

FED STATEMENT SHOWS INCREASED CONFIDENCE IN INFLATION

The Fed left its policy target rate unchanged at 1.25-1.5% at its January FOMC meeting, as expected, and updated its official post-meeting policy statement to reflect an upgraded assessment of inflation conditions.

Broader economic activity, gains in employment, household spending and business **fixed investment** were all characterized as “rising at a solid rate,” reflecting the bumper holiday shopping season, and robust 7% annualized growth in Q4 real business investment.

The Fed expressed more confidence in the inflation trajectory, changing its expectations for near-term inflation from likely to “remain somewhat below 2%” to **“expected to move up this year.”** It **acknowledged the recent increases in market-based measures of inflation compensation, noting that they “have increased in recent months but remain low” from just “remain low” in the prior statement.** The down-drift in inflation expectations in recent years posed a lingering concern for Fed officials, but the recent uptick reflects the diminishing downside risks to actual inflation.

The March 20-21 meeting will feature Jerome Powell’s first post-meeting press conference as Chair and an updated Summary of Economic Projections.

The March Summary of Economic Projections will be crucial. By then, Fed members would have had time to better digest the effects of tax reform and may upgrade their 2018 and 2019 real GDP growth projections further, and a sustained increase in energy prices and rolling off of idiosyncratic factors that held down inflation last year may lead them to bump up their inflation forecasts. Higher growth and inflation forecasts could be accompanied by an increase in the median Fed expectation for the number of 2018 rate hikes to four from three.

If incoming data in coming quarters reflect sustained increases in productivity, capital spending and stronger economic growth, the Fed could raise its estimate of the natural rate of interest, which would raise both the trajectory of its policy rate and the longer-**run median “dot.”**

Financial conditions have tightened slightly, but remain very supportive of economic growth. The economy is in strong-enough shape to handle modest gradual increases in long-run interest rates. A sharp rise, on the other hand, would jar sentiment and concern the Fed.

The Fed will undergo further changes in coming months – most notably at the head – and the voting committee as a whole will likely lean more hawkish, but as long as inflation remains near **the Fed’s 2% target, we expect it to continue to pursue a gradual** pace of policy normalization.

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