US Federal Reserve: Time after time

Economic Research Note

18 December 2014

- The US Federal Reserve ('the Fed') has continued to signal a mid-2015 start of the monetary policy normalisation process.
- The Fed now states that they will be 'patient' on deciding when to raise rates, but noted that this change of language is not a change of guidance away from the 'considerable time' characterisation.
- The Fed's economic growth and unemployment rate forecasts are little changed in the years ahead, but the inflation forecasts have been dragged lower by the recent big falls in energy prices.
- Our expectation is the first rate hike from the Fed will be in June 2015.
- We expect rate hikes to progress through H2 15 and 2016 at every second Federal Open Market Committee (FOMC) meeting, putting the Fed Funds rate at 0.75%-1% at the end of 2015 and 1.75%-2% at the end of 2016. A 'neutral' Fed Funds rate around 3.5% is expected to be reached beyond 2017.
- Markets, however, continue to price in a much more modest tightening cycle.
- This implies an outlook that should see US bond yields, especially at the shorter end of the yield curve, move higher in the year ahead – flattening the curve.
- We expect the US dollar (USD) will continue to strengthen. Equity markets could be more mixed, worrying about the rise in interest rates, but supported by better economic news. Global financial market volatility should continue to rise.

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The Fed has **reinforced expectations that they remain on track to start the monetary policy normalisation process in June 2015.**

At the final press conference for 2014, Fed Chair Janet Yellen stated that 'the Committee considers it unlikely to begin the normalisation process for at least the next couple of meetings.' She also noted that 'there are a range of views on the Committee' and that 'the timing of the initial rise in the Fed Funds target as well as the path for the target thereafter are contingent on economic conditions.'

One of the key signals that markets were looking for was a change in the language that stated that the Fed Funds rate would be held near zero for a 'considerable time following the end of its asset purchase programme this month.'

After the end of the QE3 programme in October and with the economic data confirming ongoing solid growth, **the Fed now states that 'the Committee judges that it can be patient in beginning to normalise the stance of monetary policy.'** However, the Federal Open Market Committee (FOMC) then went on to state that this change of language was 'consistent with its previous statement.'

In terms of the economy, the Fed notes that 'economic activity is expanding at a moderate pace' and that 'labor market conditions improved further, with solid job gains and a lower unemployment rate.'

In addition, 'household spending is rising moderately and business fixed investment is advancing.' The Fed did note that 'the recovery in the housing sector remains slow.'

On inflation, the Fed noted that 'market-based measures of inflation compensation have declined somewhat further; survey-based measures of longer-term inflation expectations have remained stable.'

Going further, the Fed statement noted that 'the Committee expects inflation to rise gradually towards 2% as the labor market improves further and the transitory effects of lower energy prices and other factors dissipate', but that 'the Committee continues to monitor inflation developments closely.'

This confidence would indicate that despite all the volatility in markets over recent weeks and the declines in inflation expectations, **the Fed still remains on course to deliver its first interest rate hike in mid-2015.**

Although the Fed has slightly altered its guidance on interest rates, it has re-affirmed its plan to continue re-investing the coupon payments it receives on its bond holdings back into the market and to roll-over maturities at auction.

Our view remains that an end to coupon reinvestment, on the US$4.4trn in securities the Fed has on balance sheet, will occur well after rate hikes have begun. Additionally, outright sales of some of the US$4.4trn securities on balance sheet are not currently on the agenda.

It is also interesting to note that the number of dissenters on the FOMC continues to grow, with three noted in this meeting. Two of these dissenters, Richard Fisher and Charles Plosser were on the hawkish side, while Narayana Kocherlakota dissented on the dovish side.

The path to monetary policy normalisation

We remain of the view that **the Fed will start raising interest rates at the 16-17 June 2015 FOMC meeting**. That view has not changed in recent weeks.

As we have noted previously, this policy normalisation process is expected to take place with the Fed raising both the interest on excess reserves (IOER) rate, currently at 25bp, and the reverse repo programme (RRP) rate, in a corridor in which the effective Fed Funds rate will trade.

