Deutsche Bank
Research

North America
United States

Economics
Fed Notes

Date
14 December 2018

FOMC preview: Could a Fed flinch now firm up the policy trajectory later?

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- We expect the Fed to raise rates for the fourth time in 2018 at its December meeting next week, in line with our long-held expectation. However, the more important question will be what signal the Committee sends about its policy path in the coming years. Overall, we expect the message to be that the Fed remains upbeat on the outlook and expects to raise rates further in the coming quarters, but that the pace of normalization is likely to slow next year from its recent quarterly rate as the path forward becomes more data dependent. Reflecting this, the statement should modify the forward guidance language by noting that gradual increases remain appropriate in the "near term". In a close call, we expect the 2019 median dot to fall from three hikes to two, while the median rate trajectory should remain unchanged further out.
- A decline in the 2019 dot would not cause us to downgrade our own forecast for three rate hikes next year. Indeed, if the Fed signals some flexibility around the pace of rate hikes, while maintaining its overall trajectory for the terminal rate, it could help to ease financial conditions and ultimately make three rate hikes more likely in 2019.
- The following commentary details our expectations for changes to the statement, economic projections and press conference.

Figure 1: DB expectations for changes to the Fed's December SEP

Variable	2018	2019	2020	2021	Long Run
Change in real GDP					
*December 2018 projection**	*3.1*	***2.4***	*2.0*	*1.8*	*1.8*
September 2018	3.1	2.5	2.0	1.8	1.8
Unemployment rate					
*December 2018 projection**	*3.7*	*3.5*	*3.5*	*3.7*	*4.5*
September 2018	3.7	3.5	3.5	3.7	4.5
PCE Inflation					
*December 2018 projection**	***1.8***	***1.5***	*2.1*	*2.1*	*2.0*
September 2018	2.1	2.0	2.1	2.1	2.0
Core PCE Inflation					
*December 2018 projection**	***1.9***	*2.1*	*2.1*	*2.1*	
September 2018	2.0	2.1	2.1	2.1	
Fed Funds					
*December 2018 projection**	*2.4*	***2.9***	*3.4*	*3.4*	*3.0*
September 2018	2.4	3.1	3.4	3.4	3.0

**DB US Economics estimate*

Note: Bold values represent revisions from the September SEP. Source: FRB, Deutsche Bank

Statement

We expect three changes to the meeting statement—the most important of which is to the forward guidance language. Specifically, we expect the Committee to slightly soften the phrase "The Committee expects that further gradual increases in the target range for the federal funds rate will be consistent…" In order to inch in a direction of greater data dependency as the Fed approaches the neutral range, and consistent with variations of this language that have been used by Vice Chair Clarida and Governor Brainard in recent weeks, the meeting statement may indicate that further gradual increases to the federal funds rate remain appropriate "in the near term". This change should be read as indicating a March rate hike remains firmly in the cards but that uncertainty has risen about rate increases beyond, and data dependency suggests that forward guidance should therefore soften.

This subtle shift in forward guidance is a close call as the minutes of the November meeting indicated that participants felt that changes to this language were needed at "upcoming meetings". It is therefore possible that a more comprehensive change to the forward guidance language may come next year when the fed funds rate has definitively entered the lower bound of the range of neutral estimates.

The other two changes to next week's meeting statement should be largely cosmetic. First, with respect to the assessment of the inter-meeting data, the Fed will likely note that the unemployment rate "remained steady" versus "has declined". We see little need to alter the language on household spending and business fixed investment given that the preliminary Q4 data are mostly in line with the Fed's growth outlook. Second, while the inflation language can continue to characterize headline and core inflation as "remaining near 2 percent", the Fed may state that "market-based measures of inflation compensation declined in recent months, but survey-based measures are little changed, on balance". In doing so, the Fed can acknowledge that energy prices have dampened breakeven inflation rates, while not indicating any material change to the core inflation outlook.

Finally, we expect the "Implementation note" accompanying the statement to indicate that, while the target range will be lifted by 25 basis points (bps) to 2.25-2.5%, the interest rate on excess reserves will only rise by 20 bps to 2.4%. As in June, this technical adjustment would be meant to ensure that the fed funds rate remains well within the target range.

