FOMC Preview — All Or None?

The two-day FOMC meeting culminates in a 2pmET statement on Wednesday accompanied by fresh forecasts and followed by Chair Yellen's press conference that will likely end after 3:30pm. A 25bps rate hike and further discussion of details surrounding reinvestment plans is expected. A cautious tone is expected.

Scotia continues to anticipate that reduced reinvestment will be formally announced and implemented only by the December meeting but that the "later this year" time-dependent reference will be shortened by the September or October meeting as an advance clue. The effects are ultimately likely to put mild upward pressure upon the term structure of rates and term premia into 2018. An ideal wish list on reinvestment guidance either now or in the minutes to be released on July 5th includes more detail on timing, starting points, ultimate cap thresholds, distributions of flows across individual securities and conditioning toward a data dependent path. Further discussion on the end-point for the size of the Fed's balance sheet beyond Governor Powell's recent speech may also be provided. We estimate that the initial reinvestment cap will be US$7.5 billion for each of Treasuries and MBS at the starting point (above which flows would continue to be reinvested) and that this will be raised in quarterly increments to end 2018 at caps of US$30 billion in allowed run-offs each month. That path would set the Fed on course to shrink its balance sheet ultimately toward what we think will be a steady state scenario of US$2.5 trillion by 2025. Risks would be skewed toward a larger balance sheet for longer. Such a path should be conditioned as data dependent just as the path for the fed funds target rate is.

On timing the next hike, we've been in the June and December camp for quite some time (even before recently stumbling macro/inflation data and lessened confidence in other policy initiatives). To have hiked in March then June then September would have driven market expectations that the Fed was on a mechanistic once-a-quarter hike path that would risk tightening too much too soon and it would risk going against 'gradual' and data dependent guidance. The argument for a pause after June nevertheless goes much further.

Indeed if the Fed is truly data dependent and not stubbornly committed to a forecast bias, then next week's universally expected hike is likely to be accompanied by fairly dovish guidance on balance that may include heightened caution toward timing the last projected hike of the year (we think December). There are several reasons for this.

1. It has been six months since "about half" of Fed officials incorporated fiscal stimulus into their forecasts with "almost all" flagging upside risks to their growth forecasts according to the minutes to the December FOMC. And yet said stimulus presently lies nowhere in sight for an erratic US administration. That's better than markets, mind you, where seemingly 110% of investors immediately priced in 'Trumponomics' or at least the market-beneficial parts of it all. Now, the USD, Treasuries, inflation expectations and commodity prices have reversed all or almost all of that post-election viewpoint (charts 1, 2) but stocks and the Fed's bias have not. In my opinion, too many FOMC members bought into the initial hype surrounding 'Trumponomics' and fewer should today.

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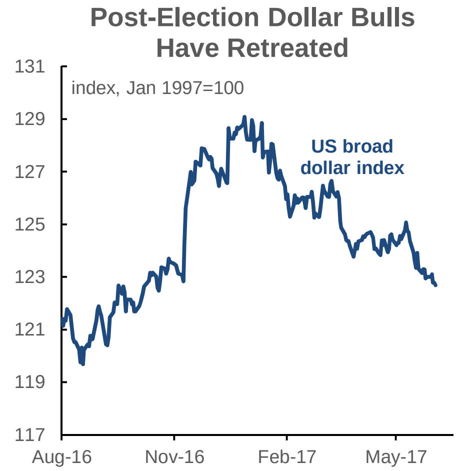
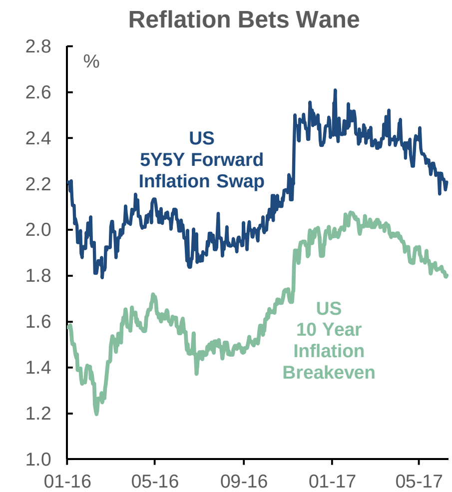
Chart 1



Sources: Scotiabank Economics, US Federal Reserve.

Chart 2



Sources: Scotiabank Economics, Bloomberg.

2. Inflation is under renewed downward pressure of late and likewise for wages. See below for more.

3. Job growth has averaged just 121,000 over the past three months compared to 224k on average during a brief acceleration in January and February. In her March 2017 speech (here), Chair Yellen had said that she thought job growth of between 75k–125k per month would absorb new labor force entrants. Also recall that the 90% confidence interval for nonfarm estimates is +/- 115,000 and so Yellen's estimates are lined up against high uncertainty surrounding often revised estimates of job growth. Regardless, being toward the upper end of this bound of late means little incremental tightening pressure on the unemployment rate that recently fell only because of large defections from the labor force.

4. The US economy grew by only 1.2% in Q1 and the average of 'nowcasts' from the Atlanta, NY and St. Louis Federal Reserve banks for Q2 equals 2.8% which means average quarterly growth of just 1.5% so far this year. That is a little below the Fed's estimate of longer run potential growth in the economy (1.8%) and thus progress toward eliminating spare capacity and shifting toward excess aggregate demand has stalled out in 2017.

In all, it's likely that the Fed shifts to the sidelines after this meeting in order to evaluate growth and inflation data; just as it took several months for a softening data trend to unfold alongside sundry government policy setbacks. The next forecast hike is in December assuming market stability, improved data, and some traction on the broader policy framework. The US administration likely has about ten months to conceive promised forms of stimulus before mid-term campaigning completely takes over.