Colonial First State
Global Asset Management

15 June 2017

US Federal Reserve: Rates higher again as the Fed prepares the balance sheet

As widely expected by us and the market (with a 98% probability priced in), the US Federal Reserve (the Fed) has **raised the Fed Funds target rate by a further 25bp to a 1.0%-1.25% range**. It is probably worth noting that this decision was not unanimous, with one member (Neel Kashkari) voting to hold monetary policy steady.

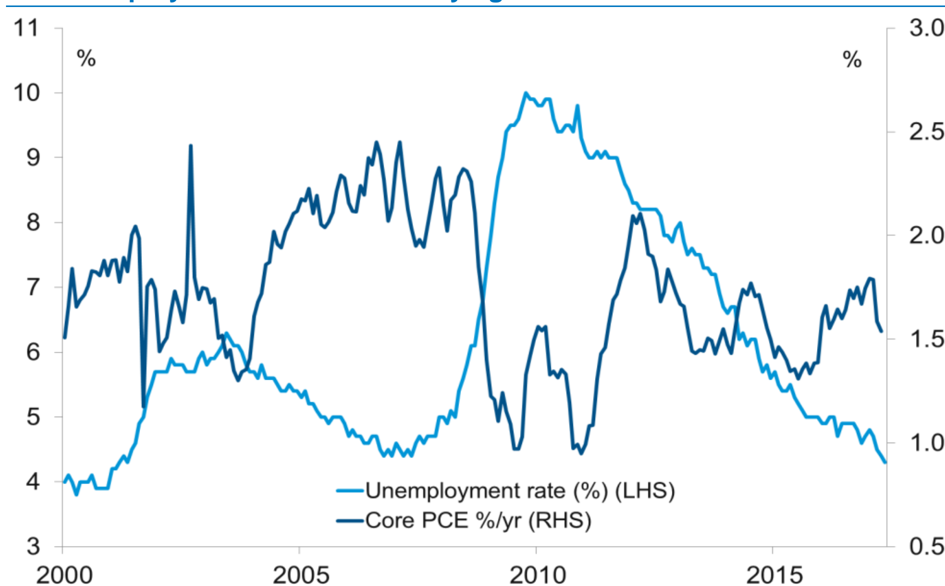
In detailing the policy decision the Fed made a number of changes to its policy statement, but largely kept its policy outlook unchanged – **with a third rate hike still expected in 2017 and three further moves in 2018 still in the plans**. In announcing the policy move the Fed stated that "the labor market has continued to strengthen and… economic activity has been rising moderately so far this year. Job gains have moderated but have been solid, on average, since the beginning of the year, and the unemployment rate has declined. Household spending has picked up in recent months, and business fixed investment has continued to expand."

On inflation the Fed acknowledged the recent lower CPI readings (including the May report, which saw a CPI reading of -0.1%/mth and a fall in the annual rate to 1.9% from 2.2%), stating that "on a 12-month basis, inflation has declined recently and, like the measure excluding food and energy prices, is running somewhat below 2%. Market-based measures of inflation compensation remain low; survey-based measures of longer-term inflation expectations are little changed, on balance."

In addition, the Fed stated that "inflation on a 12-month basis is expected to remain somewhat below 2% in the near term but to stabilize around the Committee's 2% objective over the medium term. Near term risks to the economic outlook appear roughly balanced, but the Committee is monitoring inflation developments closely."

All this commentary remains 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 continues to expect that, with gradual adjustments in the stance of monetary policy, economic activity will expand at a moderate pace and labor market conditions will strengthen somewhat further."

US Unemployment rate and Underlying inflation



Source: Bloomberg. Unemployment rate data to May 2017, Core PCE to April 2017

The path forward:

Ahead of today's Fed meeting we held the view that there would be three rate hikes over 2017 – and this remains the case. **So one more rate hike should be expected this year.**

The recent low inflation prints could, however, push this final rate hike out from September to December 2017 – with data over coming months to be critical in determining the exact timing.

