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Pause for some time

Comment on FOMC Minutes

RaboResearch

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Summary

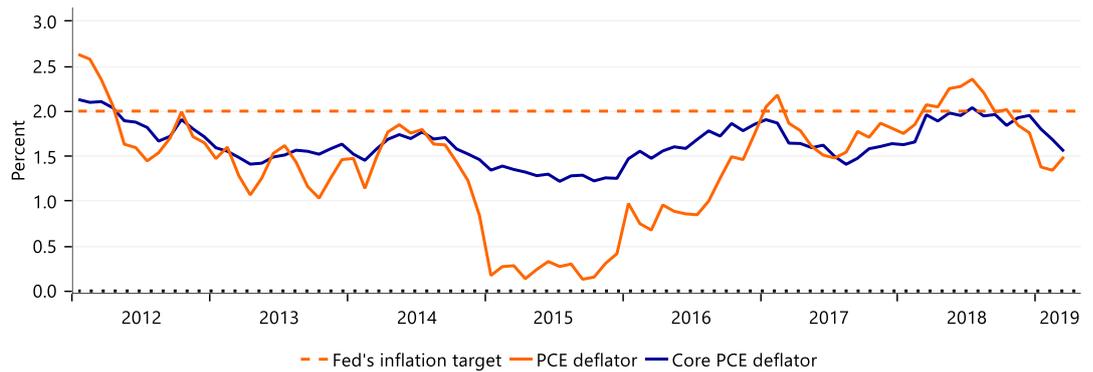
- The minutes of the FOMC meeting on April 30 and May 1 stated that a patient approach to determine future adjustments to the target range for the federal funds rate would likely remain appropriate for *some time*.
- Many participants viewed the recent dip in PCE inflation as likely to be transitory.
- 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

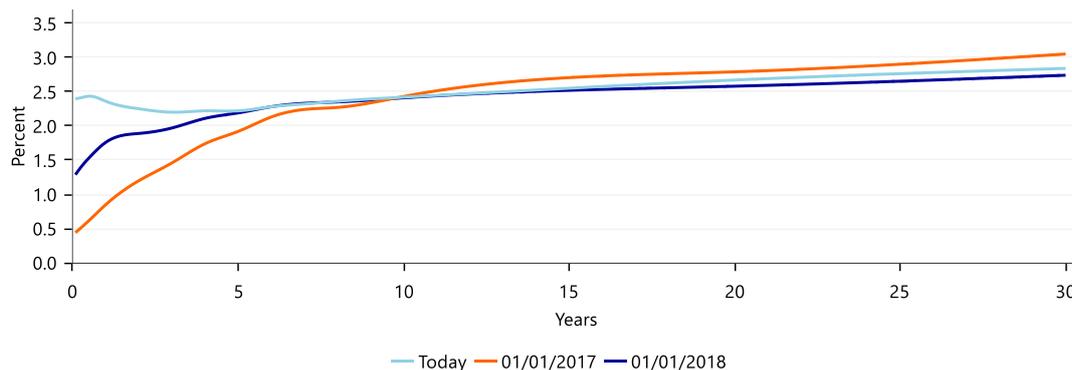
While the FOMC agrees on remaining on hold for some time, there is wide disagreement on the most likely direction of policy rates after the pause. A few participants think the Committee would likely need to tighten policy, but a few others observed that subdued inflation might indicate that resource 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](#).

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A summary of the methodology can be found on our website www.rabobank.com

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