FED RAISES RATES AND SIGNALS GRADUAL REMOVAL OF MONETARY ACCOMMODATION

The Fed’s Federal Open Market Committee decided at its September 25-26 meeting to:

- Increase by 25 basis points its Federal funds rate target to 2-2.25%, as expected, and 12 of 16 voting FOMC members signaled that it would be appropriate to raise rates again in December
- Remove from its Policy Statement the phrase that “the stance of monetary policy remains accommodative”, signaling that the Fed views that its recent and future expected rate increases will remove monetary accommodation
- Raise its real GDP forecasts for the second half of 2018 and modestly for 2019, and project that it will be appropriate for the Fed to raise its funds rate above the median FOMC member estimate of the neutral rate between 2019 and 2021.
- Increase the cap on the amount of maturing Treasury securities and MBS allowed to roll off the Fed's balance sheet each month to $30 billion and $20 billion, respectively, starting in October; (this widely expected change is likely the last increase in caps based on the Fed’s Addendum to the Policy Normalization Principles and Plans from June 14, 2017).

The policy actions taken at the meeting were unanimously approved by FOMC voting members.

Regarding the economy: The Fed maintained its assessments of economic activity as “rising at a strong rate” and the labor market as continuing to strengthen, and that the risks to the economic outlook “appear roughly balanced.” It revised its 2018 real GDP forecast to 3.1% from 2.8%, previously, reflecting the stronger-than-expected H1 growth and healthy momentum into H2 (Berenberg forecast: 3.2%). The median estimate for real GDP growth in 2019 was revised up slightly in 2019 to 2.5% from 2.4% (acknowledging that momentum this year will be sustained a bit more than the Fed had earlier estimated), was unchanged at 2% in 2020, and in the first published forecast for 2021 growth is expected to be 1.8%, in line with its estimate of long-run real GDP growth.

We expect that the Fed will eventually increase its estimate of long-run real GDP growth. Growth has significantly exceeded the Fed’s estimate of potential growth. In response to the stronger-than-expected growth, the Fed has revised up its forecasts for 2018 and modestly so for 2019, but it has maintained its 1.8% longer-run growth estimates. That the Fed has not changed its estimates of potential growth in response to the shift toward easing regulations in the non-financial and financial sectors or the Tax Cuts and Jobs Act is striking...it implies that the Fed perceives that these shifts will have only a transitory economic impact. We note that during this expansion, virtually all of the Fed's downward revision in potential growth reflects weaker projections of productivity; in fact, the sustained increases in labor force participation for the prime working-age cohort has lifted labor force growth above the Fed's estimates (“Rising US prime working-age labor participation”, September 20, 2018).

Regarding unemployment: The Fed acknowledged that labor markets remain strong. The expected unemployment rate in Q4-18 was revised up slightly to 3.7% from 3.6%, given the recent stabilization of the unemployment rate around 3.9%. The Fed left the unemployment rate forecast unchanged at 3.5% in 2019 and 2020, but expects it to rise to 3.7% in 2021. The median FOMC estimate of the natural rate of unemployment was left unchanged at 4.5%, which is surprising given that the unemployment rate has been under 4.5% for 1.5 years and wage growth has only picked up modestly.

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Our research on trends in labor force participation rates and the employment-to-population ratios suggest that the supply of labor is more elastic than is generally presumed by standard measures of full employment, and that there is still room for healthy employment gains and economic growth without generating troublesome bottlenecks. We expect the Fed to acknowledge this and significantly lower its estimate of the natural rate of unemployment—so-called full employment—close to 4%.

Remember, the Fed’s economic forecasting track record is mediocre and tends to lag actual trends—and it has a history of revising its forecasts of potential growth and the natural rate of unemployment (“The Fed’s Economic Forecasts, Uncertainties, and Monetary Policy”, March 12, 2018). Such revisions realign the Fed’s forecast to reality and make the Fed’s models look more accurate than they really are. Fed Chairman Powell emphasized the uncertainties of forecasting the longer-run variables in his recent Jackson Hole presentation (see “Fed Chair Powell stresses gradualism due to uncertainty with estimates of key longer-run variables”, August 24, 2018).

