Pause for some time

Comment on FOMC Minutes

RaboResearch
Global Economics & Markets
mr.rabobank.com

Philip Marey
Senior US Strategist
+31 30 712 1437

Contents

Summary

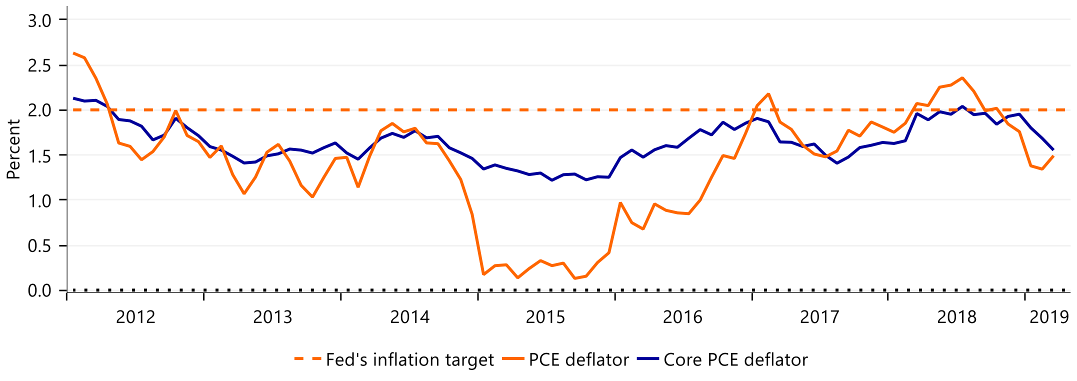
- The minutes of the FOMC meeting on April 30 and May 1 stated that a patient approach to determine future adjustments to the target range for the federal funds rate would likely remain appropriate for *some time*.
- Many participants viewed the recent dip in PCE inflation as likely to be transitory.
- While the FOMC agrees on remaining on hold for some time, there is wide disagreement on the most likely direction of policy rates after the pause. A few participants think the Committee would likely need to tighten policy, but a few others observed that subdued inflation pointed to remaining slack and could lead to inflation expectations becoming anchored at low levels.
- We think that the next change in the target range for the federal funds rate will be a cut. In fact, we expect that the threat of a recession will force the Fed to start a full-blown cutting cycle in 2020.
- The FOMC has started a discussion about the long-run maturity composition of the SOMA portfolio. A proportional portfolio would have the least impact on the term premium and give the Fed more room to cut rates if needed. A shorter maturity portfolio would reduce the scope for rate cuts, but provide room for another Operation Twist. The long-run composition could be reached in about 5 to 15 years, also depending on the transition path (gradual or accelerated).
- The Fed staff warned the FOMC that the next technical adjustment to the IOER rate might also require a technical adjustment to the ON RRP offer rate. This underlines the system failure of the Fed's current policy rate framework.

Patient approach for some time

The minutes of the FOMC meeting on April 30 and May 1 stated that a patient approach to determine future adjustments to the target range for the federal funds rate would likely remain appropriate for *some time*. The minutes confirm Chairman Powell's statement at the post-meeting press conference on May 1 that the FOMC does not see a strong case for a rate move either way.

Many participants viewed the recent dip in PCE inflation as likely to be transitory. This is also in line with Powell's press conference. The minutes referred to unusually sharp declines in the prices of apparel and of portfolio management services that would have only temporary effects on inflation. Note that PCE inflation – the Fed's preferred measure of inflation – rebounded to 1.5% year-on-year in March from 1.3% in February, core PCE inflation fell to 1.6% from 1.7%. Both measures of inflation have been below the Fed's 2.0% target since November 2018.

