Economics

Macro news

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CAPITAL MARKETS

FED TO HIKE BUT NOT CHANGE FORECASTS AT DECEMBER MEETING

The Fed will raise its target Fed funds rate at this week's FOMC meeting, but the Fed is not expected to materially alter either its economic forecasts or its forecasts of the trajectory of the appropriate Fed funds rate (the "dots") in its quarterly forecasting updates, even though the Fed clearly senses an economic regime shift under President-elect Trump.

While Fed participants know that there is a high probability of fiscal and economic policy changes and are very aware that markets (the rise in the stock market, higher bond yields and stronger US dollar) are forecasting stronger economic growth, the FOMC participants will choose not to alter their economic forecasts at this point because no new economic policies have been offered for legislation. Note that when the FOMC participants develop their economic forecasts, they are not given any guidance about what to assume about fiscal policies during the forecast period.

The widely anticipated 25 basis point rise in the Fed funds rate will lift the target policy rate to a range of 0.5%-0.75%, still a full percentage point below inflation. This will leave monetary policy highly accommodative at a time when the Fed has already virtually achieved its dual mandate and President-elect Trump's transition team is developing economic policies that aim to boost economic growth.

In its September 2016 forecasts, the Fed projected real GDP growing 2.0% in both 2017 and 2018 and 1.8% in the longer run. Inflation was forecasted to drift up to 2.0% by 2018 Q4 and then stay there for the longer run. The median FOMC participants estimated that the appropriate Fed funds rate should be 1.1% at year-end 2017, 1.9% in 2018 and 2.9% in the longer run.

Had Clinton been elected President, the Fed likely would have lowered its projections of the appropriate Fed funds rate (the "dots"), particularly its estimate of the longer-run Fed funds rate. However, with expectations of new fiscal and economic policies and uncertainties surrounding what the legislation will involve and the economic impacts, FOMC participants are likely to choose to keep its Fed funds forecasts unchanged.

The Trump election signals a clear shift in expectations about the future trajectory of the Fed funds rate, both on the part of the Fed and by financial markets. In recent years, the Fed funds futures and Eurodollar futures have been decidedly below the FOMC's median dots and in sequential meetings the Fed lowered its dots toward the markets' flatter trajectory. In an abrupt turnaround since the election, markets have dramatically raised expectations of future Fed rate increases in anticipation of economic policy reforms and stronger growth, as shown in the charts.

The Fed will lag the markets and be slow to raise its estimated dots, but it is very likely that they have stopped lowering them. This change reflects not just the Fed's current uncertainty about economic policies and economic and inflation outcomes, but also the Fed's estimates of the natural rate of interest (so-called r*), that real rate that is consistent with the economy growing along its potential rate with inflation tracking the Fed's 2% longer-run target. Remember, r* is simply an estimate and in reality nobody knows what it is precisely. But if economic policies are enacted that are perceived to lift economic growth, real interest rates would rise, and these would be reflected in the Fed's projections.

