



US Special



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The Fed's communication challenge

Financial Markets Research

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Marketing Communication

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- *The Fed has stressed that the hiking cycle will be gradual and cautious, but market expectations are undershooting the Fed's intended rate trajectory.*
- *An important observation is that even doves anticipate to hike twice this year. In fact, hawks and centrists think about more than two hikes.*
- *While Fed speakers have started pushing back against market expectations of barely one rate hike this year, it seems that the FOMC will have to make a concerted effort to realign market expectations with the dot plot.*

The March dot plot: two hikes blown away by global headwinds

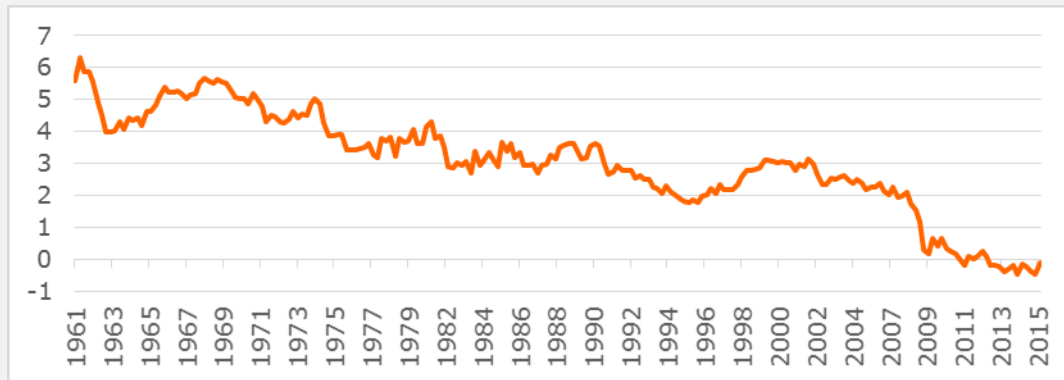
While futures markets are barely pricing in one rate hike this year, Fed speakers are still talking about at least two rate hikes before the end of the year, preferably starting in the middle of the year. In this special we take an in depth look at what the FOMC has exactly said in the past six weeks and what we should conclude from it. It all started with the FOMC meeting on March 15 and 16. According to the minutes, most participants saw foreign economic growth as likely to run at a somewhat slower pace than previously expected, a development that probably would further restrain growth in US exports and tend to damp overall demand. Accordingly, many participants expressed the view that a somewhat lower path for the federal funds rate than they had projected in December now seemed most likely to be appropriate. The dot plot published on March 16 as part of the projections of FOMC participants implied only 2 hikes of 25bps in 2016, in contrast with the 4 hikes in the December dot plot. The minutes showed that participants generally saw global economic and financial developments as continuing to pose risks to the outlook for economic activity and the labor market in the US. However, they failed to agree on a collective assessment of the balance of risks. As Yellen indicated at the press conference at the time, some saw them as balanced, some as to the downside. According to the minutes, several participants thought that the underlying factors abroad that led to a sharp, though temporary, deterioration in global financial conditions earlier this year had not been fully resolved and thus posed ongoing downside risks. However, several participants also noted the possibility that economic activity or labor market conditions could turn out to be stronger than anticipated. Despite the inability of the Committee to agree on a collective assessment of the balance of risks, the minutes stated that many participants expressed a view that the global economic and financial situation still posed appreciable downside risks to the domestic economic outlook. While the dot plot was released on March 16, the minutes were not published until April 4. However, the key message from the minutes was already delivered by Yellen in a speech about two weeks after the meeting.

Yellen's speech: gradual...

