PICTET 1805

Flash Note

United States: monetary policy

Markets react well to Fed hike

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As was widely expected, the FOMC decided at its latest policy meeting to raise the Fed funds rate target range by 25bp to 0.75%-1.0%.

The FOMC statement and projections contained some signals that were considered dovish. Median forecasts for the Fed funds rate remained basically unchanged (some increases had been feared) and the number of participants expecting more than three hikes in 2017 also remained unchanged at five. Moreover, FOMC member Kashkari dissented in favour of unchanged rates.

As markets were probably fearing more hawkish surprises, they reacted quite well. Overall financial conditions remain surprisingly relaxed.

In that context, we now believe that a hike in June is more likely than not. Our scenario of two more 25bp hikes before the year is out remains valid. However, we now expect the moves to come in June and September (instead of September and December).

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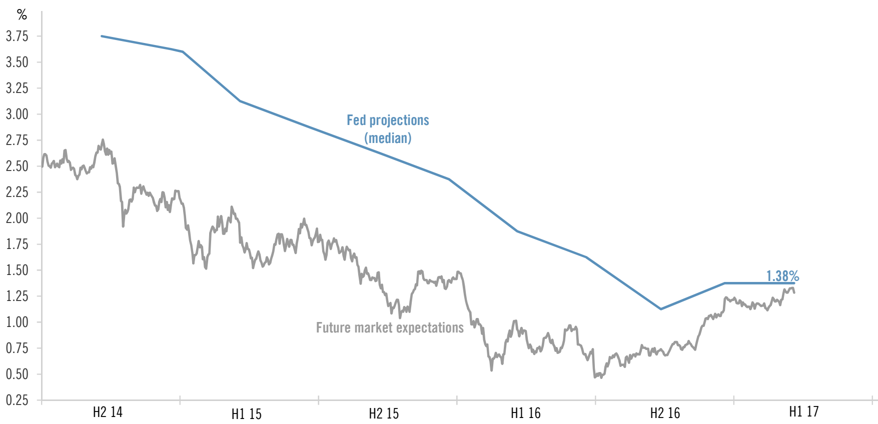
As widely expected, at yesterday's FOMC meeting, the Fed decided to hike rates by another 25bp. But financial markets reacted surprisingly well, and broad financial conditions didn't tighten on the news. We continue to expect two more rate hikes this year. However, we now think they are likely to come in June and September, instead of September and December.

Chart 1: Expected Fed funds rate at end-2017



Source: Pictet WM - AA&MR, Federal Reserve, Thomson Reuters

Another step in the normalisation process

In line with what almost every forecaster was expecting, at its meeting yesterday, the Federal Open Market Committee (FOMC) decided to hike interest rates, raising the target range for the Fed funds rate by 25bp from 0.5%-0.75% to 0.75%-1.0%. This is only the third hike in a decade, but the second over the past three months.

Fed Chair Janet Yellen explained that the decision to raise rates was appropriate *"in light of the economy's solid progress toward our goals of maximum employment and price stability*". She also said that the decision to hike *"does not represent a reassessment of the economic outlook or of the appropriate course for monetary policy"*. Interestingly, Janet Yellen repeated that the decision to hike was also reflecting their view *"that waiting too long to scale back some accommodation could potentially require us to raise rates rapidly sometime down the road, which, in turn, could risk disrupting financial markets and pushing the economy into recession"*.

