

Why this Fed meeting won't be a non-event

Downgrades to the infamous dot diagram could complicate Yellen's efforts to convince markets they are too complacent



Source: Federal Reserve

Wednesday's meeting: ignore at your peril

This week's FOMC meeting may not be the non-event that many in the market are seemingly viewing it. While the long-awaited announcement of the Fed's balance sheet unwind will be the main event, there will be keen interest in the new official forecasts. These may be used to reinforce the message that, while there is little need for aggressive interest rate hikes, the market remains too complacent on the prospect of higher interest rates.

Don't rule out a dots downgrade

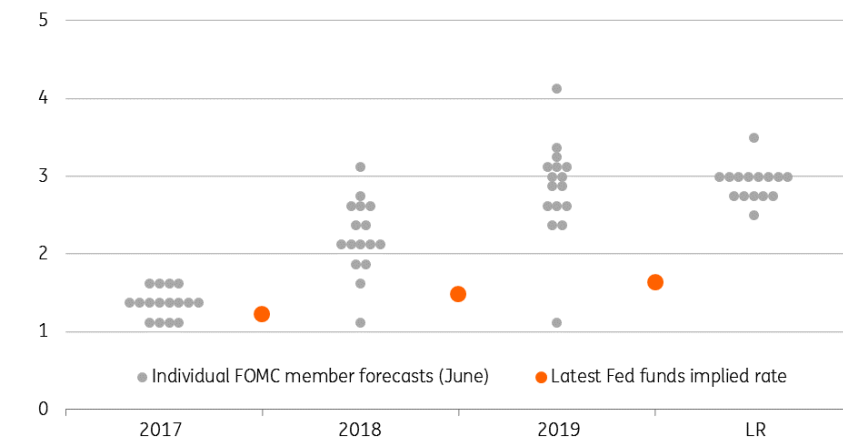
With just one hike priced in by the end of 2018, the market's view on interest rates is still worlds apart from the Fed's June projections, which pencilled in 100bp of rate hikes over the next 18 months.

We think the Fed will keep its longer-term forecasts unchanged but we're looking for a December hike followed by two more next year

Some market scepticism is understandable. The Fed has signalled higher interest rates on numerous occasions over the past couple of years, only to then subsequently not follow through with them. But also with several measures of inflation well below 2%, there is a sense that there is little need for tighter policy.

This latter point, in particular, may see some officials becoming less aggressive on their expectations for the path of interest rates. As such, we would not be surprised to see the dot diagram move closer to our forecast of three rate hikes rather than the four previously indicated.

Markets still very sceptical of Fed's dots



Source: Federal Reserve, Bloomberg

What could seal the deal for a December hike

While there may be some added caution on the dots, the encouraging economic outlook means the core message from the Fed is still that the market remains too complacent on rate hikes. The economy grew 3% in the second quarter, and there will probably only be a marginal slowdown in the third (despite some soft retail sales numbers) given the prospect of a significant inventory rebuild. We don't see any long-term economic disruption from [Hurricanes Harvey and Irma](#). In fact, in the medium term, they are likely to boost growth due to rebuilding efforts and households and businesses replacing lost equipment and belongings.

We also note inflation could rebound more quickly than the market anticipates. Headline CPI is back to 1.9% and with gasoline prices having spiked, dollar weakness is pushing up import costs, and there are tentative signs that wages are again on the rise given the tight labour market.

We therefore suspect the Fed will keep its positive, longer-term forecasts unchanged and we currently look for a December rate rise followed by two more 25bp hikes next year.

Politics, not data, the main risk to a December hike

The recent hurricanes saw President Trump push and get a three-month extension of the debt ceiling. While this is positive as this allowed relief funding to be released for affected areas but it now means the 13th December FOMC meeting will coincide with a new debt ceiling deadline.

Given the divisive nature of politics in Washington right now, we are somewhat nervous that there could be major market worries about a government shutdown, the furloughing of workers and the potential talk of debt default, although this would be highly unlikely to happen.

The result is that the Fed could conceivably choose to wait until early next year given the potential for a pickup in market volatility - although that is not our base case.

Don't rule out impact on yields once normalisation begins

In a bid to avoid taper tantrum 2.0, the Fed has for many months made it clear that it wishes to 'normalise' (or shrink) its USD 4.5 trillion balance sheet. We already know this will be done by a very slow tapering of the reinvestment of maturing assets - you can find out more in [five charts explain how the Fed plans to shrink its balance sheet](#).

Now we know most of the details, the formal announcement of an October start to the balance sheet unwind should be taken in the market's stride. But given the process will leave a sizeable extra chunk of bonds for the private sector to absorb, our Debt Strategy team estimate that this could in itself add 5-10bp on the 10-year yield.

Author

James Knightley

Chief International Economist, US

james.knightley@ing.com

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. ("ING") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies)*. The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and

which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit www.ing.com.