US Federal Reserve: Monetary policy enters a new, more active, phase

Economic Research Note

16 March 2017

After a very slow start to its monetary policy normalisation process, with only one rate hike in both 2015 and 2016, **the US Federal Reserve (the Fed) today entered a new, more active phase for monetary policy.**

Through the combination of good economic data and Fed rhetoric, the market gave the Fed an irresistible opportunity to lift interest rates again today, raising the Fed Fund target rate by a further 25bp to a new 0.75%-1.0% range.

In detailing the policy decision, however, **the Fed statement was little changed from recent months, with no change to the Fed's own expectations for the future path of monetary policy, ie. the 'dots' for 2017 remained at three rate hikes in total – two more to come this year.**

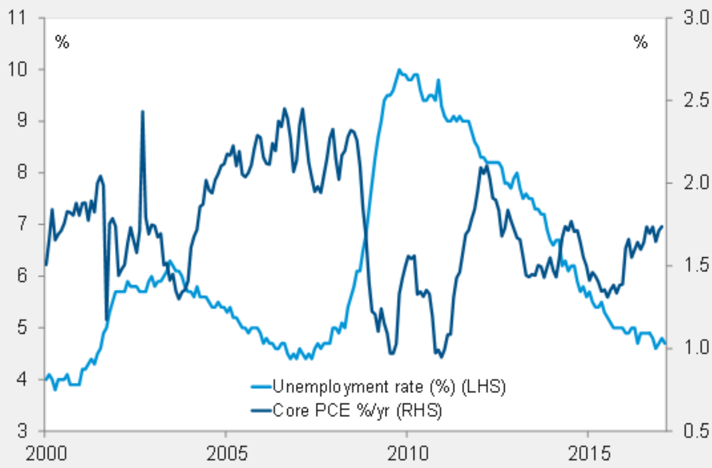
The market has taken the statement and the unchanged 2017 'dots' to be a little more dovish than expected.

The Fed's statement noted that recent data had shown "that the labor market has continued to strengthen and that economic activity has continued to expand at a moderate pace. Household spending has continued to rise moderately while business fixed investment appears to have firmed somewhat."

On inflation the Fed stated that "Inflation has increased in recent quarters, moving close to the Committee's 2 percent longer-run objective; excluding energy and food prices, inflation was little changed and continued to run somewhat below 2 percent."

All of this commentary remains consistent with a better outlook for the US economy in 2017 and is consistent with the Fed achieving its dual-mandate of full-employment and price stability – see chart below. As a result, the Fed also repeated their 'gradual' commitment, stating that "the Committee expects that, with gradual adjustments in the stance of monetary policy, economic activity will expand at a moderate pace, labor market conditions will strengthen somewhat further, and inflation will stabilize around 2 percent over the medium term." The Fed also repeated the view that "near-term risks to the economic outlook appear roughly balanced" and that "the Committee continues to closely monitor inflation indicators and global economic and financial developments.

US Unemployment rate and underlying inflation



Source: Bloomberg. Unemployment rate data to February 2017, Core PCE to January 2017.

The (new) path forward:

Ahead of today's Fed meeting we altered our view to now expect three rate hikes over 2017 – and this remains the case (with the two more rate hikes most likely to be in June and December, at this stage). Indeed as noted, **we see the move by the Fed to raise interest rates so early in 2017 as signalling a new, more active, phase of monetary policy.**

This new phase represents a desire to have monetary policy return to a more normal setting in an environment where the Fed is much more confident of achieving its dual mandate. In addition, while it remains very unclear what policies President Trump will be able to implement, **it does seem likely that a significant fiscal policy easing is in prospect.**

Until recently, we had expected that the Fed would only raise interest rates twice in 2017, but we expected three rate hikes in both 2018 and 2019. Given our views above, we now expect some pull-forward of the Fed's rate hike cycle, with **three rate hikes in both 2017 and 2018 and two in 2019 – with the peak in interest rates still at 2.5%-2.75%.**

Importantly, **we continue to expect that by 2020 the Fed will be *cutting* interest rates again.** This is based on the view that the significant easing of fiscal policy that President Trump is planning is more likely to create a boom-bust scenario for the US economy, than a permanent shift higher in the potential growth rate of the economy.