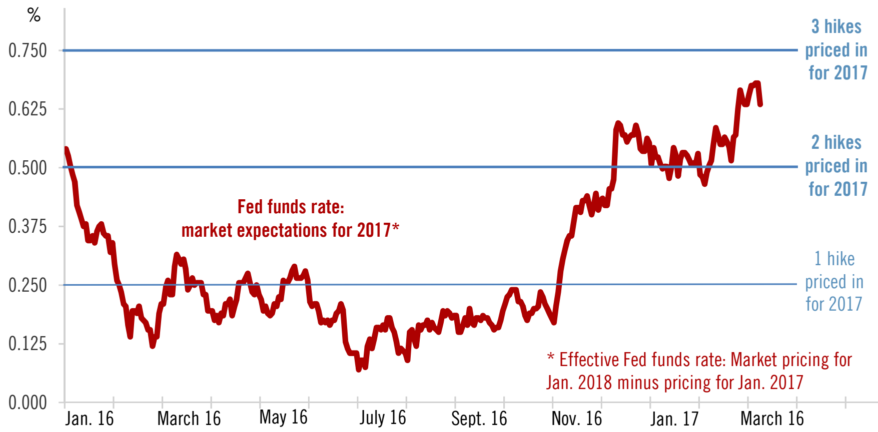
As yesterday's hike was well telegraphed in advance, of more importance were the messages and tone of the FOMC statement, its rate projections and Yellen's press conference.

As far as the economic situation is concerned, hardly surprisingly, the Fed sounded slightly more upbeat, notably on inflation. However, the Fed also modified its statement to highlight that its inflation target was symmetric. This surprised many and was possibly viewed as a dovish signal. Overall, there were only modest changes in the wording of the statement compared to the previous one, with the Fed repeating the mantra that rate hikes should be gradual. In sum, the statement was probably less hawkish than expected.

Changes in the FOMC's economic projections were also pretty minimal. The median projection for y-o-y GDP growth in Q4 2018 was revised slightly up from 2.0% to 2.1%, but growth for 2017 remained unchanged at 2.1%. Forecast for unemployment remained unchanged, with the exception of the estimate for the neutral unemployment rate, which was revised slightly down from 4.8% to 4.7%. And the projection for core PCE inflation in Q4 2017 was revised up modestly, from 1.8% y-o-y to 1.9%. Our own forecast for core PCE in Q4 2017 is slightly higher (2.1%).

Regarding the potential impact of the Trump administration's policies, Chair Yellen repeated that they were not really incorporated into the FOMC's economic projections. However, Chair Yellen did say that "c*hanges in economic policies, including fiscal and other policies, could potentially affect the economic outlook. Of course, it is still too early to know how these policies will unfold. Moreover, fiscal policy is only one of many factors that can influence the outlook*".

Chart 2: Futures market expectations of Fed funds rate

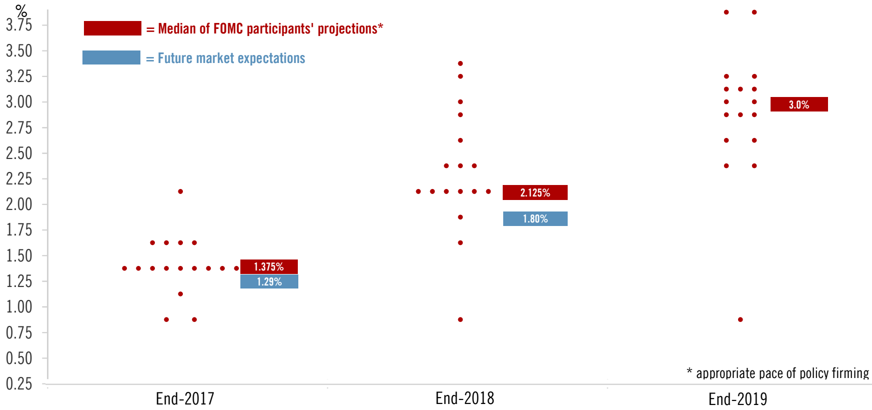


Source: Pictet WM - AA&MR, Thomson Reuters

Minimal changes in projections for Fed funds rates

Markets feared that the FOMC might revise its (in)famous 'dot plot' chart up. But in the event, the FOMC's median forecast for the Fed funds rates at the end of 2017 remained unchanged at 1.375% (which implies three 25bp hikes in total in 2017). Three FOMC members who back in December were expecting two hikes in 2017 now expect three hikes. But, a bit surprisingly, the number of participants that were expecting more than three hikes remained unchanged at five. The median forecast for end-2018 was also unchanged at 2.125% (three more 25bp hikes), while the projection for end-2019 was revised marginally up from 2.9% to 3.0% (3.5 more hikes). As markets were fearing a more hawkish shift before the FOMC meeting, all this was interpreted as a dovish signal. This dovish perception was reinforced by the vote of Minneapolis Fed president N. Kashkari against the hike (he would have preferred to stay pat).