Although we expect the first rate hike in June 2015, **we now expect a more gradual tightening process through H2 2015 and 2016.**

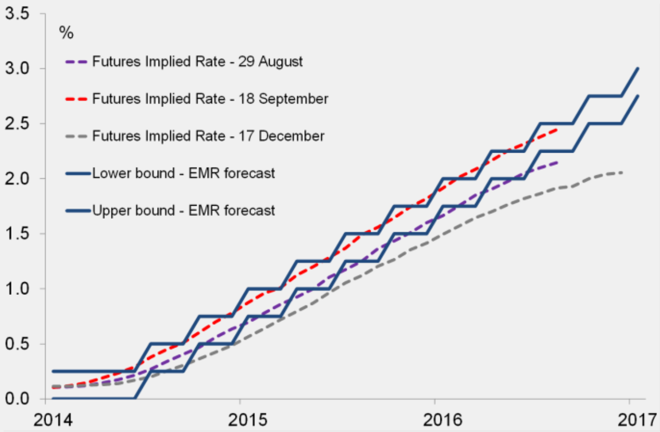
We would expect to see the Fed raise the Fed Funds target range by 25bp at each second meeting, meaning rate hikes in June, September and December 2015 and then March, June, September and December 2016.

This, in our view, would put the Fed Funds target rate in a 0.75%-1.0% range at the end of 2015 and 1.75%-2.0% at the end of 2016.

In contrast, as shown in the following chart, the market is expecting the Fed Funds rate to be 0.565% at the end of 2015 and just under 1.5% at the end of 2016.

The market then expects a Fed Funds target rate of 2% in 2017, while our own view is that the Fed Funds rate will be 2.75%-3% by 2017.

Projected path of US short rates and market expectations



Source: Bloomberg. Data to 17 December 2014. Lower and upper bound is the Economic and Market Research team forecast.

At the FOMC meeting this week, the members of the Fed have made further changes to their 'dot' forecasts for where interests will be in the years ahead.

These 'dot' forecasts form an important part of the Fed's communications strategy with markets and have been lowered marginally in the out-years, reflecting slightly lower inflation expectations.

For end 2015, the 'dot' for the median Fed Funds rate has moved from 1.375% (i.e. a range of 1.25%-1.5%) to 1.125% (i.e. a range of 1%-1.25%). The range of forecasts for 2015 is now 0.125% to 1.875%, from 0.125% to 2.875% previously.

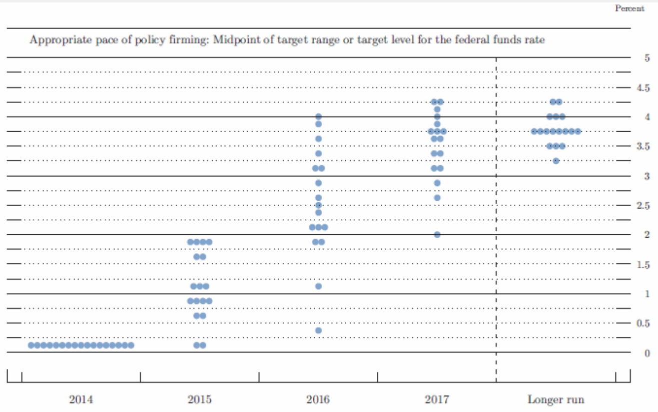
For end 2016, the median 'dot' has moved from 2.875% (2.75%-3.0%) to 2.5%. The range of forecasts for 2016 is unchanged at a wide 0.375% to 4%.

For 2017, the Fed is forecasting a median of 3.625% (i.e. a range of 3.5%-3.75%), from 3.75% previously, for the Fed Funds rate.

This is consistent with our own view of a 3.5% Fed Funds rate beyond 2017 – a rate which we would describe as the 'neutral' rate. The Fed's 'long run' Fed Funds projected rate remains at the 3.75% estimate set in September.