As a result, we expect a stronger US economy in 2018-2019 (when the bulk of the fiscal stimulus will impact) that will see inflation, interest rates, bond yields and the US dollar move higher. This collective tightening of financial conditions is expected to lead to a slowing in the pace of economic growth from around 2020, and see the Fed attempt to offset some of this impact via monetary policy easing.

The Fed's 'dots':

Our expectation for the outlook for monetary policy, for 2017-2019 at least, is consistent with the Fed's own forecasts, ie. the 'dots'.

For 2017, the Fed's 'dots' (1.4% at year-end) continues to point to three rate hikes over the course of the year (ie. the same estimate and that made in December 2016). That would put the Fed Funds target rate at 1.25%-1.5% by the end of this year.

The estimate of the end 2018 'dot' is unchanged at 2.1% (2.0%-2.25%). This implies that the Fed continues to expect to be able to tighten policy three times in 2018.

For 2019 the Fed's 'dots' now have the Fed Funds rate at 3.0% as at the end of 2019, up only marginally from the previous estimate of 2.9% (2.75%-3.0%) in December. This implies that the Fed sees a further three rate hikes through 2019.

While the Fed does not (yet) forecast the Fed Funds rate in 2020, our own forecast is for two rate *cuts* in that year. Importantly, the long-term 'dot' from the Fed is unchanged at 3.0%. The following table provides details.

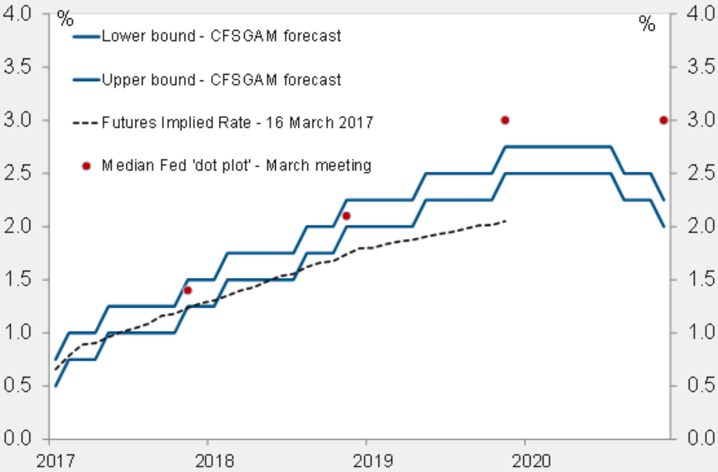
Fed Rate median 'dot' forecast

Year end	2016	2017	2018	2019	Long-term
March 2017	**N/A**	**1.4%**	**2.1%**	**3.0%**	**3.0%**
Dec 2016	0.6%	1.4%	2.1%	2.9%	3.0%
Sept 2016	0.6%	1.1%	1.9%	2.6%	2.9%
June 2016	0.9%	1.6%	2.4%	N/A	3.0%
March 2016	0.9%	1.9%	3.0%	N/A	3.3%
Dec 2015	1.4%	2.4%	3.3%	N/A	3.5%
Dec 2014	2.50%	3.63%	N/A	N/A	3.75%

Source: US Federal Reserve, 15 March 2017.

The chart below shows our expected path for the Fed Funds rate, as detailed above, plotted against the Fed's own 'dot' forecasts and what is now priced into markets.

Projected path of US short rates and market expectation



Source: Bloomberg. Data to 15 March 2017. Lower and upper bound is the target range for the Fed Funds rate. Economic and Market Research team forecast, as at 2 February 2017.

