First State Investments

US Federal Reserve: It's about time

Economic Research Note

18 September 2014

- The US Federal Reserve ('the Fed') has, once again, announced a further $US10bn tapering in the QE3 program – monthly bond purchases are now down to just $US15bn.
- The Fed has restated the plan to end QE3 with a final $US15bn taper at the 28-29 October meeting.
- In addition, the Fed has laid out a clear sequencing path for 'Policy Normalisation Principles and Plans', which – as expected – will involve raising the Fed Funds rate in a range and ending coupon reinvestment after the first rate hike. Asset sales of the $US4.4trn in securities on balance sheet are not on the agenda.
- However, the most important feature of the Fed meeting was the 'something for everyone' strategy that looks to have been employed.
- In a 'dovish' move, the Fed has retained the language that the first rate hike will be a 'considerable time' after the end of QE3. The labour market is still described as having 'significant underutilisation.'
- However, in a more 'hawkish' development the 'dot' forecasts for where the Fed Funds rate will be by the end of 2015 and 2016 have been raised by around 25bp, implying a faster pace of tightening once the move to higher rates gets underway.
- We continue to expect the first rate hike in June 2015, but the risk to this is drifting forward. The Fed's 'dot' forecasts now imply five rate hikes in 2015.
- Markets have, not surprisingly, responded to the Fed's statement in a mixed way. The equity market is up marginally, bond yields are a little higher and the USD is stronger.

Belinda Allen
Senior Analyst, Economic and Market Research

Stephen Halmarick
Head of Economic and Market Research

James White
Senior Analyst, Economic and Market Research

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The Chair of the Fed, Janet Yellen has, once again, announced a further moderation or 'tapering' in the bond purchasing stimulus program (QE3) at the 16-17 September 2014 Federal Open Market Committee (FOMC) meeting.

The Fed has announced another $US10bn/mth reduction in bond purchases, down to $US15bn/mth. The Fed will now be buying $US10bn in Treasury bonds per month and $US5bn/mth in mortgage-backed securities.

The Fed remains on track to deliver a final $US15bn taper in the QE3 bond purchase program at the 28-29 October FOMC meeting. In the latest's statement the Fed noted that 'if incoming information broadly supports...expectations of ongoing improvement in labour market conditions and inflation moving back toward its longer-run objective, the Committee will end its current program of asset purchases at its next meeting' – **QE3 ends next month.**

In addition, the Fed has laid out its 'Policy Normalization Principles and Plans' at the FOMC meeting. These plans are very much in-line with our expectations as detailed in the *Travelling Economist in the USA* report.

As detailed below, **the plan is to gradually raise the Fed Funds target rate inside a range** bound by the Interest on Excess Reserves (IOER) and the Reverse Repo program (RRP). **The end to coupon reinvestment on the $US4.4trn in securities the Fed has on balance sheet will occur after rate hikes have begun**. And **outright sales of some of the $US4.4trn securities on balance sheet are not on the agenda.**

The most important development at the FOMC meeting was, however, **the ongoing development of the Fed's forward guidance language and 'dot' forecasts.**

Contrary to some expectations, the Fed has maintained its view that 'it will likely be appropriate' to hold the Fed Funds rate near zero for a 'considerable time after the asset purchase program ends.' In addition, the Fed continues to hold the view that 'there remains significant underutilisation of labour resources.'

However, **the maintenance of this 'dovish' language has been offset by a more 'hawkish' expectation for the pace of monetary policy tightening.**

Back in June the median Fed funds rate expected by the Fed was 1.125% by the end of 2015. **Now the median rate expected is 1.375%, i.e. a range of 1.25%-1.5%, by the end of next year, i.e. an extra rate hike has been added into the 2015 timetable.**

For 2016 the median Fed funds rate expected is 2.85% or a range between 2.75%-3%, up from closer to 2.5% previously. **The first estimate for 2017 puts the median Fed Funds rate near 3.75% – i.e. at the Feds estimate of the long-run Fed Funds rate.**

It is also worth noting that the number of dissenters has doubled, with Charles Plosser, from Philadelphia, now joined by Richard Fisher, from Dallas, in arguing for a quicker move to tighten monetary policy.

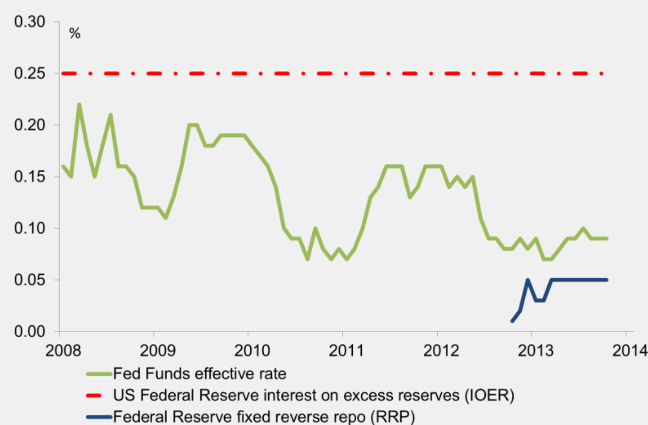
The path to monetary policy normalisation

As noted, the Fed has detailed its 'Policy Normalisation Principles and Plans' and these are consistent with our expectations.