However, as detailed below, **we also expect the Fed to begin the process of reducing its $US4.5trn balance sheet before the end of 2017**. The Fed has today updated its "Policy Normalisation Principles and Plans", stating that before the end of this year the Fed will begin implementing a 'cap' on the monthly reinvestment of $US6bn per month for its holding of Treasury bonds and $US4bn per month for its mortgage-backed securities holdings.

In terms of rate hikes, for the outyears our forecast remains for three more rate hikes in 2018 and two rate hikes in 2019 – taking the Fed Funds target rate to a peak of 2.5%-2.75%.

However, part of this rate hike cycle was based on the view that President Trump would implement a fiscal stimulus package in either late 2017 or early 2018 that boosted economic growth and inflation through 2018-2019. This package was expected to contain some combination of corporate and income tax cuts, increased infrastructure spending and reduced regulation.

While there remains time for this package to take shape, the progress so far has been disappointing and with the Administration seemingly distracted by other events – **the expected fiscal stimulus package is now likely to happen later, rather than soon.**

As a result, the three rate hike view for 2018 looks like being at risk – so that the peak in the Fed Funds target rate could be lower than our current 2.5%-2.75% forecast.

Our forecasts also incorporate two rate *cuts* from the Fed in 2020, on the view that the tightening in financial conditions we see from the Fed, higher bond yields and a stronger USD would see an economic slowdown in 2020 and the need for some policy easing.

Naturally enough, the less fiscal stimulus the US economy receives over 2018-2019 and the lower the peak in the Fed Funds rate by 2019 – the less likely rate cuts in 2020 become. **We will keep these forecasts under review as the Trump policy agenda continues to unfold.**

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 'dot' remains at 1.4% at year-end and continues to point to three rate hikes over the course of the year. That would put the Fed Funds target rate at 1.25%-1.5% by the end of this year, ie. one more 25bp rate hike expected 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 2.9% as at the end of 2019, down only marginally from the previous estimate of 3.0% (2.75%-3.0%) in March. 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.

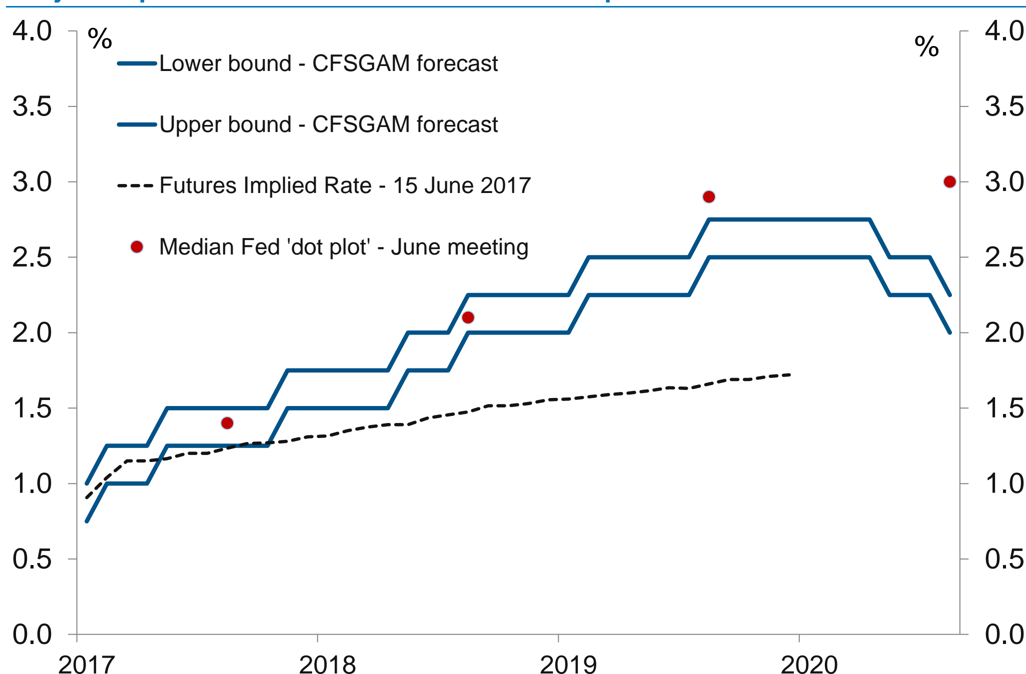
Fed Rate median 'dot' forecast

As at year end:	2016	2017	2018	2019	Long-term
June 2017	**N/A**	**1.4%**	**2.1%**	**2.9%**	**3.0%**
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 June 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 June 2017. Lower and upper bound is the target range for the Fed Funds rate. CFSGAM Economic and Market Research team forecast, as at 15 June 2017.