The Fed's Balance Sheet:

Another development for the Fed that is expected to receive more attention in the coming months is the size of the Fed's balance sheet. At just over $US4.5trn, the Fed's balance sheet is substantially larger than the pre-GFC level at just under $US1trn.

Today the Fed chose to simply repeat its previous statement that "the Committee is maintaining its existing policy of reinvesting principal payments from its holdings of agency debt and agency mortgage-backed securities in agency mortgage-backed securities and of rolling over maturing Treasury securities at auction, and it anticipates doing so until normalization of the level of the federal funds rate is well under way. This policy, by keeping the Committee's holdings of longer-term securities at sizable levels, should help maintain accommodative financial conditions."

While Fed Chair Janet Yellen has made it clear that she has no intention of using the balance sheet as an active tool of monetary policy – **there is also a clear expectation that the balance sheet should be allowed to shrink over time.** This is expected to occur by ceasing the practice of reinvesting both coupon payments and maturities of the $US2.4trn Treasury securities and $US1.8trn mortgage-backed securities currently on the balance sheet.

Indeed, **the Press Conference Fed Chair Yellen stated for the first time that Balance Sheet adjustment was discussed at the FOMC, however that no decisions had yet been reached and further discussion was expected.** One complicating factor is that Janet Yellen's term as Fed Chair expires in February 2018 and there is wide-spread expectations that she will not be reappointed. As a result, it is likely that much of the coming balance sheet adjustment will be done by the next Fed Chair – whoever that may be.

Nevertheless, **we expect Chair Yellen to outline the balance sheet reduction strategy well before her departure, perhaps at the September 2017 Fed meeting, and to begin the process of balance sheet normalisation before she leaves her post.**

Revised Economic forecasts:

As per the usual quarterly pattern, the Fed has updated its economic forecasts. As detailed in the table below, **the changes to the economic projections are very minor.**

On the labour market, the unemployment rate forecast is unchanged at 4.5% for 2017, 2018 and 2019. The longer-run unemployment rate forecast has been lowered marginally to 4.7% from 4.8%.

For 2017 the Fed's GDP growth forecast is unchanged at 2.1%. The year-end 2018 GDP growth forecast is up marginally to 2.1% (from 2.0%), with the 2019 forecast unchanged at 1.9%. The longer-run GDP forecast is also unchanged at 1.8%.

The underlying inflation (Core PCE) forecast for 2017 has increased marginally to 1.9% (from 1.8% previously). The forecasts for 2018 and 2019 are unchanged at 2.0% – as shown below.

Economic median forecasts – March 2017 and December 2016 FOMC Forecasts (% change)	2016	2017	2018	2019	Longer run
Real GDP	**N/A**	**2.1**	**2.1**	**1.9**	**1.8**
(Dec 16 f/c)	1.9	2.1	2.0	1.9	1.8
Unemployment rate	**N/A**	**4.5**	**4.5**	**4.5**	**4.7**
(Dec 16 f/c)	4.7	4.5	4.5	4.5	4.8
Core PCE inflation	**N/A**	**1.9**	**2.0**	**2.0**	**2.0**
(Dec 16 f/c)	1.7	1.8	2.0	2.0	2.0

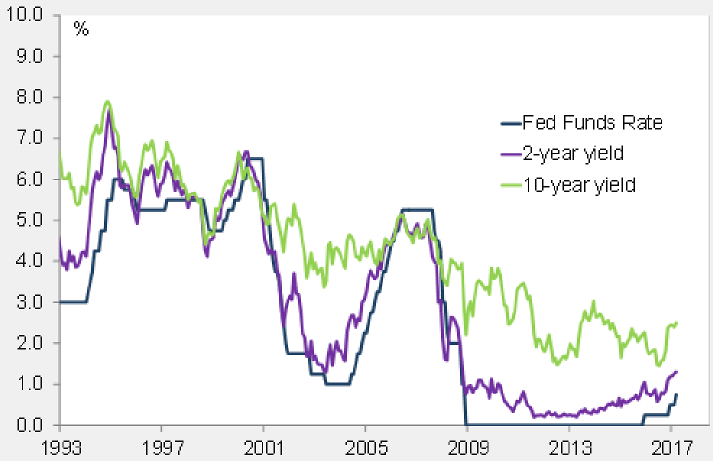
Source: FOMC, as at 15 March 2017.

