The Fed Drives A Flatter Yield Curve

- The broad tone of the entire suite of communications is either slightly dovish at the margin or at least not hawkish as some market participants and their advance positioning may have expected. Treasuries rallied as the curve bull flattened with the 10 year yield dropping about 3–4bps post-statement and 5bps on the day. The main point of success in managing markets is to put downward pressure upon the US 10 year yield that is now down by 6–7bps compared to the intraday peak just yesterday. Shorts may have gotten squeezed on this one. The 2s10s spread is now about 23bps.

- **The FOMC has much greater conviction to hike four times in 2018—** hence once more in December—which should increase market pricing for a December hike. 12 of 16 FOMC participants are now in the extra hike for 2018 camp. That part of the outcome was broadly in line with expectations and further raises the odds of a hike on December 19th assuming they skip the November meeting and remain on a one-hike-per-calendar-quarter trajectory. The rest of the dot plot was unchanged except for the insertion of the 2021 median rate projection (see charts). The longer run neutral policy rate of 3% is just rounded up from 2.9% the last time on a slight modification of the distribution of the dots; this is purely a math issue, not something to which any significance should be attached.

- **The only change to the statement (see attached comparison) was to delete the reference to how "monetary policy remains accommodative".** While this had been a point of speculation, it surprised many in the markets (and us) because of three considerations. Before turning to that, removing 'accommodative' is a somewhat dovish signal in that the Fed may be indicating it only expects to raise the policy rate as the real neutral policy rate increases over the cycle and has no further catching up to do to where the current real neutral policy rate sits.

- One consideration is that the minutes to the prior meeting said they may delete "accommodative" only "fairly soon" which is more ambiguous in timing than the "soon" reference they use to tee up a rate hike at the next meeting. Second is that **the real policy rate now sits at about 0bps relative to consensus estimates that the real neutral policy rate is about 50bps right now which may imply somewhat still accommodative policy** by being under where the real neutral rate could be if the FOMC also believes the real neutral policy rate now sits at +½% (we don't know this part of their updated views, only their long run real neutral rate estimate of +1%). Not being accommodative to me means being on top of where most estimates of the real neutral rate presently sit—if not above it. **It is possible the FOMC thinks the real neutral policy rate at present is in line with the real policy rate but we don't know that. Indeed, Chair Powell still wound up saying that policy is accommodative in the press conference which adds to the confusion.** But thirdly, **the FOMC median projection for the real policy rate is considerably more aggressive than the primary dealer consensus estimate** for how the real neutral policy rate will evolve (see chart below). The source for the latter is Q5 in the survey here, to which we at Scotia as a primary dealer contribute and as it turns out our estimate was in line with the median PD estimate. The FOMC is indicating a bigger overshoot of where the PD consensus thinks the real neutral rate should rest throughout the 2019–2021 projection horizon.

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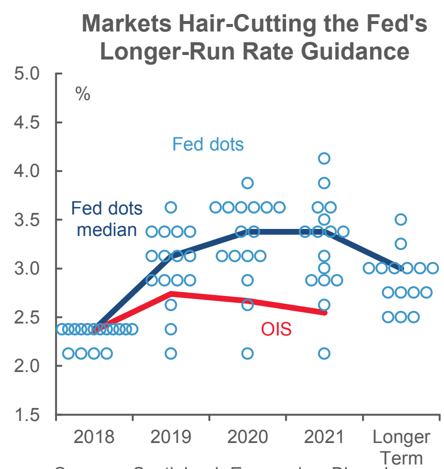
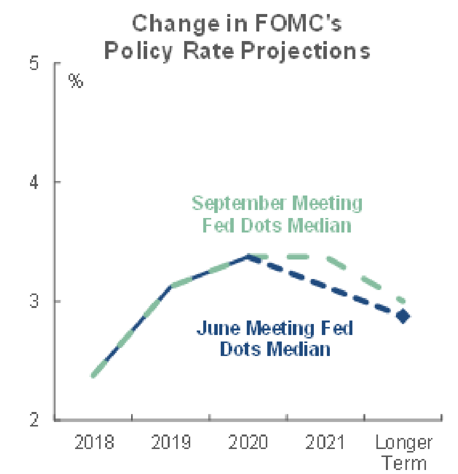
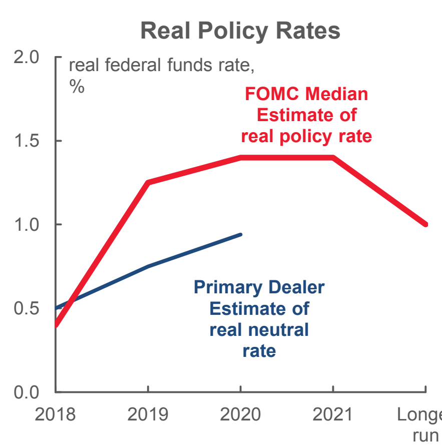


Sources: Scotiabank Economics, Bloomberg.



Sources: Scotiabank Economics, Bloomberg.



Sources: Scotiabank Economics, New York Federal Reserve, Federal Reserve Bank.

