FOMC Preview — Hawkish Risks, For Now

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It's fairly clear that the Federal Reserve will raise its fed funds target range by a quarter point to 0.75–1% when its policy statement lands at 2pmET next Wednesday. The risk to the Fed's forecasts is toward a slightly more hawkish than priced outcome. Committee forecasts are likely to receive more attention than either the statement itself or Chair Yellen's press conference at 2:30pmET.

Fed funds futures are assigning 100% odds to a hike. By year-end, they have about two-and-a-half 25bps hikes priced in which is similar to our house forecast for 3 hikes this year (chart 1). Within consensus, all but one of the Fed's 23 primary dealers expect a hike next week—including Scotia. If the Fed abides by Cleveland Fed President Mester's recent remark that "We certainly never want to surprise the markets", then expecting a hike could be the safest bet going in present markets. Recall that Yellen's omission (here) of any reference to "months ahead" as a time frame for a possible hike signalled greater urgency to markets, although it's not clear what changed her mind in just two weeks. Referencing "at our meeting later this month" also cued up a hike in similar fashion to how the Fed cued up the initial hike in December 2015.

Statement language may upgrade the assessment of business investment given increases in core capital goods orders for six of the past eight months but the latest soft report casts some doubt. **Forward rate guidance** is likely to continue to emphasize "gradual" hikes as Yellen noted: "I therefore continue to have confidence in our judgement that a gradual removal of accommodation is likely to be appropriate." **Reinvestment guidance** of QE flows will most assuredly remain unchanged to continue "until normalization of the level of the federal funds rate is well under way."

Forecasts may include small upward revisions to 2017–19 GDP growth after a slightly weaker than expected 2016 and given the Fed is lower than Bloomberg's consensus in each year. Rapidly deteriorating growth-tracking in Q1 may call this into question (chart 2). The issue is whether or not more FOMC committee participants possibly incorporate broader fiscal, trade and regulatory assumptions than the few who did in December.

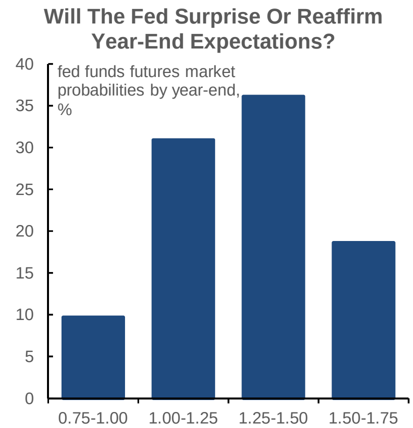
Of greater importance will be the so-called **dot plot for FOMC participants' assessments of forecast hikes**. My base case assumption is that the FOMC's median projections remain in favour of three hikes per year in each of 2017, 2018 and 2019 and a long-run "r-star" or neutral policy rate of 1% in inflation-adjusted terms that would signal approaching the end of a hiking campaign about three years out from now. **Upward growth revisions may, however, be accompanied by a faster hike profile.**

On Yellen's press conference, the risk is more skewed to a sense of déjà vu than any surprises. Her aforementioned speech on the economic outlook that she delivered on March 3rd was likely a near-verbatim warm-up for what she will say next week.

The risks to the Fed outlook are therefore slightly more skewed toward more hawkish long-run forecasts and rate guidance than the last set of dots. Yellen may not believe that herself, but again, the issue is how other committee participants change.

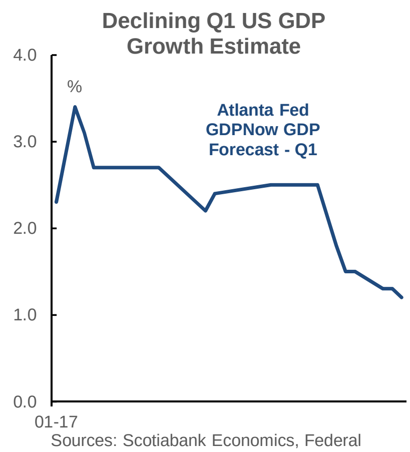
It will take a considerable period to assess whether the Fed is on the right path. Yellen is probably right that the Fed is not behind. **I skew the risks more toward reasons for why the Fed may be getting ahead of itself in hiking now** as argued here.

Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Federal Reserve Bank of Atlanta.