FED MINUTES: FED TO REVISE UP ECONOMIC PROJECTIONS, POLICY RATE PATH UNCERTAIN

The minutes to the January 30-31 FOMC meeting — the last chaired by Janet Yellen — support the post-meeting Policy Statement indicating that the Fed is more confident in its economic and inflation outlook. This points toward a rate hike in March and likely upward revisions to its projections at the March 20-21 meeting. The March 20-21 meeting will be the first with Jerome Powell as Chair; he will host his first post-meeting press conference.

With the exception of the financial market volatility, run-up in interest rates and tighter financial market conditions, key developments since the Fed’s December meeting — when it last published its economic projections — underpin the Fed’s more optimistic economic and inflation outlook and a more “hawkish” monetary policy stance: 1) wage gains accelerated in the January Employment Report; 2) the CPI picked up more than expected, confirming the Fed’s forecast of an upward drift in inflation toward its 2% target; 3) new tax legislation passed and confidence measures remained elevated; 4) the bipartisan Congressional budget agreement increases the caps on spending authorization in FY 2018 and FY 2019 to allow for more spending on defense and infrastructure; and 5) market-based measures of inflation compensation rose.

In December, the Fed revised up its real GDP growth forecast to 2.5% in 2018 and 2.1% in 2019, seemingly neglecting the positive momentum generated by deregulation and suggesting that the impact of tax reform would be modest and temporary. Looking forward, the Fed will revise up its forecasts for both 2018 and 2019. It may revise up its 2018 inflation forecast in light of higher energy prices in recent months. It is likely to keep its 2018-2019 unemployment rate forecasts at 3.9%, modestly below the current rate of 4.1% but significantly below the Fed’s estimate of the longer-run (natural) rate of 4.6%.

The following excerpt from the minutes captures the increased confidence among participants:

“A number of participants indicated that they had marked up their forecasts for economic growth in the near term relative to those made for the December meeting in light of the strength of recent data on economic activity in the United States and abroad, continued accommodative financial conditions, and information suggesting that the effects of recently enacted tax changes — while still uncertain — might be somewhat larger in the near term than previously thought. Several others suggested that the upside risks to the near-term outlook for economic activity may have increased. A majority of participants noted that a stronger outlook for economic growth raised the likelihood that further gradual policy firming would be appropriate.”

Regarding the FOMC’s estimates of the path of the Fed funds rate they deem appropriate in light of their economic forecasts — the so-called “dot plots” — the distribution of the FOMC members’ assessments for year-end 2018 will likely move up, but it will take a material change in the distribution to push the median of the number of 2018 rate hikes to four from three. However, a fourth rate increase would be entirely appropriate if the Fed increases its economic forecasts as we expect. Note that the Fed’s scheduled March 20-21 FOMC meeting occurs after the release of the February Employment Report, and more evidence of a sustained pick-up in wage growth would likely influence the Fed’s dots.
The minutes also noted that the Committee decided to preface the expectation of “gradual adjustments” in policy, in its official post-meeting statement, with “further” because of the strengthening of the near-term economic outlook and associated higher chance of increases in the Federal funds rate.

As has been the case in recent meetings, a few Fed participants expressed concern about the risk of an inflation overshoot and financial imbalances given the persistently low unemployment rate, while some argued that there was remaining labor market slack and preferred a very accommodative monetary policy stance.

The Committee discussed the possible evolution of the neutral federal funds rate, indicating that it could increase more than expected or just remain low. We believe that, if the economy and productivity continue to evolve as we expect and it becomes clear that more robust growth momentum can be sustained, Fed participants will eventually revise up its estimates of the long-run natural rate of interest, following years of downward revisions. We caution that while the natural rate of interest is an interesting concept, it is unobservable, and a problematic measure for gauging monetary policy, especially when the Fed is maintaining a bloated balance sheet.

Notably, the Committee indicated increased risks of financial market imbalances given elevated asset valuations and increased nonfinancial corporation debt, and that it will frequently reassess financial market risks and their implications for the economy “in light of the potential for changes in regulatory policies over time.”

We continue to expect that four increases in the Fed policy rate in 2018 are appropriate, and this would be consistent with the Fed continuing to pursue a gradual pace of policy normalization.

**Key Fed Events:**

- **Feb-23:** Release of the Semiannual Monetary Policy Report to Congress
- **Feb-28:** Chair Powell testifies to the House Financial Services Committee
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