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.*

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Mickey D. Levy
Chief Economist US, Americas and Asia
+1 646 445 4842
mickey.levy@berenberg-us.com

Roiana Reid
Economist
+1 646 445 4865
roiana.reid@berenberg-us.com

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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Contacts: BCM

www.berenberg.com
e-mail US: firstname.lastname@berenberg-us.com

BERENBERG
CAPITAL MARKETS

JOH. BERENBERG, GOSSLER & CO. KG

Internet www.berenberg.com

E-mail: firstname.lastname@berenberg.com

EQUITY RESEARCH

AEROSPACE & DEFENCE
Andrew Gollan +44 20 3207 7891
Charlotte Keyworth +44 20 3753 3013
Ross Law +44 20 3465 2692

AUTOMOTIVES
Adam Hull +44 20 3465 2749
Paul Kratz +44 20 3465 2678

BANKS
Adam Barrass +44 20 3207 7923
James Chappell +44 20 3207 7844
Andrew Lowe +44 20 3465 2743
Andreas Markou (EM) +44 20 3753 3022
Eoin Mullany +44 20 3207 7854
Peter Richardson +44 20 3465 2681
Jonathan Sharpe +44 20 3753 3031

BEVERAGES
Javier Gonzalez Lastra +44 20 3465 2719
Batuhan Karabekir (EM) +44 20 3465 2631
Adam Mizrahi +44 20 3465 2653

BUSINESS SERVICES, LEISURE & TRANSPORT
Roberta Ciaccia +44 20 3207 7805
Najet El Kassir +44 20 3207 7836
Stuart Gordon +44 20 3207 7858
Josh Puddle +44 20 3207 7881
Julia Winarso +44 20 3465 2627

CAPITAL GOODS
Sebastian Kuenne +44 20 3207 7856
Philippe Lorrain +44 20 3207 7823
Rizk Maidi +44 20 3207 7806
Horace Tam +44 20 3465 2726
Simon Toennessen +44 20 3207 7819

CHEMICALS
Sebastian Bray +44 20 3753 3011
Andrew Heap +44 20 3207 7918

CONSTRUCTION
Lush Mahendrarajah +44 20 3207 7896
Robert Muir +44 20 3207 7860
Olivia Peters +44 20 3465 2646

ENERGY
Yuriy Kukhtanych (EM) +44 20 3465 2675

FOOD MANUFACTURING AND H&PC
Rosie Edwards +44 20 3207 7880
Yordana Mavrodieva +44 20 3207 7817
Fintan Ryan +44 20 3465 2748
James Targett +44 20 3207 7873

FOOD RETAIL
Batuhan Karabekir (EM) +44 20 3465 2631

GENERAL MID CAP - EU
Gunnar Cohrs +44 20 3207 7894
Martin Comtesse +44 20 3207 7878
Flavien Hias +44 20 3465 2693
Aymeric Lang +44 20 3753 3037
Anna Patrice +44 20 3207 7863
Benjamin Pfannes-Varrow +44 20 3465 2620
Simona Sarli +44 20 3207 7834
Julia Scheufler +44 20 3753 3016

GENERAL MID CAP - UK
Robert Chantry +44 20 3207 7861
Sam England +44 20 3465 2687
Ned Hammond +44 20 3753 3017
Benjamin May +44 20 3465 2667
Owen Shirley +44 20 3465 2731

GENERAL RETAIL
Conrad Bartos +44 20 3753 3053
Michelle Wilson +44 20 3465 2663

HEALTHCARE
Scott Bardo +44 20 3207 7869
Jakob Berry +44 20 3465 2724
Alistair Campbell +44 20 3207 7876
Graham Doyle +44 20 3465 2634
Klara Fernandes +44 20 3465 2718
Tom Jones +44 20 3207 7877
Joseph Lockey +44 20 3465 2730
Louise Pearson +44 20 3465 2747
Laura Sutcliffe +44 20 3465 2669

INSURANCE
Trevor Moss +44 20 3207 7893
Emanuele Musio +44 20 3207 7916
Iain Pearce +44 20 3465 2665
Sami Taipalus +44 20 3207 7866

LUXURY GOODS
Zuzanna Pusz +44 20 3207 7812

MEDIA
Robert Berg +44 20 3465 2680
Laura Janssens +44 20 3465 2639
Alastair Reid +44 20 3207 7841
Sarah Simon +44 20 3207 7830

METALS & MINING
Alessandro Abate +44 20 3753 3029
Fawzi Hanano +44 20 3207 7910
Yuriy Vlasov +44 20 3465 2674

REAL ESTATE
Kai Klose +44 20 3207 7888
Tina Munda +44 20 3465 2716

TECHNOLOGY
Jean Beaubois +44 20 3207 7835
Georgios Kertsos +44 20 3465 2715
Gal Munda +44 20 3465 2746
Tammy Qiu +44 20 3465 2673

TELECOMMUNICATIONS
Ondrej Cabejsek (EM) +44 20 3753 3071
Usman Ghazi +44 20 3207 7824
Siyi He +44 20 3465 2697
Laura Janssens +44 20 3465 2639
Paul Marsch +44 20 3207 7857
Michael Summerville +44 20 3207 7914

THEMATIC RESEARCH
Nick Anderson +44 20 3207 7838
Asad Farid +44 20 3207 7932

TOBACCO
Jonathan Leinster +44 20 3465 2645

UTILITIES
Robin Abrams +44 20 3465 2635
Andrew Fisher +44 20 3207 7937
Lawson Steele +44 20 3207 7887

ECONOMICS

Florian Hense +44 20 3207 7859
Carsten Hesse (EM) +44 20 3753 3001
Kallum Pickering +44 20 3465 2672
Holger Schmieding +44 20 3207 7889

