

Fed: One more hike and start of balance sheet normalization in 2017

As widely expected, the Federal Reserve raised the fed funds rate by 25 basis points to 1.25%. The Fed supported its decision to hike by referring to improved economic data such as a pick-up in household spending and continued expansion of business investment. While bemoaning below-target inflation, the Fed continues to expect inflation to stabilize around the 2% objective over the medium term. The FOMC expects that economic conditions will evolve in a manner that “will warrant gradual increases in the federal funds rate”. The Fed is maintaining its existing policy of reinvesting principal payments from its holdings of agency debt and agency mortgage-backed securities in agency mortgage-backed securities and of rolling over maturing Treasury securities at auction. But it expects to begin implementing a balance sheet normalization program this year “provided that the economy evolves broadly as anticipated”. When it starts to normalize the balance sheet, it will reinvest only to the extent that the principal payment exceeds gradually rising caps. For Treasuries, the cap is expected to be \$6 bn/month, to be increased by \$6 bn every three months until hitting \$30 bn/month. For agency debt and MBS the cap will be \$4bn/month initially and will increase in steps of \$4 bn every three months until hitting \$20 bn/month. Neel Kashkari, a known dove, was the only dissenter. He wanted the fed funds rate to remain unchanged.

Fed’s new projections:

The central tendency forecast for GDP growth (Q4/Q4) was little changed: 2.1-2.2% for 2017 (versus 2.0-2.2% previously), 1.8 to 2.2% for 2018 (versus 1.8 to 2.3% previously), 1.8 to 2.0% for 2019 (unchanged). The central tendency projections for the unemployment rate were lowered quite a bit: 4.2-4.3% for 2017 (4.5 to 4.6% previously), 4.0 to 4.3% for 2018 (4.3 to 4.6% previously), 4.1 to 4.4% for 2019 (4.3 to 4.7% previously). Inflation forecasts were nudged down for 2017.

The dot plots, presented useful information about how participants feel about the pace of policy firming going forward. There are now no participants seeing rates above 2% by the end of 2017 (versus 1 previously). However, the dot plots still point to one additional hike this year. Participants’ view of the “equilibrium interest rate” has fallen marginally, although the median was unchanged at 3.00%. Fourteen of the 17 participants see the nominal fed funds rate between 2.50% and 3.00% in the long run.

Press conference:

Chair Yellen said that it is important the FOMC achieves its inflation target. However, core inflation has been weak and it is expected to remain below target for some time due to base effects. However, she said the FOMC does not want to react to few data points that can be noisy. She pointed out that the FOMC is confident that the conditions are in place to achieve its 2% inflation target over time. The pace of job creation remains above what is needed to absorb new participants in the labor market. While the Philips curve is flat, it only means it will take more time and a lower unemployment rate to get the desired acceleration in wage inflation. Chair Yellen indicated the FOMC intends to proceed gradually in removing monetary accommodation, in order to keep the expansion on a sustainable path. The shrinkage of the balance sheet is expected to be gradual enough as to “play quietly in the background”. In other words, interest rates will remain the primary tool for conducting monetary policy. The process of reducing the size of the balance sheet could start relatively soon according to Chair Yellen.

Bottom line:

The Fed expects to deliver one more rate hike this year (a forecast that we share) and to start reducing the size of its balance sheet. However, the FOMC’s plans rest on the economy performing well and on its confidence that inflation will rise towards its 2% target over the medium term. The continuing downward revisions of forecasts for the jobless rate just highlights the Fed’s struggles in estimating the non-accelerating inflation rate of unemployment (NAIRU), which explains why wage inflation and hence overall inflation have been much weaker than it expected. Should inflation remain stubbornly weak or unexpected shocks arise, the FOMC is likely to delay further tightening of monetary policy.

Here is the Fed's statement (emphasis is ours):

Information received since the Federal Open Market Committee met in May indicates that **the labor market has continued to strengthen** and that economic activity has been rising moderately so far this year. Job gains have moderated but have been solid, on average, since the beginning of the year, and the unemployment rate has declined. **Household spending has picked up in recent months, and business fixed investment has continued to expand.** On a 12-month basis, inflation has declined recently and, like the measure excluding food and energy prices, is running somewhat below 2 percent. Market-based measures of inflation compensation 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 Committee continues to expect that, with gradual adjustments in the stance of monetary policy, economic activity will expand at a moderate pace, and labor market conditions will strengthen somewhat further. **Inflation on a 12-month basis is expected to remain somewhat below 2 percent in the near term but 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 to 1-1/4 percent.** The stance of monetary policy remains accommodative, thereby supporting some further strengthening in 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 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.

The Committee is maintaining its existing policy of reinvesting principal payments from its holdings of agency debt and agency mortgage-backed securities in agency mortgage-backed securities and of rolling over maturing Treasury securities at auction. **The Committee currently expects to begin implementing a balance sheet normalization program this year, provided that the economy evolves broadly as anticipated.** This program, which would gradually reduce the Federal Reserve's securities holdings by decreasing reinvestment of principal payments from those securities, is described in the accompanying addendum to the Committee's Policy Normalization Principles and Plans.

Voting for the FOMC monetary policy action were: Janet L. Yellen, Chair; William C. Dudley, Vice Chairman; Lael Brainard; Charles L. Evans; Stanley Fischer; Patrick Harker; Robert S. Kaplan; and Jerome H. Powell. Voting against the action was Neel Kashkari, who preferred at this meeting to maintain the existing target range for the federal funds rate.

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

Toronto Office

416-869-8598

Warren Lovely

MD, Public Sector Research and Strategy

warren.lovely@nbc.ca

General – National Bank Financial (NBF) is an indirect wholly owned subsidiary of National Bank of Canada. National Bank of Canada is a public company listed on Canadian stock exchanges.