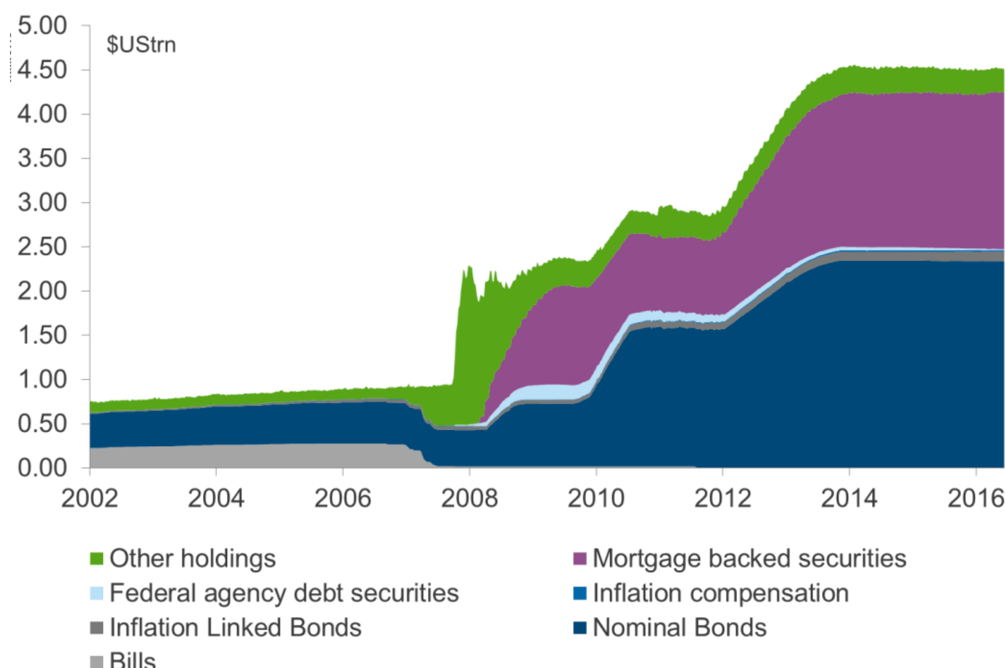
The Fed's Balance Sheet:

Prior to the Global Financial Crisis (GFC) the Fed's balance sheet was just under $US1trn. Now the balance sheet stands at approx. $US4.5trn – ballooned by the Fed's purchases of Treasury bonds and Mortgage-Backed Securities (MBS) through its asset-purchase program (ie. quantitative easing).

Previously, Fed Chair Janet Yellen had made it clear that she had no intention of using the balance sheet as an active tool of monetary policy – but **there was also a clear expectation that the balance sheet should be allowed to shrink over time**.

Following the publication of the Minutes of the March FOMC meeting, it was confirmed that the Fed discussed its balance sheet policy at the March meeting and planned to get the normalisation of the balance sheet underway before the end of 2017.