Figure 1: Undershooting the Fed's inflation target



Source: Macrobond

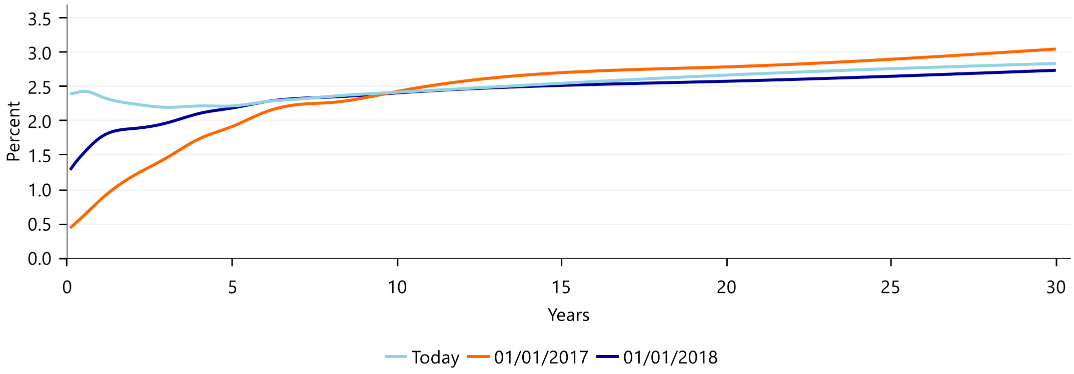
While the FOMC agrees on remaining on hold for some time, there is wide disagreement on the most likely direction of policy rates after the pause. A few participants think the Committee would likely need to tighten policy, but a few others observed that subdued inflation might indicate that resource utilization was not as high as the recent low readings of unemployment suggest. Several participants commented that if inflation did not show signs of moving up over the coming quarters, there was a risk that inflation expectations could become anchored at low levels. Note that the most recent Fed dot plot – published in March – still implies another hike in 2020.

A number of participants observed that some of the risks and uncertainties that had surrounded their outlooks earlier in the year had moderated, including those related to the global economic outlook, Brexit and trade negotiations. However, we would like to note that the FOMC meeting took place before the recent breakdown in the US-China trade negotiations. In fact, in addition to subdued inflation, an escalation of the trade war could be another reason for the doves in the FOMC to press for a rate cut once the pause is over.

Don't mention the R-word

While the FOMC is debating whether the next move should be a hike or a cut, we think that the Fed will have to start a full-blown cutting cycle in 2020 in order to avert a recession. After all, the yield curve remains partially inverted, the output gap has been elevated for an extended period, and the housing market is showing interest rate related cracks. While it is tempting to look at coincident or even lagging indicators for confirmation that the US economy is 'in a good place' as the FOMC likes to put it, we prefer to look at the leading indicators that are telling us that this will not last forever. In fact, inversions of the yield curve do have a strong forecasting record when it comes to recessions 12-18 months in the future. Therefore we expect the economy to fall into recession in 2020H2.

Figure 2: US treasury yield curve remains partially inverted



Source: Macrobond

Portfolio matters

The minutes also mention a presentation by the Fed staff about the long-run maturity composition of the SOMA (System Open Market Account) portfolio. The staff discussed two possible long-run portfolios: a 'proportional portfolio' and a 'shorter maturity portfolio.' In the first the long-run maturity composition of the Fed's portfolio would be similar to that of the outstanding US Treasury securities. The second contained only shorter-term securities with maturities of three years or less. The advantage of the shorter maturity portfolio is that it allows for another Maturity Extension Program (MEP) – more commonly known as Operation Twist – if needed, but it would also have an upward effect on the term premium that could force the FOMC to take a lower path for the federal funds rate, reducing the scope for rate cuts in case of a recession. This problem does not arise for the proportional portfolio, which would allow the Fed more room to cut rates and make clear to the public that the monetary policy stance is reflected by the federal funds rate, and not by the balance sheet. However, a number of FOMC participants judged that it would be desirable to have the capacity to conduct an MEP. Several participants expressed the view that a decision would not need to be made for some time, so this discussion is likely to continue. The staff presentation also looked into the transition path toward the long-run portfolio. A 'gradual transition' could help avoid unwanted effects on financial conditions, but it would also take many years (even more than 15) to complete. An 'accelerated transition' could shorten that to 5 years, at the cost of more disruption.