In her speech to the Economic Club of New York on March 29, Fed Chair **Janet Yellen** tried to 'explain why the Committee anticipates that only gradual increases in the federal funds rate are likely to be warranted in coming years.' In other words, why is the entire hiking cycle that the FOMC has in mind shallow to begin with? When the Fed announced its first hike in December 2015, it released a dot plot that implied 4 hikes in 2016 and 4 hikes in 2017. With 8 meetings per year, this can be realized by a hike of a quarter every other meeting. This is substantially slower than the previous hiking cycle in 2004-2006 when the Fed hiked by a quarter at each meeting between June 2004 and June 2006. Note that this was by no means an aggressive hiking cycle, as at no point did the Fed hike by two quarters in one meeting. In fact, the Fed talked about 'gradual or measured policy moves' during those years. Apparently, while 'gradual' meant 8

back in 2004-2006, it now means anything between 1 and 4. This implies that even if the FOMC were to revise the dot plot back to 4 hikes in 2016, it would still be considered 'gradual' by the Committee. In fact, for 2017 the dot plot is still showing 4 hikes. On page 5 and 6 of the speech Yellen explains the Fed's motives for a gradual hiking path in terms of the low current level of the equilibrium real interest rate and the expectation that it will rise as headwinds gradually fade. Note that we explained this in more detail in our September 2015 special *The Fed's hiking cycle: taking the slow track*, where we incorporated the changing equilibrium real interest rate in a modified Taylor rule to provide a theoretical framework to analyze the Fed's hiking cycle in a systematic manner.

Figure 1: The equilibrium real federal funds rate



Source: Laubach and Williams, 2015

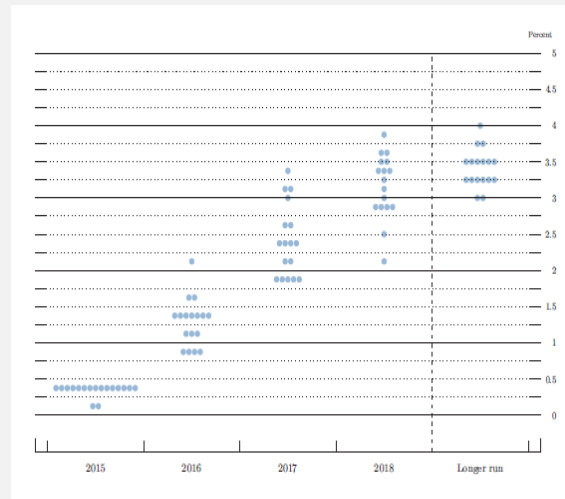
Not only is the current hiking cycle shallower than the previous version, the Fed is also stressing its data dependence and risk management approach. At every occasion, the Fed emphasizes that the hiking cycle is not on a preset course. As Yellen put it in her March 29 speech: 'not a plan set in stone that will be carried out regardless of economic developments.' She then said this proviso is especially pertinent in light of global economic and financial developments since December. So far, these developments have not materially altered the Committee's baseline outlook for economic activity and inflation over the medium term. Note that this explains why the dot plot still shows 4 hikes in 2017, the same as in December. However, the developments did lead to the removal of two hikes in 2016 from the dot plot between December and March. In Yellen's words: 'Reflecting global economic and financial developments since December, however, the pace of rate increases is now expected to be somewhat slower. For example, the median of FOMC participants' projections for the federal funds rate is now ... ½ percentage point below the December medians.' Yellen said that the revision of the FOMC projections in March demonstrate that the Fed is not on a preset course of tightening. Rather, the central bank is data dependent. She also pointed out that financial markets appear to recognize this and adjust their expectations of the fed funds rate path to incoming data, which leads to bond yield movements that serves as an 'automatic stabilizer' for the economy.