The US Federal Reserve Balance Sheet



Source: US Federal Reserve, Bloomberg data to 31 May 2017

Today the Fed has released what it calls an "Addendum to the Policy Normalisation Principles and Plans." This 'addendum' states that:

- "The Committee intends to gradually reduce the Federal Reserve's securities holdings by decreasing its reinvestment of the principal payments it receives from securities held in the System Open Market Account. Specifically, such payments will be reinvested only to the extent that they exceed gradually rising caps."
  - "For payments of principal that the Federal Reserve receives from maturing Treasury securities, **the Committee anticipates that the cap will be $US6bn per month initially and will increase in steps of $US6bn at three-month intervals over 12 months until it reaches $US30bn per month."**
  - "For payments of principal that the Federal Reserve receives from its holdings of agency debt and mortgage-backed securities, **the Committee anticipates that the cap will be $US4bn per month initially and will increase in steps of $US4bn at three-month intervals over 12 months until it reaches $US20bn per month."**
  - "The Committee also anticipates that the caps will remain in place once they reach their respective maximums so that the Federal Reserve's securities holdings will continue to decline in a gradual and predictable manner until the Committee judges that the Federal Reserve is holding no more securities than necessary to implement monetary policy efficiently and effectively."

Interestingly, in addition to these technical details, the Fed felt compelled to also state that "the Committee affirms that changing the target range for the federal funds rate is its primary means of adjusting the stance of monetary policy. However, **the Committee would be prepared to resume reinvestment of principal payments received on securities held by the Federal Reserve if a material deterioration in the economic outlook were to warrant a sizable reduction in the Committee's target for the federal funds rate.** Moreover, the Committee would be prepared to use its full range of tools, including altering the size and composition of its balance sheet, if future economic conditions were to warrant a more accommodative monetary policy than can be achieved solely by reducing the federal funds rate."

Fed Chair Yellen has repeated the view that this ‘cap’ process of reducing the balance sheet will get underway before the end of this year. She also expressed the view/hope that the balance sheet reduction process would be ‘like watching paint dry’.

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 forecasts have been lowered across the outyears by between 0.1%pts-0.3%pts.

For 2017 the Fed’s GDP growth forecast has been bumped up to 2.2% from 2.1% previously. The year-end 2018 GDP growth forecast is unchanged at 2.1%, 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 been lowered to 1.7% (from 1.9% previously). The forecasts for 2018 and 2019 are unchanged at 2.0% – as shown below.

Economic median forecasts – June and March 2017 FOMC Forecasts (% change)	2017	2018	2019	Longer run
Real GDP	**2.2**	**2.1**	**1.9**	**1.8**
(March 17 f/c)	2.1	2.1	1.9	1.8
Unemployment rate	**4.3**	**4.2**	**4.2**	**4.6**
(March 17 f/c)	4.5	4.5	4.5	4.7
Core PCE inflation	**1.7**	**2.0**	**2.0**	**2.0**
(March 17 f/c)	1.9	2.0	2.0	2.0

Source: FOMC, as at 15 June 2017

Financial markets:

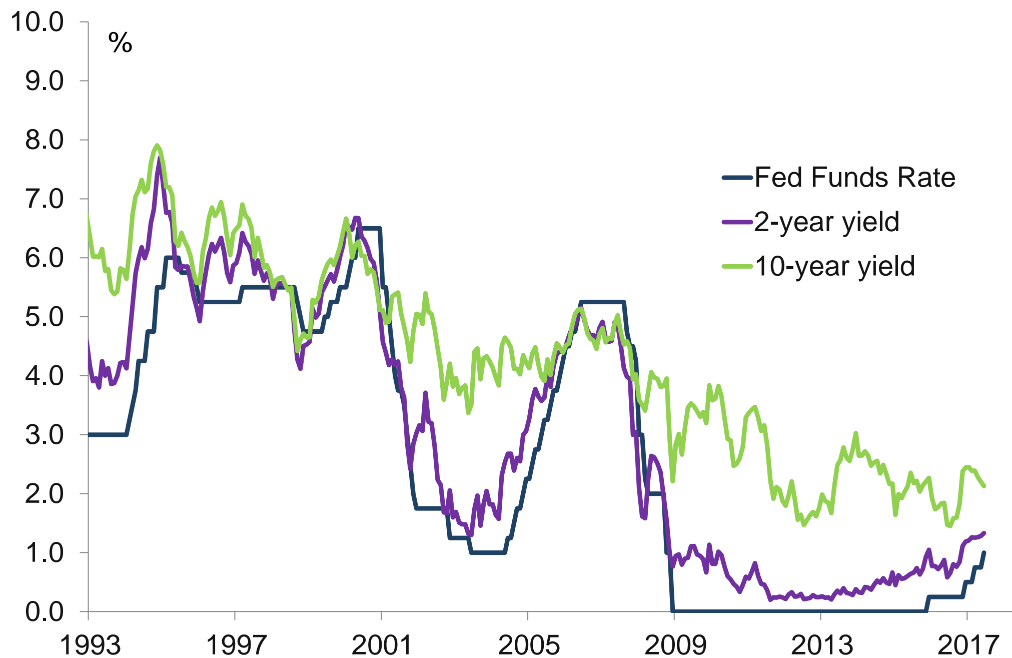
As noted, the Fed’s rate hike today was widely expected by the market. Perhaps the decision to keep the policy outlook unchanged, ie. no change in the ‘dots’, could have been interpreted as slightly ‘hawkish’ given the recent run of lower-than-expected inflation readings. The decision to detail the plans for balance sheet adjustment could also be seen in this light.

