FOMC Preview — The Dovish Hike Redux?

The two-day meeting of the Federal Open Market Committee starts Tuesday and culminates in Wednesday's 2pmET statement and Summary of Economic Projections by FOMC members followed by Chair Yellen's press conference at 2:30pmET. We are among the unanimous 75 forecasters within Bloomberg's consensus that expect the Fed to hike by 25bps, taking the fed funds target range to 0.5-0.75%. Fed fund futures remain 100% priced for a hike. To not hike would arguably risk doing more damage through negative signaling or higher inflation expectations. A cautious balance is likely to be struck on the bias and on that issue there is more of a difference of opinion across markets in a fair debate. I think there is a solid case for a dovish hike that leans against market forces that risk short-circuiting further dual mandate progress.

At the same time, **it is highly premature to expect the Fed to materially change its outlook in response to the US election**. The Fed's data dependence by definition restrains it to waiting for hard evidence on how an as-yet uncertain mixture of potential shifts in fiscal, regulatory, trade and broader foreign relations policies may impact the dual mandate and market stability. That will take a considerable amount of time over next year and beyond.

If the Fed doesn't lean against bond and currency markets then watch out, we're in for greater curve steepening into the new year and a stronger dollar. That could raise the odds of greater caution at future meetings. The broad trade-weighted dollar index is at a 15 year high and the 30 year mortgage rate has climbed by almost three quarters of a percentage point over the past couple of months. Trade (chart 1) and housing markets face downside risk. As argued here, the economic pain arrives first in the "Trump trade" before uncertain net gains to possible future fiscal, trade and regulatory policy actions that markets are probably overestimating. It's not all about Trump, however, in that the USD has been swinging higher since 2014 and yields were rising several weeks ahead of the election for global reasons. Some of this is because of improved fundamentals, some is an overshoot, and some is thanks to actions of other global central banks.

There are many ways in which the Fed could resist the urge to join the party or invoke an incrementally more dovish bias. I'm probably only thinking of a few, but it's entirely possible that it does so using any one of its main tools on game day — or a combination.

1. **Language:** They could flag tightened financial conditions in either nuanced or explicit ways. They could shift language to how real wage growth is under downward pressure (chart 2). They could also reference uncertain effects of potential fiscal and other policy shifts on the dual mandate with some forms being inflationary and some not. They could maintain reference to unchanged — if not falling — survey-based measures of inflation expectations and downplay market-based readings that have simply caught up (chart 3). Tilting away from balanced near-term growth risks toward downside risks is a possibility.

2. **Dots:** The FOMC could choose to leave the median pace of projected hikes unchanged or even lower it; either would signal caution relative to market enthusiasm. Recall that the last dots forecast two hikes in 2017 and three in each of 2018 & 2019. Two year Treasury yields have doubled since July and that may be too much too soon.

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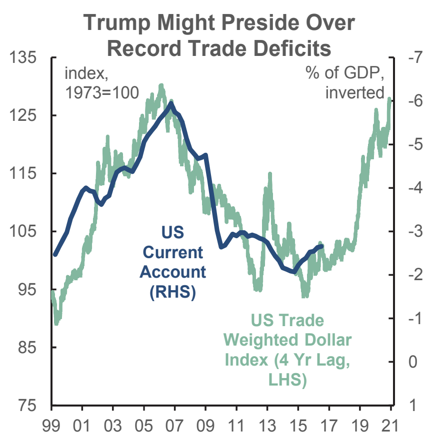
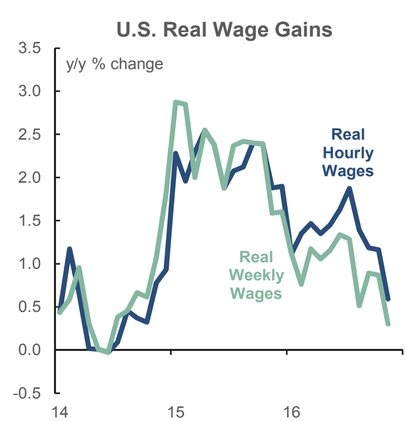
Chart 1



Source: Scotiabank Economics, Federal Reserve, Bloomberg.

Chart 2

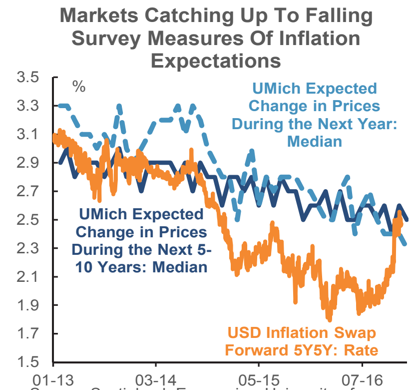


Source: Scotiabank Economics, U.S. BLS.

3. **Macro forecasts:** The FOMC could only tweak forecasts by marginally downgrading 2016 GDP growth and PCE inflation and marginally upgrading them for 2017-18 if at all.

4. **Press conference:** Especially if the FOMC's dots don't inject caution, Chair Yellen might do so with a buck-stops-here approach that makes it clearer what the top of the house is thinking. This raises the prospect of a second trade centred on the press conference. She might dwell upon the dollar and bond markets doing too much of the Fed's work too soon. She could discuss the evidence on fiscal multiplier effects and uncertain consequences to growth. She could argue they cannot act in anticipation of other policy levers versus waiting for action to show up in data-dependent fashion and how this will take considerable time to evaluate while resurrecting reference to a patient approach. She could also warn of the consequences to protectionism.

Chart 3



Source: Scotiabank Economics, University of Michigan,Bloomberg.