... and cautious

While she said that the baseline outlook has changed little on balance since December, Yellen spent 4 (out of 14) pages on the risks to the outlook for real economic activity and the inflation outlook. The two main risks to US economic activity are global economic growth – in particular in relation to China –, and commodity prices. However, she also pointed out that economic conditions could turn out to be more favorable than the Fed now expects. Therefore, she thinks the FOMC must watch carefully for signs that the economy may be evolving in unexpected ways, good or bad. Global growth and commodity prices also pose a risk to the inflation outlook, although in Yellen's view it would only delay the return of inflation to the Fed's 2% target, provided that inflation expectations remain anchored. However, she also indicated that the stability of longer-run inflation expectations cannot be taken for granted. While she thinks her baseline assumption of stable expectations is still justified, she admits that the decline in some indicators has heightened the risk that her judgment is wrong. On the other hand, she thinks it would not be all that surprising if inflation was to rise more quickly than expected over the next several years. For these reasons, Yellen said the FOMC must continue to monitor incoming wage and price data carefully.

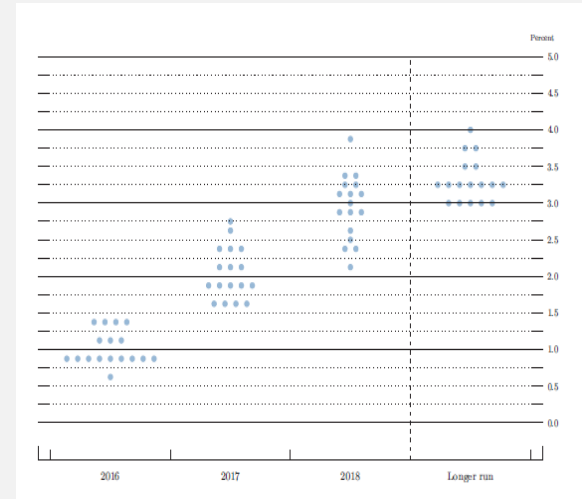
With respect to the monetary policy implications, Yellen said that 'Given the risks to the outlook, I consider it appropriate for the Committee to proceed cautiously in adjusting policy.' She thinks caution is especially warranted because at the current level of the federal funds rate, the Fed's ability to respond to economic shocks with rate policy is asymmetric. However, she also pointed out that the asymmetry should not be overstated, because the Fed would still have considerable scope to provide additional accommodation by forward guidance on the fed funds rate, quantitative easing or another Operation Twist. Note that she did not mention negative rates.

Figure 2: Dot plot in December 2015



Source: FOMC Summary of Economic Projections, December 2015

Figure 3: Dot plot in March 2016



Source: FOMC Summary of Economic Projections, March 2016

The timing of Yellen's speech, two weeks after the downward revision in the dot plot and after several FOMC speakers had started speculating about an April or June rate hike (which we discuss in detail in the following sections), left the impression that she was pushing back against those speakers and against the dot plot. However, Yellen's speech did not invalidate the March dot plot. In fact, she tried to explain the downward shift between December and March ('cautious') and why the FOMC was thinking of only 4 hikes in December to begin with ('gradual'). Had she given the speech a only few days after the March meeting, and before the other Fed speakers, her speech might have been interpreted as somewhat less dovish.

Whereas Yellen's speech was aimed at providing the Fed's philosophy behind the hiking cycle as a whole, and why the dot plot had been revised downward between December and March, other Fed speakers focused on the rate trajectory for 2016 and the timing of the next hike. We look into their speeches in detail in the following sections.