Tweaks

Finally, the staff also discussed the situation in the money markets. Note that at the time of this meeting the Fed's Board of Governors decided to cut the IOER rate by 5 bps. This was a technical adjustment to keep the federal funds rate in the target range. It did not reflect a change in the stance of monetary policy. The staff judged that the reduction of the spread between the IOER rate and the ON RRP facility to 10 bps did not pose a significant risk of increased take-up at the ON RRP facility because repo rates had been trading well above the ON RRP offer rate for some time. However, if it became appropriate in the future to further lower the IOER rate, the staff noted that the Committee might wish to consider where to set the ON RRP offer rate relative to the target range for the federal funds rate to mitigate this risk. In other words, the next time the federal funds rate needs to be pushed back toward the midpoint of the target range, the Fed may have to tweak *two* policy rates. But we are not supposed to interpret these tweaks in policy rates as a change in monetary policy. This underlines the system failure of the Fed's current policy rate framework that we discussed in our FOMC Post-Meeting Comment.

RaboResearch
Global Economics & Markets
mr.rabobank.com

Global Head

Jan Lambregts
+44 20 7664 9669
Jan.Lambregts@Rabobank.com

Macro Strategy

Europe

Elwin de Groot
Head of Macro Strategy
Eurozone, ECB
+31 30 712 1322
Elwin.de.Groot@Rabobank.com

Stefan Koopman
Market Economist
Eurozone, UK
+31 30 712 1328
Stefan.Koopman@Rabobank.com

Teeuwe Mevissen
Senior Market Economist
Eurozone
+31 30 712 1509
Teeuwe.Mevissen@Rabobank.com

Bas van Geffen
Quantitative Analyst
ECB
+31 30 712 1046
Bas.van.Geffen@Rabobank.com

Wim Boonstra
Senior Advisor
Germany
+31 30 216 2666
Wim.Boonstra@Rabobank.nl

Koen Verbruggen
Economist
France
+31 6 129 73 956
Koen.Verbruggen@Rabobank.nl

Alexandra Dumitru
Economist
UK, Ireland
+31 30 216 0441
Alexandra.Dumitru@Rabobank.nl

Maartje Wijffelaars
Senior Economist
Italy, Spain, Portugal, Greece
+31 30 216 8740
Maartje.Wijffelaars@Rabobank.nl

Michiel van der Veen
Economist
Eurozone
+31 6 831 34 616
Michiel.van.der.Veen@rabobank.nl

Americas

Philip Marey
Senior Market Strategist
United States, Fed
+31 30 712 1437
Philip.Marey@Rabobank.com

Hugo Erken
Head of International Economics
United States
+31 30 215 2308
Hugo.Erken@Rabobank.nl

Christian Lawrence
Senior Market Strategist
Canada, Mexico
+1 212 808 6923
Christian.Lawrence@Rabobank.com

Mauricio Oreng
Senior Market Strategist
Brazil
+55 11 5503 7315
Mauricio.Oreng@Rabobank.com

Asia-Pacific

Michael Every
Senior Market Strategist
Asia, Australia, New Zealand
+852 2103 2612
Michael.Every@Rabobank.com

Björn Giesbergen
Senior Economist
China, Japan
+31 30 216 2562
Bjorn.Giesbergen@Rabobank.nl

Hugo Erken
Head of International Economics
India
+31 30 215 2308
Hugo.Erken@Rabobank.nl

FX Strategy

Jane Foley
Head of FX Strategy
G10 FX
+44 20 7809 4776
Jane.Foley@Rabobank.com

Piotr Matys
FX Strategist
Central & Eastern Europe FX
+44 20 7664 9774
Piotr.Matys@Rabobank.com

Christian Lawrence
Senior Market Strategist
LatAm FX
+1 212 808 6923
Christian.Lawrence@Rabobank.com

Rates Strategy

Richard McGuire
Head of Rates Strategy
+44 20 7664 9730
Richard.McGuire@Rabobank.com

Lyn Graham-Taylor
Senior Rates Strategist
+44 20 7664 9732
Lyn.Graham-Taylor@Rabobank.com

Matt Cairns
Senior SSA Strategist
+44 20 7664 9502
Matt.Cairns@Rabobank.com

Credit Strategy & Regulation

Ruben van Leeuwen
Head of Credit Strategy
ABS, Covered Bonds
+31 30 712 1391
Ruben.van.Leeuwen@Rabobank.com

