sure. That measure is up by only just over 10% since last July and as such should be posing limited concern. Instead, is the Fed now focused upon narrower measures like the DXY or the Bloomberg version — both of which have appreciated by about 2-2½ times as much over the same period. If so, why is it emphasizing currency measures that grossly underweight (Bloomberg) or ignore (DXY, which is frankly largely a euro proxy) pegged exchange rates like the RMB that matter hugely to the US economy? Why is the Fed departing from past emphasis upon a currency measure of competitiveness that is trade weighted against all crosses and adjusted for relative rates of inflation? We need to know the measure of the USD that the Federal Reserve currently thinks is most relevant to trade and capital flows or at least to be reminded of that as markets may be having the wrong dialogue on currency risks by referencing inappropriate measures.

Q3. What is current thinking on the lags and magnitudes of USD effects on growth, inflation?

USD movements take up to four years to have their full effects on the broad current account balance of the US economy (chart 3) and, with the trade data we have so far, we're only about 6-7 months into the appreciation. Can the Federal Reserve point to new research that suggests that the lagged responses to trade competitiveness have become vastly compressed so as to merit the mention of currency risk to export growth?

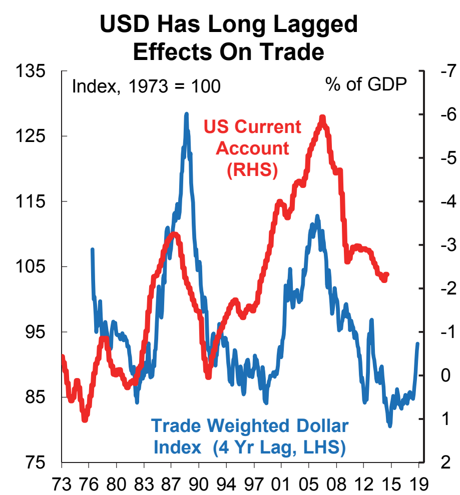
During the press conference, Chair Yellen also alluded to the strong dollar as "holding down import prices and, at least on a transitory basis, at this point pushing inflation down". It is true that import prices are suffering — they fell -9.4% y/y in February. Yet, stripping out the effects of declining oil prices, import prices are down only -1.8% y/y, e.g. the bulk of the decline in this index is generated by falling energy prices, not a weaker USD (chart 4). Moreover, prior research from the New York Federal Reserve has downplayed the pass-through of USD to import prices (and thus inflation) because of the use of the dollar in invoicing U.S. trade, the market share concerns of exporters, and sizable US distribution costs. This, and other research often quoted by the Fed, has suggested that import prices do not move one-to-one with USD. Papers like this one from the Fed have tended to argue

Chart 2



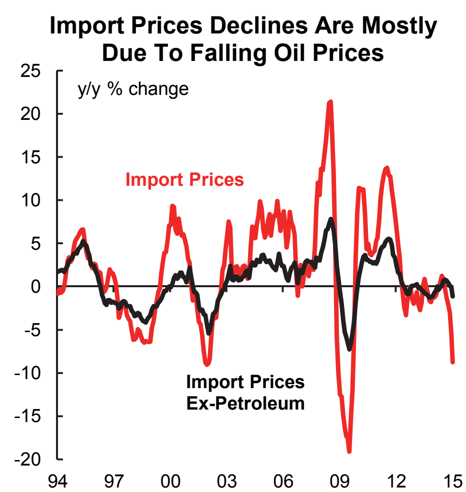
Source: Scotiabank Economics, Bloomberg.

Chart 3



Source: Bloomberg, Scotiabank Economics.

Chart 4



Source: Scotiabank Economics, Bloomberg

that exchange rate pass-through into consumer prices has diminished across multiple countries over time. Does the Fed now feel that USD pass-through is stronger than it has been historically, and does the Fed attribute much of the decline in import prices to the stronger currency?

Q4. Why did the FOMC just apply more stimulus to the US outlook?

Real rates at the front end will be lower for longer and yet it's not clear that the US outlook has deteriorated in such fashion as to justify this. Witness the largely unchanged medium-term inflation projections for 2016 (1.7-1.9%) and 2017 (1.9-2.0%) versus the downward revisions to the median end-point for fed funds projections from 2.5% at the end of next year to 1.875% now and thus an implied real rate of essentially zero. If the shocks to inflation are transitory and recent growth indicators have been distorted by equally transitory factors, it is not clear that the medium-term outlook for the US economy required additional stimulus.

Q5. What is the FOMC's view on global growth going forward?

We think growth and inflation will pick up later in the year including in the Eurozone where euro depreciation, lower oil prices, and lower bond yields should all prove stimulative. What does the FOMC think? A central bank like the Bank of Canada regularly shares its projections for major regions of the world economy but the Fed does not. In the absence of this, it is difficult to tell if the Federal Reserve believes it has cause to go against the line of reasoning that is in favour of improved global growth in future. Apart from flagging international risks, the more transparent way of evaluating what the FOMC thinks of those risks is to start publishing world growth forecasts.