Hawks: ready to hike

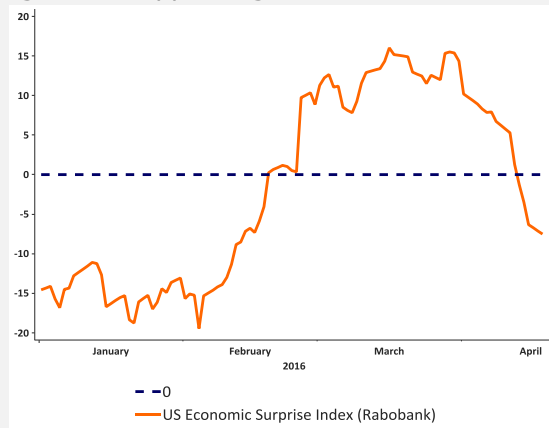
Obviously, the hawks were very vocal after the March meeting in putting forward their case for an April hike. In fact, according to the minutes, a couple of participants saw a hike as appropriate at the March meeting. We know that **Esther George** (Kansas City Fed) formally dissented at the March meeting because she preferred to hike. However, she was not alone in her view which was shared by **Jeffrey Lacker** (Richmond Fed). Although he has no voting rights in the FOMC – which determines the target for the federal funds rate – this year, as a regional Fed president he does have a vote on the discount rate. Shortly before the March meeting of the FOMC he voted for a discount rate hike, in conjunction with Esther George. This shows that at the hawkish end of the Committee's spectrum, participants are ready to hike at any meeting now. In fact, there was already a debate about an April hike at the March meeting. According to the minutes, several (i.e. doves) expressed the view that a cautious approach would be prudent and that a hike as soon as April would signal a sense of urgency they did not think appropriate. In contrast, some other participants (i.e. hawks) indicated that a hike in April might well be warranted if the incoming economic data remained consistent with their expectations.

While these two hawks wanted to hike in March, two other participants at the hawkish side of the FOMC spectrum may be less likely to support a hike at the April meeting. **James Bullard** (St. Louis Fed) – who is seen as hawkish and who is also a voter in the FOMC this year – has become a little bit more cautious in

recent weeks. On March 23 he still saw a case for an April hike. However, on April 6 he said that the apparent GDP growth slowdown in Q1 could weigh on the Fed's plan to hike rates. While he downplayed the Q1 slowdown and said that it is probably related to seasonal factors and hasn't fundamentally changed the US economic outlook, as inflation has picked up, he 'didn't want to prejudge' whether the Committee could act in April. **Loretta Mester** (Cleveland Fed) – a voter in the FOMC this year who is also seen as hawkish – has been less candid about her position. She said that the economy is evolving in a way that she thinks will likely mean that the Fed will be raising interest rates over the course of the year, although she could not tell anything about timing. She thought there was a reasonable case at the March meeting of the FOMC to wait for more data, but showed her hawkish colors by stating her dots are 'maybe a bit steeper than the median.'

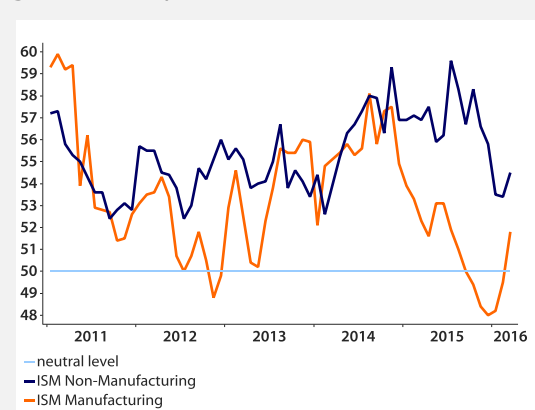
So although two hawks wanted to hike in March, they are not likely to get support for a hike this month from other hawkish participants. However, if the economy re-accelerates in Q2 the hawks will probably close ranks by the time of the June meeting.