EQUITY SALES

SPECIALIST SALES

AEROSPACE & DEFENCE
Bruna Zugliani +44 20 3207 7818
AUTOMOTIVE & THEMATICS
Chris Armstrong +44 20 3207 7809
BANKS & DIVERSIFIED FINANCIALS
Iro Papadopoulou +44 20 3207 7924
BUSINESS SERVICES, LEISURE & TRANSPORT
Rebecca Langley +44 20 3207 7930
CONSTRUCTION,CHEMICALS, METALS & MINING
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Rupert Trotter +44 20 3207 7815
CONSUMER DISCRETIONARY
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HEALTHCARE
Frazer Hall +44 20 3207 7875
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SALES

BENELUX
Miel Bakker +44 20 3207 7808
Martin de Laet +44 20 3207 7804
Alexander Wace +44 20 3465 2670

GERMANY
Michael Brauburger +49 69 91 30 90 741
Nina Buechs +49 69 91 30 90 735
André Grosskurth +49 69 91 30 90 734

GERMANY (cont'd)
Florian Peter +49 69 91 30 90 740
Joerg Wenzel +49 69 91 30 90 743

UK
Alexandra Clément +44 20 3753 3018
Fabian De Smet +44 20 3207 7810
Karl Hancock +44 20 3207 7803
Sean Heath +44 20 3465 2742
David Hogg +44 20 3465 2628
Peter Kaineder +44 20 3753 3062
James Matthews +44 20 3207 7807
David Mortlock +44 20 3207 7850
Eleni Papoula +44 20 3465 2741
Bhavin Patel +44 20 3207 7926
Richard Payman +44 20 3207 7825
Joanna Sanders +44 20 3207 7925
Mark Sheridan +44 20 3207 7802
George Smibert +44 20 3207 7911
Anita Surana +44 20 3207 7855
Paul Walker +44 20 3465 2632

FRANCE
Thibault Bourgeat +33 1 5844 9505
Alexandre Chevassus +33 1 5844 9512
Dalila Farigoule +33 1 5844 9510
Clémence Peyraud +33 1 5844 9521
Benjamin Voisin +33 1 5844 9507

SCANDINAVIA
Frederik Angel +44 20 3753 3055
Marco Weiss +49 40 350 60 719

SWITZERLAND, AUSTRIA & ITALY
Andrea Ferrari +41 44 283 2020
Carsten Kinder +41 44 283 2024
Gianni Lavigna +41 44 283 2038
Jamie Nettleton +41 44 283 2026
Benjamin Stillfried +41 44 283 2033

CRM

Louise Hughes +44 20 3753 3066
Jessica Jarmyn +44 20 3465 2696
Edwina Lucas +44 20 3207 7908
Greg Swallow +44 20 3207 7833

CORPORATE ACCESS

Lindsay Arnold +44 20 3207 7821
Jennie Jiricny +44 20 3207 7886
Stella Siggins +44 20 3465 2630

EVENTS

Laura Hawes +44 20 3753 3008
Suzy Khan +44 20 3207 7915
Charlotte Kilby +44 20 3207 7832
Natalie Meech +44 20 3207 7831
Ellen Parker +44 20 3465 2684
Sarah Weyman +44 20 3207 7801

SALES TRADING

HAMBURG
Tim Storm +49 40 350 60 415

PARIS
Vincent Klein +33 1 58 44 95 09
Antonio Scuotto +33 1 58 44 95 03

LONDON
Mike Berry +44 20 3465 2755
Stewart Cook +44 20 3465 2752
Mark Edwards +44 20 3753 3004
Tristan Hedley +44 20 3753 3006
Peter King +44 20 3753 3139
Christoph Kleinasser +44 20 3753 3063
Chris McKeand +44 20 3207 7938
Simon Messman +44 20 3465 2754
AJ Pulleyn +44 20 3465 2756
Michael Schumacher +44 20 3753 3006
Paul Somers +44 20 3465 2753

EQUITY TRADING

HAMBURG
David Hohn +49 40 350 60 761
Gregor Labahn +49 40 350 60 571
Lennart Pleus +49 40 350 60 596
Marvin Schweden +49 40 350 60 576
Linus Weidner +49 40 350 60 798
Philipp Wiechmann +49 40 350 60 346
Christoffer Winter +49 40 350 60 559

LONDON
Edward Burlison-Rush +44 20 3753 3055
Richard Kenny +44 20 3753 3083

ELECTRONIC TRADING

Daniel Eichhorn +49 40 350 60 391
Matthias Führer +49 40 350 60 597

BERENBERG CAPITAL MARKETS LLC

Member FINRA & SIPC

E-mail: firstname.lastname@berenberg-us.com

EQUITY SALES

SALES

Kelleigh Faldi +1 617 292 8288
Isabella Fantini +1 646 445 4861
Shawna Giust +1 646 445 7216
Rich Harb +1 617 292 8228
Zubin Hubner +1 646 445 5572
Jessica London +1 646 445 7218
Ryan McDonnell +1 646 445 7214

SALES (cont'd)

Emily Mouret +1 415 802 2525
Peter Nichols +1 646 445 7204
Kieran O'Sullivan +1 617 292 8292

CRM

Laura Cooper +1 646 445 7201

CORPORATE ACCESS

Olivia Lee +1 646 445 7212
Tiffany Smith +1 646 445 4874

EVENTS

Patricia Ehrhart +1 646 445 4863

SALES TRADING

Christopher Kanian +1 646 445 5576
Lars Schwartau +1 646 445 5571
Brett Smith +1 646 445 4873
Bob Spillane +1 646 445 5574

ECONOMICS

Mickey Levy +1 646 445 4842
Roiana Reid +1 646 445 4865