Special Report

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FOMC Meeting Preview

- **The Federal Reserve is likely to signal a slightly more hawkish bias next week.**

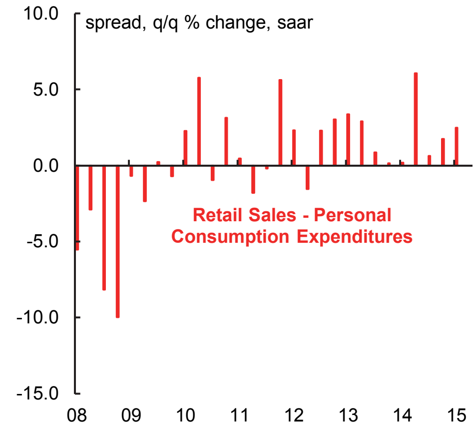
With perhaps two strokes of a pen, the domestic economy has improved enough to raise our conviction that the Federal Reserve will hike by September although there remain important international and market risks.

The Domestic Economy Increases The Probability Of A September Hike

The new information to be incorporated into the FOMC's outlook is the April trade balance and May's retail sales figures including significant revisions to prior months on both counts. We may now be dealing with the possibility that the economy didn't actually contract by 0.7% in Q1 and may have either contracted by less or was perhaps even flat, and that Q2 could be easily 2.5% growth with the significant possibility of 3%+ growth. Better trade and retail figures could have prompted inventory disinvestment as a partial offset but the Fed would probably look through that by emphasizing 'final-demand' which excludes inventory effects. We caution, however, that there can be large differences between growth in retail sales volumes and total consumption volumes where retail is only about 42% of total spending (see chart).

Chart 1

Retail Sales Can Mislead



Source: Scotiabank Economics, BEA U.S. Census Bureau.

Dual Mandate Criteria Reflecting Progress

With the growth situation seemingly improving, the Fed can have more confidence that recent progress on its jobs-and-inflation mandate should persist — and possibly accelerate. Job gains may have moderated since Q4's 324k/month pace, but remain strong at an average 217k/month this year. Core CPI has held steady near 2% (1.8% y/y in April) and will likely post a repeat performance when May numbers land this week. If labor gains continue at the current clip, recent wage increases (+0.7% q/q for three of the past four quarters) could also continue or increase. Also note that survey and market-based measures of inflation expectations have either remained reasonably stable or risen over recent months.

International And Market Risks Still Pose Uncertainty

The balance of the FOMC still will not have enough confidence to hike before September as the data keeps rolling in and they are very data dependent. They are clearly stating they don't want to abruptly surprise markets versus laying out a clear near-term path. Further, international risks remain — such as the rising probability of a Greek tragedy following the IMF's departure from negotiations. Add to that the fact that progress on hard inflation data is still at a nascent stage and USD strength could well exert downward pressure upon import prices and core inflation measures over 2015H2 and beyond.

A further risk lies in the further extent to which markets do the Fed's tightening work with the USD stronger since the last April FOMC and Treasury yields rising to the point to which the 30 year fixed mortgage rate is now at its highest this year. Both developments counsel caution. As usual, the residual ironic challenge to our forecast is the extent to which markets believe it too well and too soon for the Fed's comfort.

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Connecting the Dots

Thus while we expect the Fed to be hawkish on balance next week, it will still be cautious. To this effect, the so-called ‘dots’ showing meeting participants’ forecasts for the Fed Funds rate could well reduce 2016 and 2017 rate expectations by 25bps/year or more. After all, a 1.875% funds rate at the end of 2016 and a 3.125% funds rate at the end of 2017 entail hikes more than every second meeting for the next two years if the Fed only hikes twice in 2015. The market may already be less optimistic than the Fed on 2016 and 2017 rate hikes, but that was the case prior to the March meeting — where lower dots brought significant volatility.