The Fed’s forecasts of the appropriate path of the Fed funds rate: The median FOMC member forecast for the appropriate total number of rate increases this year was unchanged at four, but now 12 participants now view it appropriate to raise rates again in December, up from seven at its June meeting. That would put the funds rate target at 2.25%-2.5% by year-end, decidedly above inflation for the first time since 2008. The median Fed member still expects three policy rate increases in 2019 (which would raise the target policy rate to 3.0%-3.25%) and one in 2020 (to 3.25%-3.5%). We note, however, that this Fed projection of the appropriate funds rate is based on a significant slowdown in economic growth toward the Fed’s current estimate of potential growth. The Fed does not project any changes to its policy rate in 2021, but expects the stance of its policy to be slightly restrictive—i.e., above its longer-run rate, which it nudged up to 3.0% from 2.9%.

The Fed’s removal of the phrase that “the stance of monetary policy remains accommodative” is notable. The Fed has been discussing revising/removing this phrase as the Federal funds rate approaches its estimate of the neutral rate, and this change in the Fed’s characterization of monetary policy in its official Policy Statement suggests—as Chairman Powell described in his post-meeting press conference—that the Fed is comfortable that its recent rate increases and those planned in the next year will move monetary policy toward neutral, with the acknowledgment that the natural rate of interest is an unobservable variable and forecasting it involves lots of uncertainty.

Note that even though the Fed has been normalizing its policy for the last two years, financial conditions remain very easy and supportive for economic growth.

Regarding inflation: PCE inflation forecasts for year-end 2018 and 2020 were unchanged at 2.1%, revised down slightly to 2% in 2019 and projected to be 2.1% in 2021, reflecting the Fed’s comfort with inflation remaining slightly above its 2% longer-run target for a prolonged period, and also the Fed’s expectation that inflation will not move materially above 2%.
## Figure 1: FOMC's Summary of Economic Projections at its September meeting

<table>
<thead>
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<th>Variable</th>
<th>Median</th>
<th>Central tendency</th>
<th>Range</th>
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<td>Unemployment rate</td>
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<td>3.5</td>
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<td>June projection</td>
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<td>3.5</td>
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<td>n.a.</td>
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<tr>
<td>PCE inflation</td>
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<td>2.1</td>
<td>2.1</td>
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<td>June projection</td>
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<td>2.0</td>
<td>2.1</td>
<td>2.0</td>
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<tr>
<td>Core PCE inflation</td>
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<td>appropriate policy path</td>
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<td>Federal funds rate</td>
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<td>3.1</td>
<td>3.4</td>
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<td>June projection</td>
<td>2.4</td>
<td>3.1</td>
<td>3.4</td>
<td>n.a.</td>
</tr>
</tbody>
</table>

Source: Federal Reserve

## Figure 2: FOMC Participants' Assessments of Appropriate Monetary Policy Rate

![Chart of FOMC participants' assessments of appropriate monetary policy rate](image)

Source: Federal Reserve
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Contacts

BERENBERG CAPITAL MARKETS LLC

EQUITY RESEARCH
Andrew Fung +1 646 949 9207
Donald McLane +1 646 949 9239
Adam Mizrachi +1 646 949 9022
Gal Munda +1 646 949 9201
Patrick Trudchlo +1 646 949 9207

EQUITY SALES
Enrico DeMatt +1 646 949 9230
Kelley Gable +1 617 292 8288
Ted Paccetti +1 646 949 9221
Shawn Gust +1 646 949 7286
Rich Herb +1 617 292 8228
Zubin Haines +1 646 949 9202
Michael Lesser +1 646 949 9221
Jessica Lonken +1 646 949 9202
Anthony Musco +1 617 292 8282
Ryan McDonnell +1 646 963 9274
Emily Mount +1 435 922 2525
Peter Nichols +1 646 949 9331
Kieran O’Malley +1 617 292 8202
Rodrig Ortega +1 646 949 9295
Ramamurthy Siva +1 435 802 3023
Matt Wadell +1 646 949 9220

CRM
Laia A. Gonzales +1 646 949 9210
Monika Kwok +1 646 949 9221

CORPORATE ACCESS
Olivia Lee +1 646 949 9207
Tiffany Smith +1 646 949 9208

EVENTS
Laura Hawkes +1 646 949 9209

SALES TRADING
Ronald Centa +1 646 949 9194
Michael Hough +1 646 949 9166
Christopher Karian +1 646 949 9103
Lori Schwerin +1 646 949 9901
Brent Smith +1 646 949 9105
Bob Spillane +1 646 949 9102
Jordan White +1 646 949 9222

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