The particulars contained herein were obtained from sources which we believe to be reliable but are not guaranteed by us and may be incomplete. The opinions expressed are based upon our analysis and interpretation of these particulars and are not to be construed as a solicitation or offer to buy or sell the securities mentioned herein.

Research Analysts – The Research Analyst(s) who prepare these reports certify that their respective report accurately reflects his or her personal opinion and that no part of his/her compensation was, is, or will be directly or indirectly related to the specific recommendations or views as to the securities or companies.

NBF compensates its Research Analysts from a variety of sources. The Research Department is a cost centre and is funded by the business activities of NBF including, Institutional Equity Sales and Trading, Retail Sales, the correspondent clearing business, and Corporate and Investment Banking. Since the revenues from these businesses vary, the funds for research compensation vary. No one business line has a greater influence than any other for Research Analyst compensation.

Canadian Residents – In respect of the distribution of this report in Canada, NBF accepts responsibility for its contents. To make further inquiry related to this report, Canadian residents should contact their NBF professional representative. To effect any transaction, Canadian residents should contact their NBF Investment advisor.

U.S. Residents – With respect to the distribution of this report in the United States, National Bank of Canada Financial Inc. (NBCFI) is regulated by the Financial Industry Regulatory Authority (FINRA) and a member of the Securities Investor Protection Corporation (SIPC). This report has been prepared in whole or in part by, research analysts employed by non-US affiliates of NBCFI that are not registered as broker/dealers in the US. These non-US research analysts are not registered as associated persons of NBCFI and are not licensed or qualified as research analysts with FINRA or any other US regulatory authority and, accordingly, may not be subject (among other things) to FINRA restrictions regarding communications by a research analyst with the subject company, public appearances by research analysts and trading securities held a research analyst account.

All of the views expressed in this research report accurately reflect the research analysts' personal views regarding any and all of the subject securities or issuers. No part of the analysts' compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in this research report. The analyst responsible for the production of this report certifies that the views expressed herein reflect his or her accurate personal and technical judgment at the moment of publication. Because the views of analysts may differ, members of the National Bank Financial Group may have or may in the future issue reports that are inconsistent with this report, or that reach conclusions different from those in this report. To make further inquiry related to this report, United States residents should contact their NBCFI registered representative.

UK Residents – In respect of the distribution of this report to UK residents, National Bank Financial Inc. has approved the contents (including, where necessary, for the purposes of Section 21(1) of the Financial Services and Markets Act 2000). National Bank Financial Inc. and/or its parent and/or any companies within or affiliates of the National Bank of Canada group and/or any of their directors, officers and employees may have or may have had interests or long or short positions in, and may at any time make purchases and/or sales as principal or agent, or may act or may have acted as market maker in the relevant investments or related investments discussed in this report, or may act or have acted as investment and/or commercial banker with respect thereto. The value of investments can go down as well as up. Past performance will not necessarily be repeated in the future. The investments contained in this report are not available to retail customers. This report does not constitute or form part of any offer for sale or subscription of or solicitation of any offer to buy or subscribe for the securities described herein nor shall it or any part of it form the basis of or be relied on in connection with any contract or commitment whatsoever.

This information is only for distribution to Eligible Counterparties and Professional Clients in the United Kingdom within the meaning of the rules of the Financial Conduct Authority.

National Bank Financial Inc. is authorised and regulated by the Financial Conduct Authority and has its registered office at 71 Fenchurch Street, London, EC3M 4HD.

National Bank Financial Inc. is not authorised by the Prudential Regulation Authority and the Financial Conduct Authority to accept deposits in the United Kingdom.

HK Residents – With respect to the distribution of this report in Hong Kong by NBC Financial Markets Asia Limited ("NBCFMA") which is licensed by the Securities and Futures Commission ("SFC") to conduct Type 1 (dealing in securities) regulated activity, the contents of this report are solely for informational purposes. It has not been approved by, reviewed by, verified by or filed with any regulator in Hong Kong. Nothing herein is a recommendation, advice, offer or solicitation to buy or sell a product or service, nor an official confirmation of any transaction. None of the products issuers, NBCFMA or its affiliates or other persons or entities named herein are obliged to notify you of changes to any information and none of the foregoing assume any loss suffered by you in reliance of such information.

The content of this report may contain information about investment products which are not authorized by SFC for offering to the public in Hong Kong and such information will only be available to, those persons who are Professional Investors (as defined in the Securities and Futures Ordinance of Hong Kong ("SFO")). If you are in any doubt as to your status you should consult a financial adviser or contact us. This material is not meant to be marketing materials and is not intended for public distribution. Please note that neither this material nor the product referred to is authorized for sale by SFC. Please refer to product prospectus for full details.

There may be conflicts of interest relating to NBCFMA or its affiliates' businesses. These activities and interests include potential multiple advisory, transactional and financial and other interests in securities and instruments that may be purchased or sold by NBCFMA or its affiliates, or in other investment vehicles which are managed by NBCFMA or its affiliates that may purchase or sell such securities and instruments.

No other entity within the National Bank of Canada group, including NBF, is licensed or registered with the SFC. Accordingly, such entities and their employees are not permitted and do not intend to:

(i) carry on a business in any regulated activity in Hong Kong; (ii) hold themselves out as carrying on a business in any regulated activity in Hong Kong; or (iii) actively market their services to the Hong Kong public.

Copyright – This report may not be reproduced in whole or in part, or further distributed or published or referred to in any manner whatsoever, nor may the information, opinions or conclusions contained in it be referred to without in each case the prior express written consent of National Bank Financial.