Figure 4: Disappointing Q1 data



Source: Rabobank, Bloomberg

Figure 5: PMIs point to better Q2



Source: Macrobond

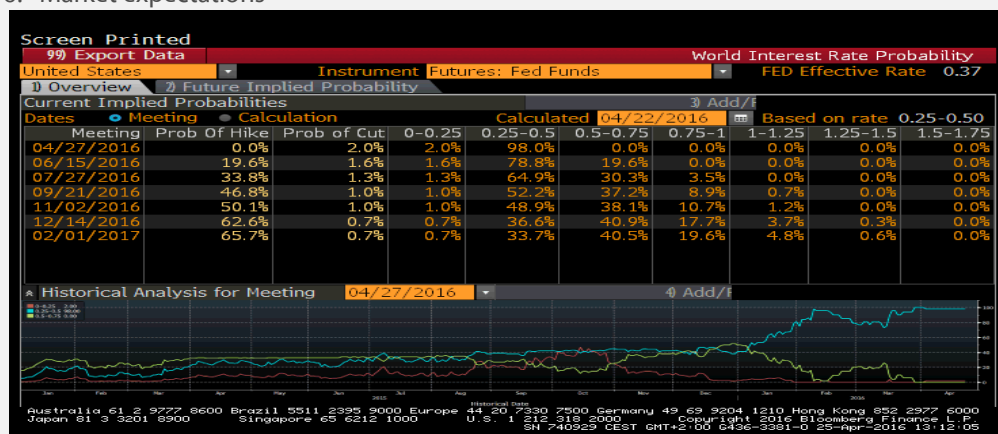
Centrists: 2-3 hikes, starting in June

The centrists in the FOMC are not likely to support an April rate hike either, but they do appear to be converging on June. What's more, they are thinking about 2-3 hikes before the end of the year. **Dennis Lockhart** (Atlanta Fed) – a non-voter in the FOMC this year – has had a change of mind in recent weeks about the timing of the next hike. On March 21, he still thought that 'there is sufficient momentum evidenced by the economic data to justify a further step at one of the coming meetings, possibly as early as the meeting scheduled for end of April.' However, on April 14 he said he will no longer push for a rate increase in April: 'consumer spending and business investment seem to be softening, and yes that gives me pause. Based on what I have seen, I am not going to be advocating a move in April – I have changed my mind.' Note that his own research staff is producing the well-known GDPNow, which put Q1 growth at 0.3% on April 13. While Lockhart has changed his mind about the timing of the next hike, he still sees 2-3 hikes in 2016 as possible. If growth bounces back quickly, Lockhart said he could still see multiple rate hikes as possible this year: 'If you look at the calendar, there are enough meetings remaining this year that if the data suggest it's the appropriate policy to have three moves. Two moves, three moves, both are possible at this stage. It's going to depend on how the economy evolves.' **Robert Kaplan** (the Dallas Fed president since September 8, 2015) – a non-voter in the FOMC this year – said the correct course now is to be patient and cautious on the timing of the next move. However, he said that doesn't mean standing still. He thinks that the FOMC will make another move in the not too distant future if GDP recovers in the way he expects. He does not support a hike in April 'in light of a puzzling weakening of economic growth', but he is 'certainly very open' to the possibility of a June move. **John Williams** (San Francisco Fed) – a non-voter in the FOMC this year – thinks that 2-3 rate rises in 2016 is reasonable (April 12). In recent interviews he said that the US economy remains on track for a gradual path of rate hikes and fears over the impact of a slowing global economy and bouts of financial volatility are overdone. He said: 'Let's not get sidelined

by the noise and distraction commentary can sometimes cause.' Earlier, on March 21, he said that 'April or June would definitely be potential times to have an increase in interest rates.' **Patrick Harker** (the Philadelphia Fed president since July 1, 2015) – a non-voter in the FOMC this year – is positioning himself as a dove for now: 'it might prove prudent to wait until the inflation data are stronger before we undertake a second rate hike. I believe as we move into the second half of the year with economic activity growing at trend or slightly above trend, the unemployment rate below its natural rate, and price pressures starting to assert themselves, policy can truly normalize.' However once he sees data moving in the right direction he is likely to support a decent pace of monetary tightening, as he also said 'it's possible the Fed could hike at least 3 times in 2016.' This suggests he is better seen as a data-dependent centrist.

While Lockhart, Kaplan, Williams and Harker do not vote in the FOMC this year, they do take part in the meetings and are able to influence the discussion. Moreover, they may also give us an idea about the centrists who are voting this year, such as Board members **Jerome Powell** and **Stanley Fischer** (Vice Chairman of the Board) who have been rather silent on this topic.

Figure 6: Market expectations



Source: Bloomberg

Hawkish comments by doves?