We continue to hold to the view that **the Fed will start raising interest rates at the 16-17 June 2015 FOMC meeting**. The risk to this view is now drifting forward, but remains dependent on economic data.

This policy normalisation process is expected to take place with the Fed raising both the IOER rate, currently at 25bp, and the RRP, currently at 5bp, in a corridor in which the effective Fed Funds rate will trade.

US short-term interest rates

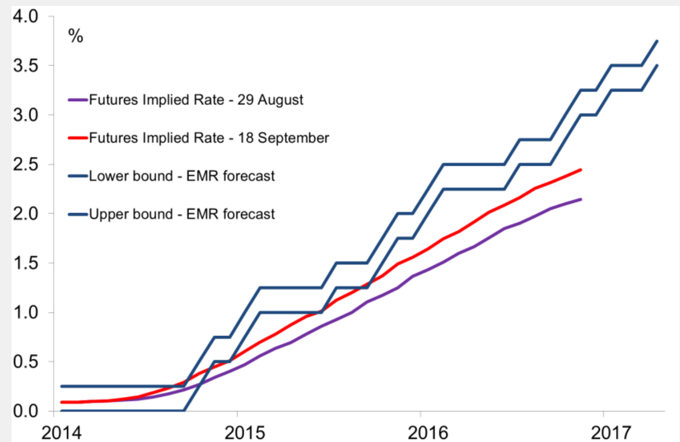


Source: Bloomberg. Data to 17 September 2014.

Once this monetary policy normalisation process gets underway we expect the effective Fed Funds rate to be around 1%-1.25% by the end of 2015, 2.5%-2.75% by the end of 2016 and then to the neutral Fed Funds rate around 3.5%-3.75% in 2017.

This projected path for the Fed Funds rate is shown on the following chart. As can be seen, our expected path differs from the market expectations, although the market is clearly moving in our direction – helped along by the Fed's guidance.

Projected path of US short rates and market expectations



Source: Bloomberg. Data to 18 September 2014. Lower and upper bound is the Economic and Market Research team forecast.

In addition to higher interest rates, the Fed has laid out a clear path for its balance sheet plan.

The 'Policy Normalisation Principles and Plans' state that:

– 'During normalisation, the Federal Reserve intends to move the federal funds rate into the target range set by the FOMC primarily by adjusting the interest rate it pays on excess reserve balances.'

– 'During normalisation, the Federal Reserve intends to use an overnight reverse repurchase agreement facility and other supplementary tools as needed to help control the federal funds rate. The Committee will use an overnight reverse repurchase agreement facility only to the extent necessary and will phase it out when it is no longer needed to help control the federal funds rate.'

– 'The Committee intends to reduce the Federal Reserve's securities holdings in a gradual and predictable manner primarily by ceasing to reinvest repayments of principal on securities held in the SOMA.'

– 'The Committee expects to cease or commence phasing out reinvestments after it begins increasing the target range for the federal funds rate; the timing will depend on how economic and financial conditions and the economic outlook evolve.'

– 'The Committee currently does not anticipate selling agency mortgage-backed securities as part of the normalisation process, although limited sales might be warranted in the longer run to reduce or eliminate residual holdings. The timing and pace of any sales would be communicated to the public in advance.'

– 'The Committee intends that the Federal Reserve will, in the longer run, hold no more securities than necessary to implement monetary policy efficiently and effectively, and that it will hold primarily Treasury securities, thereby

minimising the effect of Federal Reserve holdings on the allocation of credit across sectors of the economy.'

– 'The Committee is prepared to adjust the details of its approach to policy normalisation in light of economic and financial developments.'

The Fed's monetary policy timetable will look, therefore, something like this:

FOMC meeting	Fed action
2014	
28-29 October	QE3 to be completed. Janet Yellen to emphasise progress is being made on the dual mandate, but that first rate hike remains some time away.
16-17 December	Fed's economic projections updated to show achievement of dual mandate in 2015. Exit strategy remains for eventual move out of zero-rate bound.
2015	
27-28 January	Fed to continue to highlight details around the mechanics of policy tightening using IOER and RRP. Continue to indicate that policy normalisation process will get underway when appropriate.
17-18 March	Economic projections updated – markets looking for timing of first rate hike.
28-29 April	Fed expresses confidence on the economic outlook and confidence that they have the necessary tool to push rates higher.
16-17 June	**First rate hike.** Fed Funds target range lifted from 0%-0.25% to 0.25%-0.50%. IOER to 0.5% from 0.25% and RRP from 0.05% to 0.3%. Economic forecasts updated.
28-29 July	Fed Funds target moved to 0.5%-0.75% and other short rates moved higher.
16-17 September	Fed Funds target moved to 0.75%-1.0% and other short rates moved higher. Economic forecasts updated.
27-28 October	Fed Funds target moved to 1.0%-1.25% and other short rates moved higher.
15-16 December	No change in policy. Economic projections updated – with further rate hikes indicated for 2016.