- Forecast changes are summarized in the following bullets by comparing today's forecasts to the last forecasts in June.
    - **GDP:** As expected, there was an upward revision in the 2018 real GDP median forecast. It presently sits at 3.1% (prior was 2.8%). The median 2019 estimate is up a tick to 2.5% (prior was 2.4%). 2020 is unchanged. The 2021 median forecast was introduced at 1.8% and the long-run potential growth rate forecast is unchanged at 1.8%.
    - **Unemployment rate:** The median estimate for the 2018 unemployment rate was revised upwards to 3.7% (3.6% prior). **This comes as a surprise to us, but it isn't clear whether this is due to faster assumed labor force entry or a deterioration in the forecast pace of job growth.** There was no change in the 2019 and 2020 forecast, with both years sitting at 3.5%. The 2021 forecast was announced at 3.7% and the long-run unemployment rate remains at 4.5%.
    - **PCE:** There was a downward revision in the 2019 median estimate by 0.1% to 2.0% (2.1% prior). The 2021 median estimate reads 2.0%. The rest of the years' forecasts were unchanged with 2018 at 2.1%, 2020 at 2.1% and the longer run left at 2%.
    - **Core PCE:** Core PCE inflation remained unchanged at 2% for 2018 and then 2.1% in 2019 and 2020. The median estimate for 2021 is 2.1%. The Fed does not forecast core PCE inflation in the long run.
- **In my personal opinion, the Fed Chair's stance during the press conference on trade policy and its influences was somewhat curious in two regards.** For one, I was a bit surprised to hear the Fed chair state that we have yet to see higher prices due to tariffs. Technically that's true in terms of broad, lagging CPI and PCE inflation. It is not true, however, in terms of the targeted items to date as we've obviously seen much higher prices for steel, aluminum, washing machines and solar panels. Further, the impact of the latest and biggest batch of US tariffs on imported Chinese goods is still ahead of us to be evaluated in inflation data into year end. For another, Chair Powell conflicts with his predecessors who are freer to caution on trade policy as Powell chooses to state that tensions could end well with much lower tariffs. It isn't at all clear that this is the goal of the US administration, versus blatant protectionism that may endanger the world economy or cause trade diversion away from the US and in favour of other parts of the global economy.
- Also, Chair Powell says that the USD has only "partly recovered" the decline of 2017 and was therefore somewhat dismissive toward entertaining discussion of the implications of dollar strength to pass-through arguments into measures like inflation and trade. The broad dollar index fell from 128.9 to 115.4 and has since climbed back to about the 125–126 range. **In my opinion, Powell sounded too dismissive toward USD strength and implications for inflation pass through as it has recovered almost all of the prior peak. This is a legitimate issue for the FOMC to discuss given estimates of how prior dollar weakness may have driven much of the rise in core PCE inflation and the resumption of dollar strength threatens this effect in the opposite direction.**
- **Powell was also generally dismissive toward EM risks.** He said that only a "small number" of countries face challenges and for reasons reflecting large fiscal and current account deficits etc. On balance, Powell did not signal much concern about EMs. I think he's right on that count.
- There were no dissenters.
- Please see the attached statement comparison.
- US President Trump holds a press conference at 5pmET. It's unclear whether it will focus upon his UN meetings, or involve comments upon Fed policy and sundry other matters.
- The next FOMC decision will be on November 8th, two days after mid-term elections which punts further significant risk on Fed communications until after the election.

RELEASE DATE: SEPTEMBER 26, 2018

Information received since the Federal Open Market Committee met in August indicates that the labor market has continued to strengthen and that economic activity has been rising at a strong rate. Job gains have been strong, on average, in recent months, and the unemployment rate has stayed low. Household spending and business fixed investment have grown strongly. On a 12-month basis, both overall inflation and inflation for items other than food and energy remain near 2 percent. Indicators of longer-term inflation expectations are little changed, on balance.

Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. The Committee expects that further gradual increases in the target range for the federal funds rate will be consistent with sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2 percent objective over the medium term. Risks to the economic outlook appear roughly balanced.

In view of realized and expected labor market conditions and inflation, the Committee decided to raise the target range for the federal funds rate to 2 to 2-1/4 percent.

In determining the timing and size of future adjustments to the target range for the federal funds rate, the Committee will assess realized and expected economic conditions relative to its maximum employment objective and its symmetric 2 percent inflation objective. This assessment will take into account a wide range of information, including measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial and international developments.

Voting for the FOMC monetary policy action were: Jerome H. Powell, Chairman; John C. Williams, Vice Chairman; Thomas I. Barkin; Raphael W. Bostic; Lael Brainard; Richard H. Clarida; Esther L. George; Loretta J. Mester; and Randal K. Quarles.

RELEASE DATE: AUGUST 1, 2018

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In view of realized and expected labor market conditions and inflation, the Committee decided to maintain the target range for the federal funds rate at 1-3/4 to 2 percent. ~~The stance of monetary policy remains accommodative, thereby supporting strong labor market conditions and a sustained return to 2 percent inflation.~~

In determining the timing and size of future adjustments to the target range for the federal funds rate, the Committee will assess realized and expected economic conditions relative to its maximum employment objective and its symmetric 2 percent inflation objective. This assessment will take into account a wide range of information, including measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial and international developments.

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