An important observation on the speculations about the timing of the next hike by various FOMC speakers is that not only hawks and centrists, but also doves anticipate to hike (at least) twice this year. This means that we cannot discard these speculations as the opinions of hawks, who are a minority in the Committee and therefore not to be taken seriously. In fact, explicit evidence that the FOMC is still thinking about two hikes comes from the doves. Most recently, on April 18, **Eric Rosengren** (Boston Fed) – who is known as a dove and who is also a voter in the FOMC this year – said that 'the very shallow path of rate increases implied by financial futures-market pricing would likely result in an overheating that necessitates the Fed eventually raising interest rates more quickly than is desirable, which could endanger the ongoing recovery and continued growth. I would prefer that the Federal Reserve not risk making the mistake of significantly overshooting the full employment level, resulting in the need to rapidly raise interest rates with potentially disruptive effects and an increased risk of a recession. While there have been significant headwinds from abroad, and market turbulence related to those headwinds, I view the US economy as fundamentally sound.' He acknowledged the Q1 slowdown, but expects GDP growth to pick up in Q2 and employers to continue adding jobs. He would prefer to push unemployment somewhat below 4.7% – his own estimate of full employment – in order to pull more people back into the labor force. 'Probing just how low the unemployment rate can fall before risking overheating in the economy can be beneficial for labor markets. That would go hand-in-hand with a gradual normalization of interest rates, but not with the extremely shallow rate path envisioned by investors. I do not see that the risks are so elevated, nor the outlook so pessimistic, as to justify the exceptionally shallow rate path currently reflected in financial futures markets.' Another strong piece of evidence is the opinion of **Charles Evans** (Chicago Fed). While he does not vote in the FOMC this year, he is seen as an überdove. In fact, he already preferred only two

hikes for 2016 back in December and thought that the dot plot at the time – which implied 4 hikes – was a bit too restrictive for what he thought was appropriate. On March 22 he made it clear that he is no longer struggling to convince colleagues with clearly more hawkish views. Both before and after Yellen's March 29 speech Evans called for two hikes this year: 'A very shallow funds rate path, such as the one envisioned by the median FOMC participant, is appropriate' he said on April 5. On March 31, he said that he sees one rate hike in the middle of the year, and one at year-end.

Meanwhile, **William Dudley** (NY Fed president and Vice Chairman of the FOMC) – who is seen as a dove – has been deliberately vague on monetary policy. The same is true for **Neel Kashkari** (the Minneapolis Fed president since January 1, 2016), who does not vote in the FOMC this year. Most members of the Board of Governors have remained silent or vague. This includes **Daniel Tarullo** – who is also seen as a dove – and the usually dovish **Lael Brainard**. However, as mentioned earlier we may get some idea of where they stand from other doves and centrists who did share their thoughts with the public. Note that all members of the Board and the NY Fed president always have a vote in the FOMC.

Conclusion

Now that we are heading for another weak Q1 GDP growth figure, support within the FOMC for an April hike seems to have diminished. However, even the doves still intend to hike twice this year. In fact, the centrists and hawks expect to hike at least twice, but possibly three to four times. In contrast, futures markets are now pricing in one hike this year, with a 50.1% probability that it will take place in November and a 62.6% probability that the FOMC will wait until December before hiking. For June only a 19.6% probability of a rate increase is priced in. Consequently, if the economy reaccelerates in Q2 the Fed may surprise the markets with a June hike. While popular thought has it that the Fed always undershoots its dots, the December 2015 hike proved that this is not always the case. Note that when the FOMC did not hike in September 2015, most in the markets – but not us – thought that the Fed was not going to hike until 2016. While Fed speakers have started pushing back against market expectations, it seems that it will require a more concerted effort from the FOMC to realign market expectations with the dots. A less dovish FOMC statement at this week's meeting would be a good start, but it will probably take a speech by Chair Janet Yellen herself to get the job done.

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