Source: First State Investments.

New Economic forecasts: 2017 and beyond!

At this week's FOMC meeting, the Fed has lengthened its forecast horizon out one year to 2017 and updated its forecasts for 2014, 2015 and 2016.

As detailed in the following table, the changes to the economic projections are minor. Growth for 2014 has been lowered marginally, but with the unemployment rate forecast also lowered. The inflation forecast is unchanged.

Revisions for 2015 and 2016 are minimal, while the Fed expects growth of 2.3%-2.5% in 2017 and an unemployment rate of 4.9%-5.3%, i.e. below the long-run estimate of 5.2%-5.5%. Inflation in 2017 is expected to be on-target at 1.9%-2.0%.

Economic central tendency forecasts

FOMC projections (% change)	2014	2015	2016	2017	Longer run
Real GDP	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	5.9-6.0	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	1.6-1.9	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 September 2014.

As noted above, apart from the new economic forecasts out to 2017, the Fed members have updated their expectations for where the Fed Funds will be by the end of 2017.

These 'dot' forecasts form an important part of the Fed's communications strategy with markets and have been increased in each of the out-years.

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

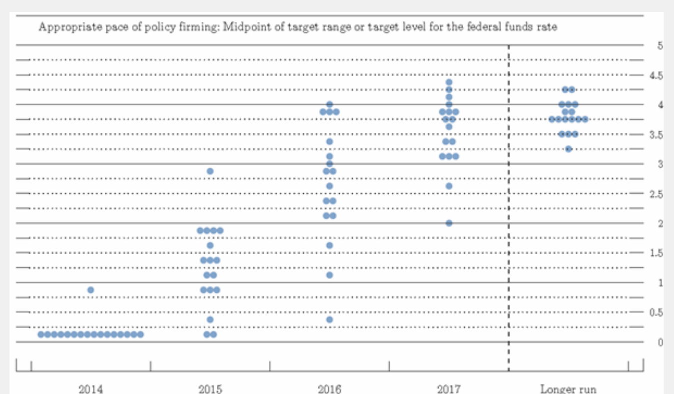
For end 2016, the median 'dot' has moved from 2.5% to 2.875% (i.e. a range of 2.75%-3.0%). The range of forecasts for 2016 is a wide 0.375% to 4%.

For 2017, the Fed is forecasting a median of 3.75% for the Fed Funds rate and a range of 2% to 4.375%.

This is consistent with our own view of a 3.75% Fed Funds rate in 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 June.

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

Appropriate pace of policy firming 'dot plot'



Source: FOMC, as at 17 September 2014.

The vast majority of the Fed members (14 of 17) now expect the first rate hike in 2015 (up from 12 out of 16 in June). One expects the first move in 2014, with two (down from 3) preferring to wait until 2016.

Financial markets

The Fed's statement looks to have had 'something for everybody'.

Longer-dated Treasury bonds have moved higher, with 10yr yields up 3bp at 2.62%, whilst 2yr yields are up 3bp at 0.57%.

We continue to expect to see bond yields move higher in the months ahead. 10yr yields could be expected to trade towards 3% by year-end 2014, while the yield curve is expected to flatten.

US 10 year bond yields

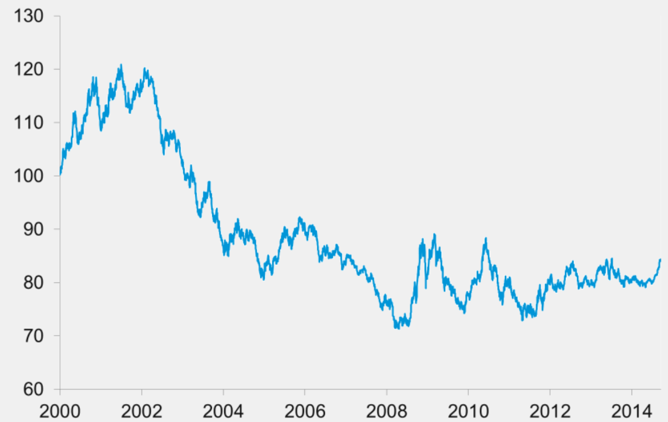
Source: Bloomberg. Data to 18 September 2014.

The US equity market has ended the day a little stronger, with the Dow up 0.15% and the S&P500 up 0.13%. The equity market has been supported by the retention of the 'considerable period' language and encouragement from Fed Chair Yellen that the economy will need to show further improvement before interest rates are increased.

The US dollar (USD) has strengthened on the day, buoyed by the more aggressive policy tightening path that the Fed's 'dots' imply for 2015 and beyond.

The USD DXY has rallied to 84.73 from 84.07 previously, while EUR/USD is down at 1.2845 from 1.2865 and AUD/USD is lower at 0.8950 from 0.8960.

USD Index



Source: Bloomberg. Data to 18 September 2014.

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