Chart 3: Median FOMC projections for Fed funds rate (the 'dot plot')



Source: Pictet WM - AA&MR, Federal Reserve, Thomson Reuters

Balance-sheet normalisation will not begin soon

Regarding the potential reduction in the size of the Fed's balance sheet, Chair Yellen said in her press conference that "as *a matter of prudent planning, we discussed at this meeting a number of issues related to an eventual change to our reinvestment policy. We made no decisions, and we will continue our discussion at subsequent meetings*". She also repeated the mantra that the Fed will continue to maintain its holdings at a constant level until "*normalization of the level of the federal funds rate is well under way*". Asked about what level of rates 'well under way' means, she answered by saying she couldn't be more specific, and that the Fed's confidence in the economy was also a factor.

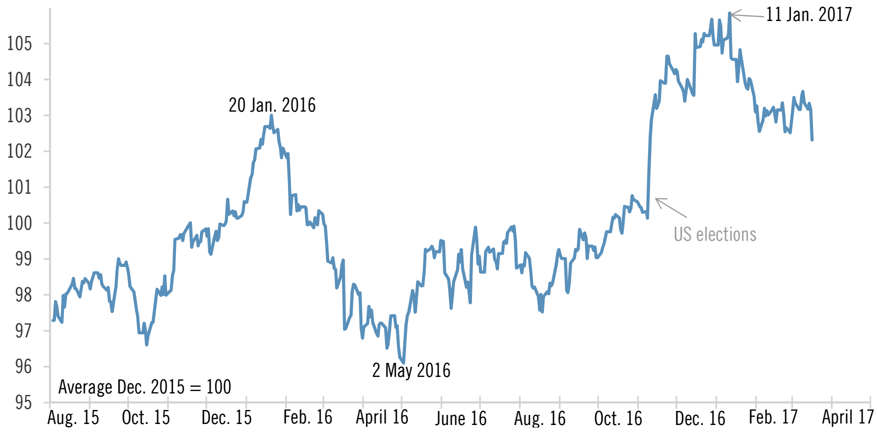
We continue to expect that the Fed will start to reduce the pace of reinvestment sometime in H1 2018.

We still expect two more 25bp hikes before the year is out

In a nutshell, taken together, the FOMC's statement, the press conference and economic projections were not particularly dovish in our view. The Fed is relatively upbeat on the economy, thinks international risks have receded and is still planning to remove monetary accommodation gradually. However, markets that were probably fearing more hawkish surprises, took all this as quite a dovish sign. Stocks rose, long-term rates fell and the dollar – on a broad trade-weighted basis – depreciated by almost 1.0%. This means that overall financial conditions have not tightened much in spite of yesterday's Fed hike.

The fact that financial conditions remain surprisingly accommodative in spite of two 25bp hikes in just three months is important. We were forecasting that the FOMC would pause in June because we were expecting some significant tightening in financial conditions following yesterday's hike. Of course, this could still come, but we now think a hike in June is more likely than not. Our scenario of two more 25bp hikes before the year is out remains valid, but we now expect the moves to happen in June and September, instead of September and December. And risks are probably tilted towards a total of four hikes over the year. A lot will depend on the policies decided by the Trump administration and Congress.

Chart 4: USD real trade-weighted value (broad index, J.P. Morgan daily measure)



Source: Pictet WM - AA&MR, Thomson Reuters

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