Vaclav Vacikar
Analyst
Financials
+31 30 712 1519
Vaclav.Vacikar@Rabobank.com

Hyung-Ja de Zeeuw
Senior Strategist
Corporates
+31 30 712 1555
Hyung-Ja.de.Zeeuw@Rabobank.com

Bas van Zanden
Senior Analyst
Pension funds, Regulation
+31 30 712 1869
Bas.van.Zanden@Rabobank.com

Cas Bonsema
Analyst
ABS
+31 30 712 1849
Cas.Bonsema@Rabobank.com

Energy Markets

Ryan Fitzmaurice
Energy Strategist
+1 212 916 7874
Ryan.Fitzmaurice@Rabobank.com

Agri Commodity Markets

Stefan Vogel
Head of ACMR
+44 20 7664 9523
Stefan.Vogel@Rabobank.com

Carlos Mera
Senior Commodity Analyst
+44 20 7664 9512
Carlos.Mera@Rabobank.nl

Michael Magdovitz
Commodity Analyst
+44 20 7664 9969
Michael.Magdovitz@Rabobank.com

Client coverage

Wholesale Corporate Clients

Martijn Sorber	Global Head	+31 30 712 3578	Martijn.Sorber@Rabobank.com
Hans Deusing	Netherlands	+31 30 216 9045	Hans.Deusing@Rabobank.com
David Kane	Europe	+44 20 7664 9744	David.Kane@Rabobank.com
Neil Williamson	North America	+1 212 808 6966	Neil.Williamson@Rabobank.com
David Teakle	Australia, New Zealand	+61 2 8115 3101	David.Teakle@Rabobank.com
Ethan Sheng	Asia	+852 2103 2688	Ethan.Sheng@Rabobank.com
Ricardo Rosa	Brazil	+55 11 5503 7150	Ricardo.Rosa@Rabobank.com

Financial Institutions

Eddie Villiers	Global Head	+44 20 7664 9834	Eddie.Villiers@Rabobank.com
Roeland Bronsveld	Benelux	+31 30 216 9030	Roeland.Bronsveld@Rabobank.com
Krishna Nayak	Germany, Austria, CEE	+44 20 7664 9883	Krishna.Nayak@Rabobank.com
Philippe Macart	France	+44 20 7664 9893	Philippe.Macart@Rabobank.com
Mauro Giachero	Italy	+44 20 7664 9892	Mauro.Giachero@Rabobank.com
Martin Best	UK, Scandinavia, Middle East	+44 20 7809 4639	Martin.Best@Rabobank.com
Paul Duddy	USA	+1 212 916 3799	Paul.Duddy@Rabobank.com
Wouter Eijsvogel	Treasury Sales Europe	+31 30 216 9723	Wouter.Eijsvogel@Rabobank.com
David Pye	Central Banks	+44 20 7664 9865	David.Pye@Rabobank.com

Capital Markets

Herald Top	Global Head of Capital Markets	+31 30 216 9501	Herald.Top@Rabobank.com
Nader Pasdar	Capital Markets USA	+1 212 808 6861	Nader.Pasdar@Rabobank.com
Adam Wotton	Capital Markets Asia	+852 2103 2629	Adam.Wotton@Rabobank.com
Willem Kröner	Global Head of Equity Capital Markets	+31 30 712 4783	Willem.Kroner@Rabobank.com
Crispijn Kooijmans	DCM FIs & SSAs	+31 30 216 9028	Crispijn.Kooijmans@Rabobank.com
Bjorn Alink	DCM Securitisation & Covered Bonds	+31 30 216 9393	Bjorn.Alink@Rabobank.com
Othmar ter Waarbeek	DCM Corporate Bonds	+31 30 216 9022	Othmar.ter.Waarbeek@Rabobank.com
Joris Reijnders	DCM Corporate Loans	+31 30 216 9510	Joris.Reijnders@Rabobank.com
Brian Percival	DCM Leveraged Finance	+44 20 7809 3156	Brian.Percival@Rabobank.com

Disclaimer