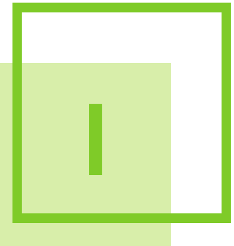
Investment Note



22 March 2018

The Fed strikes a hawkish tone

The US Federal Reserve hiked interest rates by 25 basis points (bps) on Wednesday, with Jerome Powell giving his first press conference as Chairman. While the rate rise was widely predicted, the FOMC's "dot plot" suggests the Fed has become more hawkish than expected. In this note, our Chief Economist Megan Greene examines the FOMC's change of stance and questions whether the dots join up.

The Fed's March announcement and Jerome Powell's press conference offered no dramatic shocks, but the bias was decidedly hawkish relative to what we expected. The Fed hiked rates by 25bps, but that was as close to a foregone conclusion as you can really get with Fed policy moves.[1] What was more telling was the shift in the so-called dot plot, showing that most FOMC members were more hawkish about the Fed's rate path over the next three years.[2] We think there are a number of reasons to be skeptical of this hawkishness and have left our forecast unchanged for three rate hikes this year and two next year.

Dots rise

The median dots suggest the Fed still plans to hike rates three times in 2018, though that is less of a slam dunk than it was in December.[2] Only one more FOMC member needs to think the Fed should hike rates four times this year for the median to shift up to four. Three rate hikes were also forecast for 2019 and a further two for 2020 (both revised up from December). The Fed also increased its long run Fed Funds rate from 2.75% in December to 2.9%.[2] This might not be a huge jump, but we aren't convinced it should have been moved up at all.

The FOMC also published a series of updated forecasts for the US economy, showing slightly higher growth rates (2.7% in 2018—right in line with our forecast—and 2.4% in 2019 decelerating to 2.0% in 2020), lower unemployment rates (3.8% in 2018 and 3.6% in 2019 and 2020) and roughly stable inflation (both headline and core PCE inflation hovering around 2% for the next three years). While the Fed expects unemployment to fall over the next few years, it left its estimate of full employment (the non-accelerating inflation rate of unemployment, or NAIRU) at 4.5%.[2]

Taken all together, these numbers simply don't add up. If you think unemployment will fall almost a full percentage point below NAIRU and still don't think that will spark an acceleration of inflation, you probably have your estimate of NAIRU wrong. We expect this discrepancy will be revised in June to reflect a lower NAIRU.

Another discrepancy in the forecasts exists between growth and inflation. Jay Powell highlighted that the impact of tax cuts on economic growth is very uncertain, but he expects any feed through to growth

[1] Federal Reserve: Press Release – FOMC Statement, 21 March 2018.
[2] Federal Reserve: FOMC Economic Projections, 21 March 2018.

would be demand-driven.[3] If this were the case, we should expect growth forecasts revised up and inflation to accelerate. The FOMC forecasts reflect the former without reflecting the latter. We disagree with Mr. Powell on the impact of the tax bill on the economy; we think it is a positive supply-side shock and therefore could be disinflationary.

Fed should avoid much more hawkishness

Today's announcement and press conference hardly represented a sea change in the Fed's message, but we think the FOMC should avoid getting any more hawkish. We aren't buying the idea that we may be facing a late-cycle surge in inflation. Instead, we expect inflation to accelerate very moderately over the next few years given a number of disinflationary forces in the economy that we expect to offset the inflationary pressures we have witnessed this year. Longer-term global drivers and disruptors such as demographics, an oversupply of cheap labor globally and lackluster productivity growth continue to drag on inflation. In addition to this, there are three reasons to think the Fed dot plots may revert back down closer to where they were last December:

1. GDP may underwhelm in Q1 and Q2. The Atlanta Fed's Nowcast estimates Q1 GDP at 1.8%, down from over 5% at the beginning of the year.[4] Retail sales have fallen three months running and hours worked, industrial production and nondurable goods (ex-transport) all fell in January. Industrial production rebounded in February, but the continued fall in retail sales suggests that the result has been a build-up in inventories. Destocking over the next quarter could be a drag on growth.

2. The US is potentially staring down a trade war with China. We expect the administration to invoke Section 301 in the next few weeks to impose tariffs on Chinese electronics and other goods. We also expect China to retaliate with anti-dumping cases in agriculture at the WTO. China may also retaliate in other ways—for example the PBoC could rebalance its portfolio away from US treasuries. The tariffs the US has already imposed on steel and aluminum are macro-economically relatively insignificant for the US economy, but an expansion of tariffs to include other goods and countries (and an inevitable retaliation) would be a drag on growth. It could also boost inflation, though in our view companies don't enjoy the pricing power they would need to pass through the full cost of tariffs to the end-user. Either way, there is heightened uncertainty around the growth and inflation outlooks stemming from trade. Asked about this issue, Jay Powell chose to stay in his own lane and asserted that trade policy is not the remit of the Fed.

3. Financial conditions have tightened already this year, even without rate hikes. The spread between LIBOR (the benchmark rate used for adjustable loans, including mortgages) and OIS (the overnight indexed swap, a proxy for the Fed Funds rate), while far lower than it was during the financial crisis, is higher than it has been since mid-2009.[5] Furthermore we can expect financial conditions to continue to tighten as the Fed shrinks its balance sheet.

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[3] You can read the full transcript of Jerome Powell's press conference opening remarks here.
[4] Federal Reserve Bank of Atlanta: GDP Now, as of 21 March 2018.
[5] Bloomberg: Why it Matters That the Libor-OIS Spread is Widening, 9 March 2018.

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How the new kid did

This was Jerome Powell's first press conference—ever. He handled it well, and seemed to be more of a straight shooter than either Janet Yellen or Ben Bernanke before him. This may be owing to his background in the private sector. We can parse his words till the end of time but I don't think there was a huge amount of insight we could glean about the new chairman's personal views on monetary policy. He did suggest that the dot plots should not be taken as gospel (Hallelujah!) and indicated he is open to holding a press conference at all Fed meetings so that they truly are all "live."[6]

Bottom line

This Fed statement and press conference went smoothly given that they represented the chairman's first. Generally there was no sea change in the Fed's overall message but there was a distinctive hawkish bent, reflected in the market moves off the back of it (equities turned red, treasuries bounced).[7] We have left our forecast unchanged for three rate hikes in 2018 and two rate hikes in 2019 based on disinflationary forces in the economy, uncertainty about economic growth in the first half of this year and tightening financial conditions. Overall, the risks to our rate forecast are on the upside.

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[6] You can watch the full FOMC press conference here.
[7] Bloomberg, as of 21 March 2018.