March 21, 2018

A slightly more hawkish Fed add one more rate hike in 2019

As widely expected, the Federal Reserve increased the fed funds rate by 25 basis points to 1.50-1.75%. The Fed was encouraged by the economic outlook which “has strengthened in recent months”. Inflation is expected to move up in the coming months and stabilize around 2% “over the medium term”. The FOMC still thinks near-term risks to the economic outlook is roughly balanced. The Fed said that with further gradual adjustments in the stance of monetary policy, economic activity will expand at a moderate pace. The decision to raise rates was unanimous within the FOMC.

Fed’s new economic projections:

The central tendency forecast for real GDP growth (Q4/Q4) was raised for 2018 to 2.6-3.0% (versus 2.2-2.6% previously), to 2.2-2.6% for 2019 (versus 1.9-2.3% previously), and to 1.8-2.1% for 2020 growth (versus 1.7-2.0%). As a result, the central tendency projections for the unemployment rate was revised down to 3.4-3.7% in 2019. However, inflation forecasts were little changed.

The dot plots still point to three rate hikes in 2018 (including today’s hike). But one more hike has been added to 2019 (now three hikes expected in that year). For 2020, the median shows the fed funds rate at 3.4% or half a percentage point above the median estimates of the “equilibrium interest rate”.

Press conference:

Chairman Powell did not spare any efforts to put the dot plot into perspective. He pointed out that they were individual projections, subject to large uncertainties. He also noted that although the median dot for 2020 (3.4%) was above the long run rate projection (2.9%), this would be only modestly restrictive. Again, he warned that it refers to a situation three years down the road and a lot could change between now and then. Commenting on the economic outlook, he said that broadly speaking, participants were expecting meaningful impacts from the tax cuts on demand, over the forecast horizon. However, on the supply side, he noted that some positive impact should be expected, although the size and timing are uncertain. To a question about financial imbalances, Chairman Powell said the FOMC’s current view is that vulnerabilities are low to moderate. Yet, he acknowledged that some asset prices are elevated compared to historical levels. In response to a question about the shape of the yield curve, he said that recession probabilities are not higher than usual, but if the yield curve was to invert the FOMC would monitor how financial intermediation may be affected.

Bottom line:

The Fed’s decision to raise interest rates should not have been surprising in light of the improving U.S. economy and the recently announced Bipartisan Budget Act which included significant fiscal stimulus — resulting in an upgraded growth outlook over the forecast horizon. The statement and projections clearly point to a Fed that is now more confident in hitting its inflation target. Although the median of the dot plot still shows 2.1% (i.e. three hikes in total for this year), that could easily have moved up had just one of the participants been a bit more hawkish. In other words, don’t rule out an even more hawkish Fed in the coming months if the economy continues to strengthen. At this point we continue to call for two additional rate hikes from the Fed before year-end, followed by three hikes next year, in line with Fed expectations.

Krishen Rangasamy/Paul-André Pinsonnault

Here is the Fed’s statement (sections highlighted by us):

Information received since the Federal Open Market Committee met in January indicates that the labor market has continued to strengthen and that economic activity has been rising at a moderate rate. Job gains have been strong in recent months, and the unemployment rate has stayed low. Recent data suggest that growth rates of household spending and business fixed investment have moderated from their strong fourth-quarter readings. On a 12-month basis, both overall inflation and inflation for items other than food and energy have continued to run below 2 percent. Market-based measures of inflation compensation have increased in recent months but remain low; survey-based measures 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 economic outlook has strengthened in recent months. The Committee expects that, with further gradual adjustments in the stance of monetary policy, economic activity will expand at a moderate pace in the medium term and labor market conditions will remain strong. Inflation on a 12-month basis is expected to move up in coming months and to stabilize around the Committee’s 2 percent objective over the medium term. Near-term risks to the economic outlook appear roughly balanced, but the Committee is monitoring inflation developments closely.

