FED MINUTES: GRADUAL RATE INCREASES LIKELY, BUT EVOLUTION OF DATA IS KEY

The minutes to the September 25-26 FOMC meeting echoed recent comments from Fed officials about solid economic momentum, sustainable 2% inflation, robust labor market performance, the intention to continue with gradual policy rate increases (next in December), and that a policy rate slightly above neutral will be appropriate if economic and inflation conditions evolve in line with projections.

FOMC members were upbeat about the economy and judged the risks to the outlook as balanced. Upside risks included 1) elevated consumer confidence; 2) supportive financial conditions; and 3) larger-than-expected boost from fiscal policy. Downside risks cited were 1) trade policy uncertainties; 2) divergence between U.S. and foreign growth resulting in a stronger U.S. dollar; and 3) spread of the financial stresses from a few EMs to other countries and financial markets.

The minutes suggested that there was little discussion about the FOMC median estimate of 1.8% longer-run growth - a couple of participants noted that recent strong GDP growth may reflect “increases in the growth rate of the economy’s productive capacity,” while a number of participants noted that the stimulus from fiscal policy changes will probably fade in coming years. At the September meeting, the Fed increased its estimate of 2018 real GDP growth (Q4/Q4) to 3.1% from 2.8% and nudged its forecast for 2019 up to 2.5%. Thus, the Fed is forecasting a fairly significant slowdown in economic growth, based in part on its assessment that a large part of the current momentum is driven by the tax cuts and will fade.

FOMC members were generally confident about sustainable 2% inflation, and some noted inflationary pressures stemming from strong demand or tariffs. However, a couple of members were concerned that longer-run inflation expectations were below levels consistent with its 2% target because actual inflation had run below 2% for so long and preferred to see a modest increase in inflation expectations.

We note that while inflationary pressures remain well-contained, an unanticipated rise in inflation uncomfortably above the Fed’s longer-run 2% target is a risk. The recent trend has been favorable: core consumer, producer, and important price inflation have moderated after the run-up early this year and inflation expectations have remained well-anchored. If inflation and inflationary expectations remain near 2%, the Fed will continue to normalize rates at a gradual pace, but any signs of undesired increases would present a challenge.

Fed members gave a few reasons for removing the phrase that “the stance of monetary policy remains accommodative” from its Official Post-Meeting Policy Statement in September:

1) “the characterization of the stance of policy as "accommodative" had provided useful forward guidance in the early stages of the policy normalization process”
2) “this characterization was no longer providing meaningful information in light of uncertainty surrounding the level of the neutral policy rate”
3) “it was appropriate to remove the characterization of the stance from the Committee's statement before the target range for the federal funds rate moved closer to the range of estimates of the neutral policy rate”
4) “the Committee's earlier communications had helped prepare the public for this change”

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We believe these and other comments do not suggest that the Fed perceives that its monetary policy is no longer accommodative, rather that the Fed funds rate is closer to what it perceives neutral policy to be and that presently the Fed is comfortable with the path toward policy normalization. Chair Powell and other Fed officials have stated clearly that there is a wide band of uncertainty about the natural rate of interest and that the Fed is not relying on any point estimate in its conduct of policy.

With these caveats in mind, the median FOMC member estimates that the longer-run appropriate Fed funds rate consistent with the median FOMC projection of real GDP growth (1.8%) and its 2% inflation target is 3%. The Fed currently projects that it will be appropriate to raise its policy rate above that level, to 3.1% by the end of 2019 and to 3.4% at the end of 2020 and 2021. In the minutes, comments by most participants conform with this median forecast:

- “a number judged that it would be necessary to temporarily raise the federal funds rate above their assessments of its longer-run level”
- “a few participants expected that policy would need to become modestly restrictive for a time”
- “a couple of participants indicated that they would not favor adopting a restrictive policy stance in the absence of clear signs of an overheating economy and rising inflation.”

But the Fed’s acknowledgement of the uncertainties surrounding these estimates suggest strongly that while the Fed is pleased with its current path of interest rate and balance sheet normalization, its future policy decisions remain data-dependent on trends in the real economy, inflation, indicators of inflationary expectations and financial conditions.

While most members perceived that financial conditions were easy, some expressed concerns about continued increases in leveraged loans and their looser terms and standards as possible risks to financial stability. The discussion of financial markets in these minutes is stale given the equity market sell-off that occurred two weeks after the September meeting. However, in light of the sound momentum in the economy, the stock market correction is unlikely to derail the Fed's plan to raise rates 25 basis points at its December meeting. However, a significant tightening or loosening of financial conditions would influence Fed’s perspective of the appropriate path of interest rates.

The minutes again included discussions about the yield curve and its implications for the economy: 1) an inversion could signal increased chance of recession; 2) the yield curve is probably a less reliable indicator of recession now given low term premiums; and 3) recent increases in long-run interest rates may reduce the change of inversion in the near term.

Newly appointed Vice Chairman Richard Clarida is now the Chair of the Subcommittee on Communications. As the Fed approaches a trickier stage of its policy normalization, its transparency and communications are of paramount importance. The move to hold a press conference following every FOMC meeting (compared to quarterly now) is one step in the right direction, in our view.
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