These interest rate forecasts provided by the members of the FOMC are shown in the following chart. Each dot represents one FOMC participant's forecast.

Appropriate pace of policy firming 'dot plot'



Source: FOMC, as at 17 December 2014.

The vast majority of the Fed members (15 of 17) now expect the first rate hike in 2015 (up from 14 out of 17 in September).

Revised Economic forecasts

At the FOMC meeting this week, the Fed has updated its economic forecasts.

As detailed in the below table, the changes to the economic projections are minor – except for headline inflation.

Growth for 2014 has been increased marginally, with the unemployment rate forecast lowered. The headline inflation forecast is lower, but the core inflation forecast is unchanged.

Revisions for 2015, 2016 and 2017 are also minimal, except for lower headline inflation – on the back of lower oil prices.

Economic central tendency forecasts – current and previous

FOMC projections (% change)	2014	2015	2016	2017	Longer run
Real GDP	**2.3-2.4**	**2.6-3.0**	**2.5-3.0**	**2.3-2.5**	**2.0-2.3**
(Sept f/c)	2.0-2.2	2.6-3.0	2.6-2.9	2.3-2.5	2.0-2.3
(June f/c)	2.1-2.3	3.0-3.2	2.5-3.0	n/a	2.1-2.3
Unemployment rate	**5.8**	**5.2-5.3**	**5.0-5.2**	**4.9-5.3**	**5.2-5.5**
(Sept f/c)	5.9-6.0	5.4-5.6	5.1-5.4	4.9-5.3	5.2-5.5
(June f/c)	6.0-6.1	5.4-5.7	5.1-5.5	n/a	5.2-5.5
Core PCE inflation	**1.5-1.6**	**1.5-1.8**	**1.7-2.0**	**1.8-2.0**	**n/a**
(Sept f/c)	1.5-1.6	1.6-1.9	1.8-2.0	1.9-2.0	n/a
(June f/c)	1.5-1.6	1.6-2.0	1.7-2.0	n/a	n/a

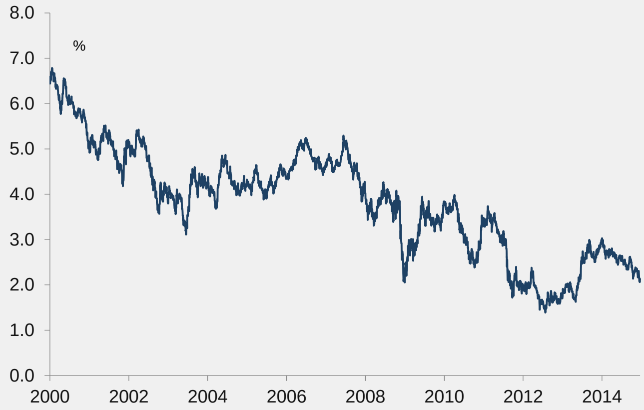
Source: FOMC, as at 17 December 2014.

Financial markets

Markets have responded in a mixed way to the Fed's statement and Fed Chair's press conference.

Treasury bond yields are a little higher on the day, with 10yr yields up 8bp at 2.14%, whilst 2yr yields are up 6bp at 0.61%. The yield curve has, therefore, steepened marginally.

US 10 year bond yields



Source: Bloomberg. Data to 17 December 2014.

The US equity market has had a volatile session, but generally headed higher. The Dow has ended the day up 1.7%, with the S&P 500 up 2.05%.

The USD has also ended a volatile session higher.

The USD index (DXY) has rallied to 89.007 from 88.125 previously, while the Euro (EUR/USD) is down at 1.2335 from 1.2510 and the Australian dollar (AUD/USD) is lower at 0.8115 from 0.8215.

We continue to expect further gains in the USD in the months ahead, especially against both the EUR and the Japanese yen (JPY) as the European Central Bank and Bank of Japan embark on more aggressive QE programmes.

USD Index

Source: Bloomberg. Data to 17 December 2014.

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