NATIONAL BANK OF CANADA
FINANCIAL MARKETS

FED Policy Monitor

Economics and Strategy

June 13, 2018

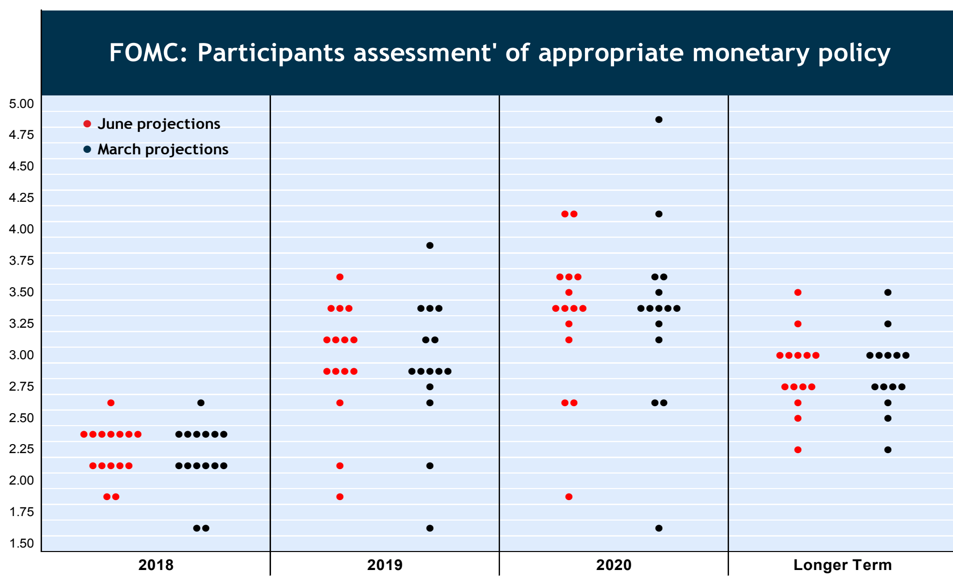
A slightly more hawkish Fed add one more rate hike in 2018

As widely expected, the Federal Reserve increased the fed funds rate by 25 basis points to 1.75-2.00%. It also raised the interest rate paid on required and excess reserve balances by 20 basis points to 1.95%. The decision, which was taken unanimously, was encouraged by the strength of the labour market and the solid rate of economic expansion. More specifically, the Fed statement noted that household spending had picked up since the last FOMC meeting and that business fixed investment had continued to grow strongly. The fact that headline and core inflation had moved closer to the 2.0% target was also acknowledged. As for near-term risks to the economic outlook, the committee still categorized them as “roughly balanced”. One notable change in the statement was the removal of forward guidance. Indeed, gone was the indication that the Fed funds rate were likely to remain, for some time, below levels that are expected to prevail in the long run. Since rate are quickly moving towards what the Fed considered to be the long-term neutral rate (2.875%). It made sense to get rid of that passage.

Fed’s new economic projections

The central tendency forecast for real GDP growth (Q4/Q4) was raised for 2018 to 2.7-3.0% (versus 2.6-3.0% previously), left unchanged for 2019 at 2.2%-2.6%, and revised to 1.8-2.0% for 2020 (versus 1.8-2.1%). As a result, the median projection for the unemployment rate was revised down to 3.6% from 3.8% in 2018, to 3.5% from 3.6% in 2019, and to 3.5% from 3.6% in 2020. Meanwhile, the long run estimate for NAIRU stayed put at 4.5%.

As had been anticipated by some analysts, the median fed fund rates projection for 2018 was raised from 2.125% to 2.375%, and for 2019 from 2.875% to 3.125%, but was left unchanged for 2020 at 3.375%. At previous FOMC meetings, there was an equal number of participants (6) expecting three and four rates hikes in 2018. The latest iteration of the dot plot showed that one of those twelve participants had changed its mind and was now anticipating a total of four hikes instead of three. For 2019, now four participants expected rates to reach 2.875% by year-end, the same number than those anticipating an increase to 3.125%.



FOMC: Summary of Economic Projections	Latest	March projections
Change in Real GDP (%)		
2018	**2.7 - 3.0**	2.6 - 3.0
2019	**2.2 - 2.6**	2.2 - 2.6
2020	**1.8 - 2.0**	1.8 - 2.1
Long Run	**1.8 - 2.0**	1.8 - 2.0
Unemployment Rate (%)		
2018	**3.6 - 3.7**	3.6 - 3.8
2019	**3.4 - 3.5**	3.4 - 3.7
2020	**3.4 - 3.7**	3.5 - 3.8
Long Run	**4.3 - 4.6**	4.3 - 4.7
PCE Inflation (%)		
2018	**2.0 - 2.1**	1.8 - 2.0
2019	**2.0 - 2.2**	2.0 - 2.2
2020	**2.1 - 2.2**	2.1 - 2.2
Long Run	**2.0**	2.0

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Press conference

During his press conference Chairman Powell sounded quite positive about the U.S. economy, saying that it is in great shape and that confidence is high. On the inflation front, the Chairman view was that it was too early to claim victory; he would need to see the inflation rate close to 2% on a sustained basis to do so. The FOMC’s objective is to foster a sustained expansion and, in the Chairman’s view, moving gradually on the path towards a neutral policy stance has been and remains the right approach. Mr. Powell pointed out that the Fed is not at the table where trade policy is discussed so he tried to avoid answering questions on the matter. Nonetheless, he said Fed business contacts expressed some concern about the uncertainty of international trade policy but those worries have not yet transpired in actual economic data. Finally, he downplayed the long-term forecast of the NAIRU saying that one should not concentrate on unobservable economic variables, but focus instead on incoming economic data. Starting next year, the FOMC will hold press conference after every meeting but the summary of economic projections will still be released quarterly.

Bottom line

The overall changes to the central tendency of economic projections have moved marginally stronger across the horizon. Given their economic outlook and confidence that the risks to this outlook appear roughly balance, now a majority of participants see the fed funds rate moving up to 2.375% (7 participants) or above (1 participant) by year-end. We take notice but want to see how risks related to international uncertainties including from emerging market will evolve before changing our forecast of only one more rate hike this year.

Fed's statement (sections highlighted by us):

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 at a solid rate. Job gains have been strong, on average, in recent months, and the unemployment rate has declined. Recent data suggest that growth of household spending has picked up, while business fixed investment has continued to grow strongly. On a 12-month basis, both overall inflation and inflation for items other than food and energy have moved close to 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 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.

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.

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