Summary of Economic Projections

On the whole, while the expected changes to the meeting statement could be viewed as erring slightly dovish, we believe the Summary of Economic Projections (SEP) will clarify that not much has changed relative to the Fed's baseline growth and inflation outlook from the September 26 meeting.

Economic projections: Baseline little changed but tailwinds fading

With respect to real GDP growth, we anticipate just a one-tenth decline in the 2019 estimate to 2.4% due to slightly softer global growth and the recent tightening of financial conditions. Recall that the minutes of the November 8 meeting indicated that the Board staff's medium-term growth projection for real GDP growth was only a "bit weaker than in the previous forecast, primarily reflecting a lower path for equity prices, leaving the unemployment rate little revised". Since that meeting, financial conditions have tightened somewhat further, with the S&P 500 down nearly 5% and IG spreads about 25 bps wider. However, we do not see the mild downgrade to 2019 growth carrying through to either 2020 or 2021, which should remain unchanged at 2.0% and 1.8%, respectively.

Given that growth is expected to remain firmly above potential in 2019 before moving back toward potential in 2020 and slightly below in 2021, we see no material changes to the Fed's median estimate of the unemployment rate over the forecast horizon. Hence, the Fed is likely to continue to project the unemployment rate falling another couple of tenths to 3.5% in 2019, remaining at that level in 2020, and then rising to 3.7% in 2021 as a modestly restrictive policy stance should nudge growth slightly below potential. As the November 8 meeting minutes also indicated, the staff expected that "With labor market conditions already tight, the staff continued to assume that projected employment gains would manifest in smaller-than-usual downward pressure on the unemployment rate and in larger-than-usual upward pressure on the labor force participation rate." This is important because it implies some scope for longer-run potential growth to be revised higher or the NAIRU to be revised a bit lower. Indeed, the range for the long-run estimate of the NAIRU has drifted lower over the last three forecast meetings. Hence, we would not be surprised if this slipped a tenth to 4.4%, although this is not our base case. Note, also, that both Vice Chairs Clarida and Quarles have recently noted the possibility of higher potential growth.

The most important aspect of the Fed's 2019 economic forecast for their rates trajectory is likely to be their expectations for inflation. With the growth and labor market outlook only modestly changed relative to September, and with the November 8 minutes noting that the "staff's forecasts for both total and core PCE price inflation were little revised on net", we expect core PCE inflation to remain unchanged from 2019 onward at 2.1%. The risk is that it declines by one-tenth, however, which could be justified by the 2% climb in the trade-weighted dollar since the September meeting, the modestly softer-than-expected incoming inflation data or a potential downward revision to the long-run estimate of the NAIRU. The most dramatic, but also least consequential, revision to their forecast for 2019 should be a downgrade to headline PCE inflation, by around half a percent, due to the more than 25% decline in oil prices since the September meeting.

Such marginal changes to the 2019 outlook would likely belie a somewhat more meaningful shift in the balance of risks around the Fed's outlook. As we noted recently (see: From headwinds to tailwinds and back again?), some softening in the Fed's narrative in recent weeks has been due to the perception that some tailwinds for the economy have faded and could turn into headwinds, namely softer global growth momentum and tighter financial conditions. While not material enough to significantly alter the Fed's baseline assessment at this point, we think these developments have taken some of the steam out of overheating risks that caused the Fed to sound more hawkish earlier this year.

Dots: 2019 median to slip but broader trajectory unchanged

A downgrade to 2019 growth, diminished tailwinds and slightly softer incoming inflation data have at the margin weakened the argument for moving to a restrictive stance in 2019. We read recent comments from a few Fed officials, including Chair Powell and Vice Chair Clarida, as leaning in this direction as well, though to be sure, Governor Brainard and NY Fed President Williams appear to have left their expectations broadly unchanged. With this modest shift in inflation risks in mind, we see the median dot for 2019 slipping from three rate hikes to two amidst a broader downward migration in the dots.

This is a very close call given the above discussion, particularly since it will only take two dots to fall from three to lower the median, assuming that Governor Bowman's dot, which is introduced at this meeting, is in line with three hikes. Given who we believe was at the median of three hikes in September, we view this decision as being up to the Chair and dependent on what signal he wants to send. The pressing question for the Committee is, what signal will best help them to sustain the economic expansion in the coming years, and at this point we think it leans in a direction of providing some support to financial conditions in the near term.

