Caution to the trade winds

FOMC Post-Meeting Comment

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Take it to the next level

As widely expected, the FOMC decided to hike the target range for the federal funds rate by 25 bps. The IOER rate was raised by 25 bps as well. The reinvestment cap of the balance sheet normalization program rose to $50bn/month ($30bn for treasuries and $20bn for agency debt and MBS), according to schedule. While the median rate path in the FOMC projections for 2018-2020 remained unchanged, there is now a large majority for 4 hikes in 2018 versus 3 hikes: 12-4. In June, there was only a marginal majority of 8-7. So the FOMC expects one more hike this year, followed by 3 in 2019 and 1 in 2020. The forecasting horizon was extended to 2021, but the FOMC expects to remain on hold that year. The longer run federal funds rate was raised slightly to 3.0% from 2.9%, but that still means that the FOMC expects to be in restrictive territory by the end of 2019 and through 2020-2021.

The economic forecasts were tweaked slightly. Most notably GDP growth for 2018 was raised to 3.1% from 2.8%, justified by strong economic data in Q2 and Q3. GDP growth for 2019 was raised to 2.5% from 2.4%. The unemployment rate for 2018 was raised to 3.7% from 3.6%. PCE inflation for 2019 was reduced to 2.0% from 2.1%, but core inflation forecasts remained unchanged.

The extension of the projections to 2021 revealed that the FOMC expects GDP growth to slow down to its longer run rate of 1.8%, unemployment to rise after 2020 and (both headline and core) inflation to remain unchanged at 2.1%.

The FOMC removed the phrase that 'the stance of monetary policy remains accommodative' from its formal statement, but Powell said that this did not signal a rate path change. In fact, it shows that everything evolves in line with expectations. Powell said that it is still accommodative, but we do not need to stress that anymore. Also the FOMC does not know exactly where neutral is. Now that the target range is 2.00-2.25% we are apparently close enough the FOMC's estimate of the neutral level of 3.0% to drop the 'accommodative' phrase. Note that the median rate forecasts remained unchanged, so we agree that not too much should be made of this.

Change of call

While we stuck to our call of three hikes in 2018 as the US-China trade war escalated, it is clear that the FOMC remains sanguine about the impact on the US economy. In fact, the dot plot revealed that there is now a large majority in favor of 4 hikes. Powell said that they didn't see the effects of tariffs in the data yet and that the impact would be relatively small. We would like to add that with recent data indicating that domestic momentum remains strong – the Atlanta Fed's GDP nowcast for Q3 stood at 4.4% on September 19 – it would take time for the trade war to slow US economic growth down to a pace that would concern the FOMC. Therefore, we now change our call to four hikes this year, with the next hike in December.

Heading toward inversion (and worse?)

However, the Fed's (over)confidence may very well get us closer to the next recession. In fact, our calculations in 'When will the Fed invert the yield curve?' suggest that the FOMC projections –with core PCE inflation rising only modestly to 2.1% while raising the federal funds rate to 3.4%– are a blueprint for a monetary policy mistake. Before the end of 2019, by the fifth hike from now, the Fed would invert the yield curve, and that could signal a recession in early 2021.

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