16 December 2016

Latest thoughts on the Fed rate hike

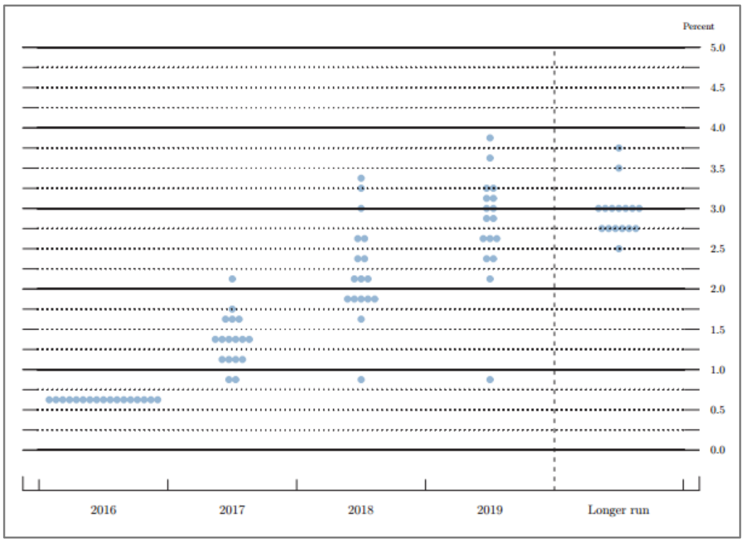
The U.S. Federal Reserve (Fed) raised interest rates at the December Federal Open Market Committee (FOMC) meeting on Wednesday for the first time in 2016. New projections show Fed officials expect three quarter-point rate increases in 2017, up from the two seen in the previous forecasts in September, based on median estimates. **Manulife Asset Management Chief Economist Megan Greene** believes while the announcement suggests a hawkish stance from the Fed, a look behind the headlines suggest an altogether more tempered outlook.

Markets have gotten too far out

I have to admit I'm a little confused. My inbox is full of notes with headlines announcing "Fed Turns Hawkish," but I just don't see it. Presumably this assertion is based on the FOMC's decision to hike interest rates by 25 basis points[1] and to raise its forecast for the number of rate hikes in 2017 from two to three[2] (Figure 1, FOMC participants' assessments of appropriate monetary policy, or the "Dot Plot").

But in my view, just about everything else about Fed chairwoman Janet Yellen's statement and press conference was dovish. While the markets seem to be experiencing a bout of "Trumphoria" (euphoria based on assumed policies President-elect Trump will implement when he comes into office)[3], in our view the markets have gotten too far out over their skis and inflation, growth and rates are likely to come in lower than seems to be currently assumed by investors.

Figure 1: FOMC participants' assessments of appropriate monetary policy, i.e. midpoint of target range or target level for the federal funds rate[4]



[1] Federal Reserve: FOMC Statement, 14 December 2016
[2] Federal Reserve: Economic projections of Federal Reserve Board members and Federal Reserve Bank Presidents Under Their Individual assessments of projected appropriate monetary policy, December 2016, 14 December 2016
[3] The Economist: Stockmarkets after the American election, 26 November 2016
[4] U.S. Federal Reserve, 14 December 2016. New projections show Fed officials expect three quarter-point rate increases in 2017, up from the two seen in the previous forecasts in September, based on median estimates (1.375%)

Still in the New Normal

While the Fed finally managed to hike rates this year and its expectations for the number of rate hikes next year has increased, the Fed's own forecasts reinforce the idea that the "new normal" is not yet over. The Fed's GDP forecasts hardly changed from September to December, with GDP growth over the next three years hovering around 2%[5]. The forecast for longer-run GDP growth remained the same in September and December at 1.8%. The forecast for Core PCE inflation, the Fed's favorite measure for inflation, remained unchanged from September to December[1]. The Fed clearly does not think that the election of Mr. Trump will have a huge impact on GDP growth or inflation.

We tend to agree that growth and inflation are unlikely to rise as the markets are hoping. Even if Mr. Trump manages to push through some of the fiscal stimulus measures that he has proposed, a number of them (infrastructure spending in particular) will not feed into the real economy until 2018 or 2019. Some fiscal stimulus and trade tariffs could cause core inflation to accelerate mildly in the US. This however is likely to be offset by a strengthening US dollar (so that the US continues to import deflationary pressures) and a lack of robust wage growth (Employment Cost Index, for example, remains very low by historical standards[6]).

Much has been made of the FOMC's dot plot shifting upwards to expect three hikes next year instead of two[2]. For starters, we should not take the dot plots as gospel. Don't forget, after all, that the FOMC forecast four rate hikes for this year compared with the measly one[7]. Furthermore, if we only consider the dot plots for the voting members of the FOMC, the expectation for rate hikes only increases from 2.5 to three. The Fed's long run rate forecast is at 3%[4]. This low level is consistent with the "lower-for-longer" thesis.

Fog of Uncertainty

Looking beyond the numbers, Fed Chairwoman Ms. Yellen's rhetoric was extremely dovish. She bent over backwards to highlight that the shift from two to three expected rate hikes next year is hardly a shift at all and only reflected a few FOMC members changing their stance. Ms. Yellen also highlighted that the Fed—like the rest of us—is "operating in a fog of uncertainty"[8]. It is incredibly difficult to guess which policies Mr. Trump will pursue as president, and which he will be able to implement and when they might feed through into the real economy.

Comments on Growth

Ms. Yellen did make two interesting statements about the economy. First, she highlighted that the US economy does not need fiscal stimulus in order to hit full employment[8]. She made an effort to shroud this comment in diplomatic language to insist that she is not pretending to offer President-elect Trump policy advice. But her meaning was clear in any case: not all fiscal stimulus is created equal, and there is little point in spending unwisely because all it will really give us is accelerating inflation.

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[5] Federal Reserve: Summary Of Economic Projections, 14 December 2016
[6] Bureau of Labor Statistics: ECI Summary, 28 October 2016
[7] Financial Times: Fed scales back forecasts for rate rises amid global risks, 16 March 2016
[8] Federal Reserve: Press conference with Janet Yellen, 14 December 2016

Second, Ms. Yellen seemed to back away from the idea that perhaps if the Fed runs the economy a little hot, some discouraged job hunters might rejoin the labor force[8]. She had first mooted this point at the Boston Fed conference. On Wednesday, she was quick to highlight that she had never recommended running the economy hot, but rather had simply noted this was an interesting intellectual question worth exploring. We should all take note on how to gracefully back away from something you'd previously suggested.

Lower for Longer

The initial response to Wednesday's Fed was to insist the central bank has become more hawkish, but we disagree with this entirely. Instead the Fed seems to agree with us that we are unlikely to see the kind of acceleration in GDP growth and inflation that investors subject to "Trumphoria" seem to be expecting. We think the markets are perhaps channeling some of the irrational exuberance that former Fed Chair Alan Greenspan once warned against. Our belief that we remain in a low growth, low inflation, low rate environment therefore remains intact. Growth and inflation might get a slight bump from fiscal stimulus, but this will only help on the margins and is unlikely to shift potential growth significantly.