Fed preview: First of four

Jay Powell's first FOMC meeting as chairman will end with a rate hike, but the accompanying statement's tone and forecast update will be key for markets

Source: Federal Reserve

A done deal?

Financial markets are pricing in a greater than 90% probability that the Federal Reserve will raise rates 25bp on Wednesday, and depending on which metric you look at, even a very small chance they go up by 50bp. We agree that a 25bp move- leaving the fed funds target rate range at 1.5% to 1.75%- is virtually certain given the excellent growth backdrop and rising inflation threat. A 50bp move would be an unnecessary shock for markets.

So with a hike looking like a done deal, much of the focus on Wednesday will be on the Fed's so-called "dot diagram". The last forecast assessment, published in December, showed the median expectation amongst Fed officials was for three rate rises this year. Following new Fed Chair Jay Powell's first monetary policy testimony to Congress in February, expectations have been creeping higher that this could become four.

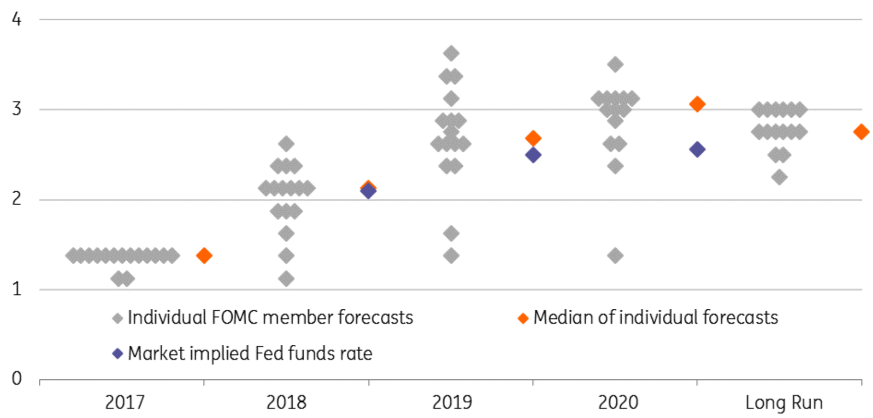
Headwinds to tailwinds

In prepared remarks, Powell talked of "solid growth" and a "robust jobs market" while repeating comments from previous Chair Janet Yellen that some of the shortfall in inflation reflected "transitory factors we do not expect will repeat". However, he also hinted at a shift in the perceived balance of risks, citing fiscal policy and export demand that have swung from being considered "headwinds" to now being described as "tailwinds". While being careful to repeat that the Fed was merely implementing "gradual" rate hikes and that all decisions are data dependent, this shift suggests the potential for an increase in growth, inflation and interest rate forecasts.

It is also important to remember that the dots in the interest rate diagram reflect all officials' views, not just the ones who get to vote. Two of the most dovish Fed officials in Neel Kashkari and Charles Evans are no longer in that core group so there is a slightly more hawkish tilt to the "voters" this year. As such, our view continues to be that the Fed will raise rates by 25bp on four occasions this year.

The tone of the accompanying statement is likely to be mildly more upbeat, reflecting these changes, but it will be interesting to see if the Fed passes comment on potential implications from President Trump's protectionist trade policies. If it does, it's more likely to be a warning of the threat from an escalation, rather than overt criticism of what the President is trying to do.

Fed's 'dot diagram' in December



Source: Federal Reserve, Bloomberg

Watch inflation

Strong activity in the US economy is clear for everyone to see, but there are a broader range of views on inflation. We are on the more hawkish end, believing we could see headline CPI reach 3% this summer. This is down to a combination of cell phone data plan distortions unwinding, a weaker dollar pushing up import prices, rising commodity prices, hikes in prescription drug charges in addition to shrinking slack in the economy and growing corporate pricing power. Throw in rising wages and we think financial markets are a little too complacent about the path of inflation. As such, there is a growing prospect that the Fed could follow up with three more rate hikes in 2019.

As for US Treasuries, the mix of rising inflation, a widening fiscal deficit (resulting from tax cuts and more government spending) plus the Fed's ongoing policy of shrinking its balance sheet mean that the US yield curve will flatten while shifting higher. We see the US 10-year yield moving above 3% over the course of 2018.

Author

James Knightley
Chief International Economist, US
james.knightley@ing.com

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