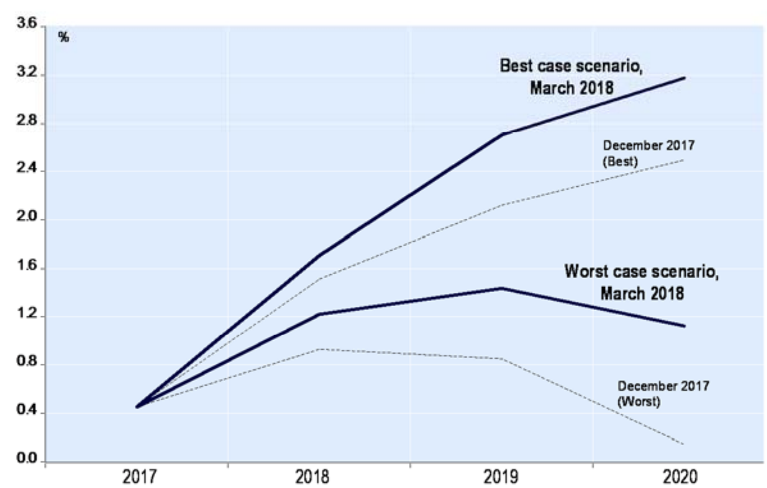
In view of realized and expected labor market conditions and inflation, the Committee decided to raise the target range for the federal funds rate to 1-1/2 to 1-3/4 percent. The stance of monetary policy remains accommodative, thereby supporting strong labor market conditions and a sustained return to 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 objectives of maximum employment and 2 percent inflation. 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. The Committee will carefully monitor actual and expected inflation developments relative to its symmetric inflation goal. The Committee expects that economic conditions will evolve in a manner that will warrant further gradual increases in the federal funds rate; the federal funds rate is likely to remain, for some time, below levels that are expected to prevail in the longer run. However, the actual path of the federal funds rate will depend on the economic outlook as informed by incoming data.

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

U.S.: Fed raises growth forecasts

Output gap calculated using CBO's estimates of potential and Fed's latest GDP projections



NBF Economics and Strategy (data via Federal Reserve, Congressional Budget Office)

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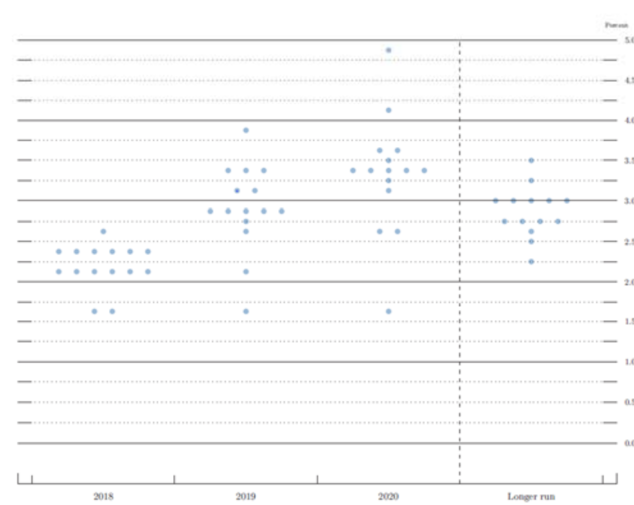
Figure 2. FOMC participants' assessments of appropriate monetary policy: Midpoint of target range or target level for the federal funds rate



FED Policy Monitor

Economics and Strategy

Montreal Office
514-879-2529

Stéfane Marion
Chief Economist and Strategist
stefane.marion@nbc.ca

Paul-André Pinsonnault
Senior Fixed Income Economist
paulandre.pinsonnault@nbc.ca

Krishen Rangasamy
Senior Economist
krishen.rangasamy@nbc.ca

Marc Pinsonneault
Senior Economist
marc.pinsonneault@nbc.ca

Matthieu Arseneau
Senior Economist
matthieu.arseneau@nbc.ca

Angelo Katsoras
Geopolitical Analyst
angelo.katsoras@nbc.ca

Kyle Dahms
Economist
kyle.dahms@nbc.ca

Jocelyn Paquet
Economist
jocelyn.paquet@nbc.ca

Toronto Office
416-869-8598

Warren Lovely
MD & Head of Public Sector Strategy
warren.lovely@nbc.ca

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