That said, as discussed further below, we would expect a downgrade in the 2019 dot to be downplayed by Powell in the press conference and further offset by a signal from the statement and press conference that the market has underestimated the odds of another rate hike in the near term. Indeed, a decline in the 2019 dot would not cause us to downgrade our own forecast for three rate hikes next year. Indeed, if the Fed signals some flexibility around the pace of rate hikes, while maintaining its overall trajectory for the terminal rate, it could help to ease financial conditions a bit and ultimately make three rate hikes more likely in 2019.

With the medium-term economic outlook unchanged, we expect the terminal fed funds rate to remain at 3.4% in 2020 and to stay unchanged into 2021. An unchanged terminal rate would reinforce the signal that, while the Fed may need to slow the pace of increases or even pause in the coming quarters, their broader view that policy will have to reach a restrictive stance is little changed. The 2021 dot is to be watched. In September, a number of Fed officials anticipated rate cuts in 2021 even though the median dot held steady at its 2020 level. While unlikely, and indeed it would send a negative signal that could reinforce the pessimism in current rates pricing, only two dots would need to move lower in 2021 for the median dot to signal a rate cut at that point.

Press conference

The press conference and the statement that precedes it will be an opportunity for Chair Powell to amplify/explain/provide some spin around any changes that occur in the post-meeting announcement and the dots chart. Powell would probably like to add some color about the change to the forward guidance language and about the 2019 dot, whether it is lower or not. We expect his basic message concerning expectations about further rate moves will be that with this meeting’s rate increase, the Committee is now close to the range of estimates of neutral, although we still have a couple more hikes to go to get to the middle of that range and the Committee’s consensus view of neutral in the longer term. He will likely emphasize that the Committee's decisions will continue to be driven importantly by incoming data, and that based on the FOMC’s current expectations for growth, unemployment, and inflation, a slowing of the recent quarterly pace of rate hikes at some point next year will probably be in order. Indeed, the Committee median is already expecting a pause in that pace during 2019.

If the median dot is lowered to two moves in 2019, Powell will likely want to emphasize that the Committee continues to expect further rate hikes to come in

2020—that is, he will not want to encourage expectations that the Fed is now close to finished in a market that is already expecting significantly fewer rate hikes than the Fed feels will be needed. Hence, we would expect some mildly hawkish tones to soften a dovish swing toward lower dots. On the other hand, if the median dot remains at three hikes in 2019, Powell may choose to soften this mildly hawkish surprise for the markets by emphasizing that the Fed will likely be slowing the pace as it reaches its estimate of neutral. He will likely also emphasize that the pace it slows to will be determined by the performance of both the economy and inflation signals.

We expect that Powell will be asked about the implications of the move to press conferences every meeting, and the degree to which this will add some flexibility to the Fed's ability to change the pace of rate hikes. Here, the response will likely be to the affirmative, that yes, the press conferences will serve both to increase the transparency of Fed decisions and to facilitate changes of the pace in rate hikes if dictated by surprises in the data.

Given recent moves in the market, Powell will almost certainly also be asked about the further flattening of the yield curve, as well as the deterioration in financial conditions, and whether he sees these developments as an indication that recession risks have risen appreciably. His answer will likely acknowledge that the Fed is monitoring these developments closely and that the step down in financial conditions has played into their view that growth prospects for the year ahead have softened a bit, as has some evidence of slowing momentum abroad. But he will probably also emphasize that the near-term risk of recession still appears to be low, and that the standard signals normally received from the yield curve are clouded by the unusual compression of the term premium in the bond market.

Finally, Powell could well be asked about, among other things, the risks in rapid growth of corporate credit, the effects of developments on the trade policy front, and his thoughts about comments concerning Fed policy from the Administration. We expect he will say that corporate credit trends also bear close watching, although so far, they do not show up significantly in the Fed's financial stability alarm bells, echoing the sentiment from the Fed's recent financial stability report. On tariffs, he may note that the economic implications of developments to date seem manageable, and we expect no comments concerning various admonitions from the Administration.

Appendix 1

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