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Article

It's all relative for the Fed

Fed leaves policy unchanged, and balance sheet reductions are coming "relatively soon".

Content

Edging towards September

The Federal Reserve has left interest rates unchanged and suggests "gradual" policy tightening will continue. They are edging towards a September announcement on reducing the size of the balance sheet. The fed funds rate is to be kept in a 1% to 1.25% target range. The accompanying statement was little changed to the one issued in June with the Fed still believing inflation will "stabilise around the Committee's 2% objective over the medium term" despite remaining "somewhat below 2% in the near term". As a result, the Fed continues to anticipate "gradual increases in the federal funds' rate".

> The Fed also gave more information on the balance sheet reduction strategy.

The balance sheet has ballooned to US$4.5tr thanks to QE, the Federal Reserve is keen to get this down and has already announced a plan of gradually limiting the reinvestment of proceeds of maturing assets. The only question has been the timing. This statement suggests it will begin "relatively soon", whereas previously the Fed had merely said it will begin "this year". We look for the September FOMC meeting to formally say that balance sheet reduction will start in October.

If we're right, this will happen

Assuming we are correct, our debt strategists estimate that only US$197bn of the US$425bn in maturing Treasuries in 2018 would still be reinvested. With the market having to absorb more Treasuries, we think there is some complacency regarding the potential for higher longer dated yields and a steeper yield curve. In terms of the outlook for interest rates, the Fed (as of last month) was still indicating it expected to raise interest rates four times over the next 18 months – a total of 1 percentage point. This is in stark contrast to the market which is pricing in barely one 25bp move over the same period. The softer activity and inflation figures combined with the likelihood of a September balance sheet announcement means that December seems the earliest opportunity for the next rate move and we think it will happen.

The prospects for rates

Looking further ahead, we still forecast two rate rises in 2018, anticipating reasonable 2- 2.5% GDP growth over the next year and a likelihood that inflation will gradually return to target, helped by a tight labour market and the prospect of a gradual uptick in wage growth. Recent comments on asset price valuations ("somewhat rich" according to Janet Yellen and equities "running very much on fumes" according to San Francisco Fed President Williams) and loose financial conditions (fairly flat yield curve and dollar softness) suggest Fed officials are broadening out their reasoning for tighter monetary policy. For the market though, they will need to see the data improve before they will be convinced.

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