Financial markets:

Although the Fed's policy decision to lift interest rates today was widely expected, the Fed's statement and unchanged 'dot' forecasts were seen as more dovish-than-expected. The US equity markets have rallied on the day. The Dow is up around 0.5%, with the S&P 500 up 0.9% on the day.

US 10 year government bond yields are down around 10bp at 2.50%, while 2 year yields down 7bp at 1.305% - slightly flattening the yield curve.

US Fed Funds Rate, 2-year and 10-year bond yields



Source: Bloomberg. Data to 15 March 2017.

The US dollar (USD) has weakened on the day, pushed lower by the Fed's unchanged 'dots' for 2017 and the Fed Chair's insistence that monetary policy adjustments will continue to be gradual. The DXY index is at 100.52 from 101.70 previously. EUR/USD is at 1.0735 from 1.0605, with the EUR also supported by early results from the Dutch election. USD/JPY is 113.30 from 114.75 previously, while the AUD is at $US0.7715 from $US0.7560.

USD Index

Source: Bloomberg. Data to 15 March 2017.

Some comments on the US Debt Ceiling:

While not related to the Fed, it is worth making some comments on the US debt ceiling. In November 2015 the US Congress 'suspended' the previous debt ceiling of $US18.1trn until 15 March 2017. As of 16 March 2017, the debt ceiling will be set to the current actual level of debt outstanding of $US19.9trn.

Theoretically, that means that the Treasury will have no legal authority to borrow more money from today onwards, ie. the total amount of debt outstanding will be the same as the new limit of $US19.9trn.

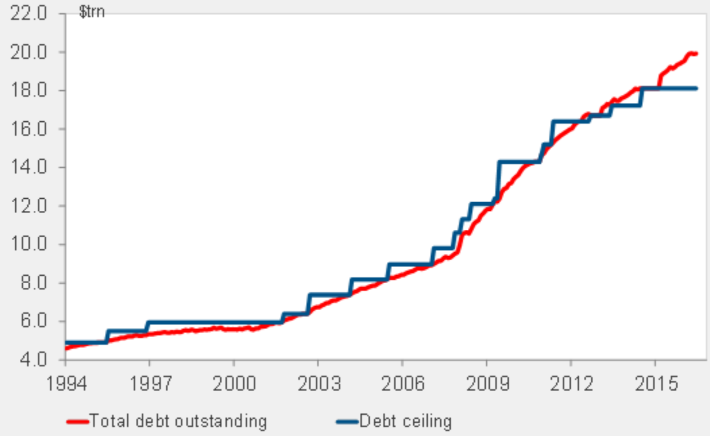
In practice, the Treasury can employ a number of 'extraordinary measures' to keep under the new debt ceiling for a number of months. The Congressional Budget Office (CBO)[1] has stated that **"the Treasury will probably run out of cash sometime in the fall of 2017."**

That means that by around September-October-November 2017 Congress will have to do one of three things: raise the debt ceiling (again); abolish the debt ceiling; or suspend the debt ceiling for another time period.

Of these three options, **the most likely outcome (at this stage) is a further suspension of the debt ceiling** – continuing the pattern seen in recent years, where the actual level of debt runs above the 'suspended' ceiling, before the ceiling is raised again.

Importantly, **it remains very unlikely that the Treasury will be put in the position they found themselves in late 2013 when government had to be 'shut down' to avoid the Treasury having to cease payment of its obligations.**

US Government debt: Actual and ceiling



Source: Bloomberg. Data to 28 February 2017.

Comments/questions welcome,

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