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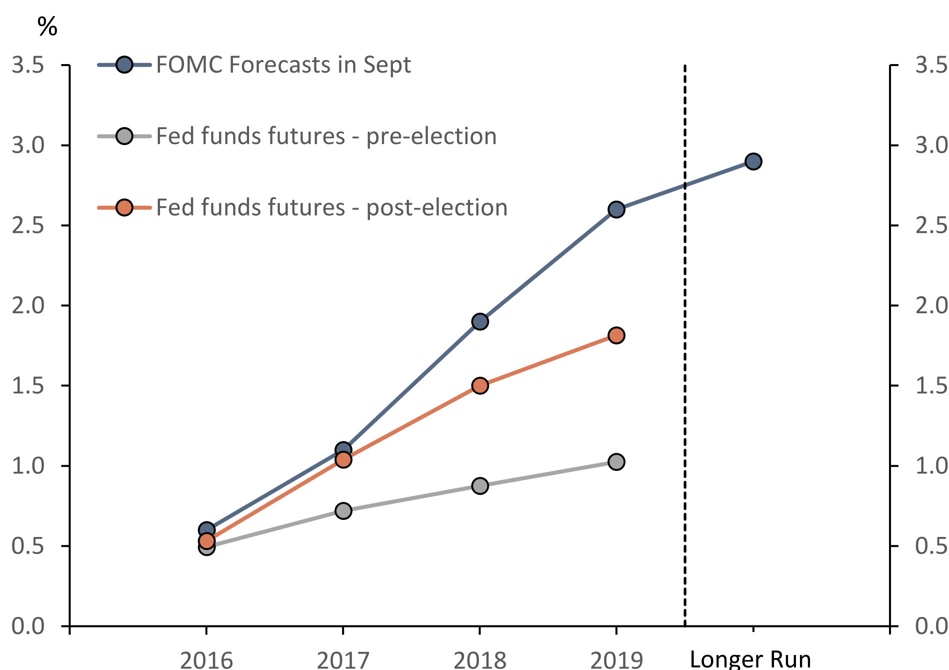
Even when **President Trump's campaign proposals are developed into legislative proposals in early 2017 and enacted by Congress later in the year, the Fed's updated economic forecasts reflecting policy changes will show only a modest rise in** GDP growth in 2018-2019 of several tenths, far below what will be projected by either the Trump Administration (and presumably the Congressional Budget Office). This is because the Fed's FRB-US macro model estimates the impact of fiscal policy changes primarily by taking the change in the budget deficit and applying some multiplier to it--while tending to understate the impact of fiscal and economic reforms that do not involve static changes in the budget deficits. Nor does the Fed's model tend to reflect the impacts of regulatory changes.

As a consequence, the Fed will have the tendency to underestimate the economic impact of either a deficit-neutral corporate tax reform that lowers the real costs of capital and improves efficiencies and the allocation of capital, or improved economic performance stemming from regulatory reform.

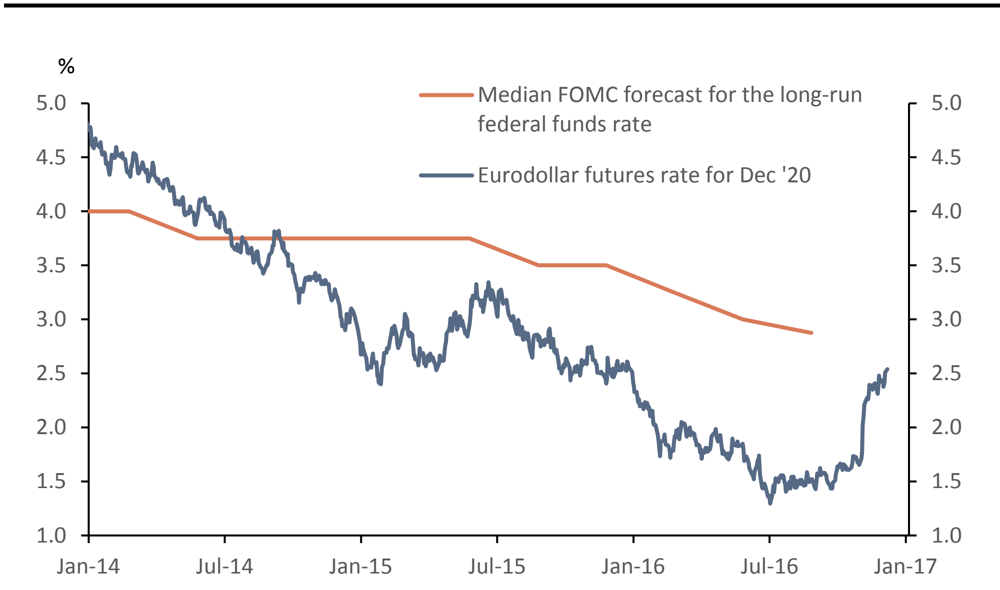
Reflecting these observations, the Fed's economic forecasts are likely to lag behind the market forecasts. If pro-growth fiscal reforms are enacted, this may set the **stage for the Fed's monetary policy falling behind the curve.**

Chart 1: Market and Fed Expectations for the Fed Funds Rate*



**Note: Fed funds expectations are for end of year, except for 2019 which is for October 2019. Fed funds futures data are as of December 9th 2016. Source: Federal Reserve Board, Bloomberg and Berenberg Capital Markets*

Chart 2: Market and Fed Expectations for Interest Rates in the Long-Run



Source: Federal Reserve Board, Bloomberg and Berenberg Capital Markets

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