However, the key driver for US financial markets today was the weaker-than-expected May CPI report. Headline CPI was -0.1%/mth in May, with the annual rate down to 1.9% from 2.2%. The core CPI rose just 0.1%/mth, with the annual rate down to 1.7% from 1.9% previously.

The US equity markets were mixed on the day. The Dow is up around 0.2%, with the S&P 500 down -0.1% on the day.

US 10 year government bond yields are down around 9bp at 2.13%, while 2 year yields are down 3bp at 1.33% - flattening the yield curve.

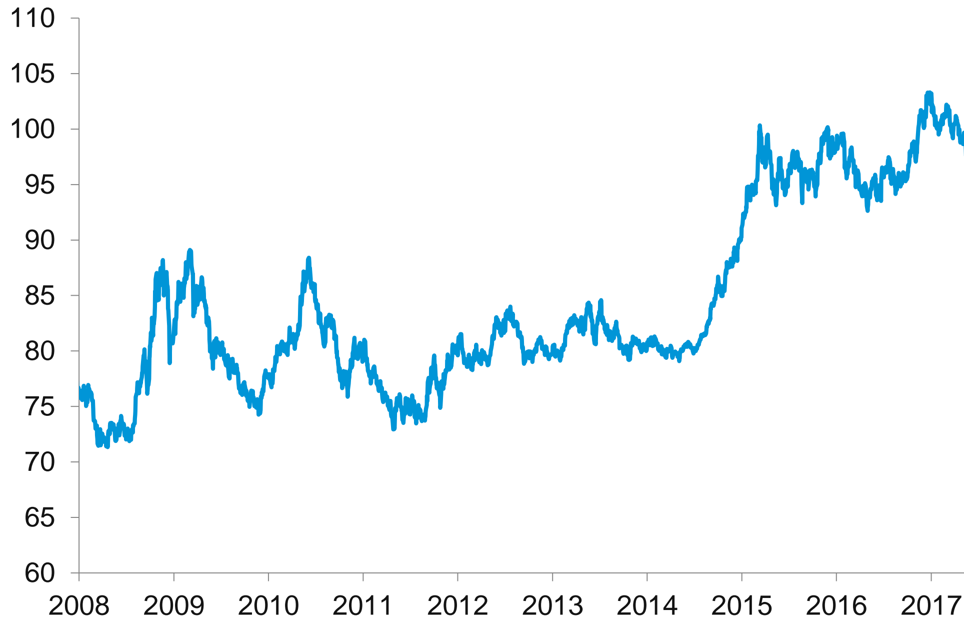
US Fed Funds Rate, 2-year and 10-year bond yields



Source: Bloomberg. Data to 15 March 2017.

Despite the interest rate hike today, the low May CPI print has seen the USD weaken a little. The DXY index is down at 96.928 from 96.975 previously. EUR/USD is at 1.1220 from 1.1218, USD/JPY is at 109.60 from 110.07, while the AUD is at $US0.7590 from $US0.7535.

USD Index



Source: Bloomberg. Data to 15 March 2017

Comments/questions welcome,

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