

## Flash Note

### US – 31 January Fed meeting preview

#### Fed to drop hints about its increased optimism

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The Fed meets on 30-31 January, a 'tier 2' meeting as there will be no press conference nor new economic projections. Rates should remain on hold. Still, the Fed could drop some hints that its optimism about the US and global economy is on the rise.

We think this increased optimism will pave the way for higher 2018 growth forecasts at its meeting in March, as well as for a new dot chart showing four 2018 rate hikes (versus three at the December meeting).

We think the Fed will avoid sounding too hawkish just now – especially given the leadership transition between Yellen and Powell.

In our recently updated Fed scenario, we see four rate hikes this year and two next year – more than are currently being priced by money markets.

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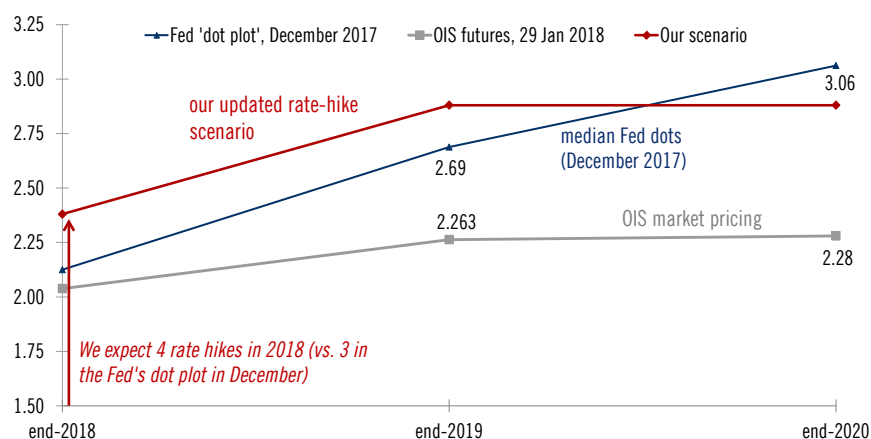
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The Federal Reserve meets on 30-31 January. This is considered a '**tier-2**' meeting as there will be neither a press conference, nor new economic and rates projections. With a **rate hike very unlikely to be announced**, the focus will be on the post-meeting statement, which will be analysed closely. It could contain some **moderate hawkish hints**, in our view.

Indeed, we think the statement will reflect the fact that the Fed is gradually **raising its expectations about the impact of the Trump tax cuts**, and associated ongoing 'animal spirits', on US growth. The tone of the last Fed meeting in December – when Fed Chair Janet Yellen spoke about the cuts' "modest" impact on growth – is already proving to have been **too conservative**, and many Fed officials have turned **more optimistic** in their speeches of late. The influential New York Fed president Bill Dudley has even spoken about possible "**overheating**" risks, breaking away from his previous stance when the major risk – and fear – he saw was deflation.

A modestly hawkish Fed statement would mean the Fed upgrades its outlook to "**balanced**", from "roughly balanced". We also think the Fed will note the **strong gains in private consumption** last quarter (up 3.8% q-o-q SAAR, according to the recently-released GDP data). It could also take note of the recent **pick-up in market based inflation expectations**.

Chart 1: The Fed's dot plot versus current market (and our own) expectations



Source: Pictet WM – AA&MR, Federal Reserve. (Pricing as of 29 January)

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Dropping the mention that it is monitoring “global economic and financial developments” – would be another slightly hawkish sign, suggesting that the **global picture is less of a worry for Fed members**. Indeed, global growth has been picking up sharply of late, mirrored by a much more optimistic tone at many international institutions – and at the World Economic Forum in Davos last week. The International Monetary Fund (IMF) has just raised its 2018 growth forecast to 3.9% (from 3.7% in 2017 and 3.2% in 2016).

A more hawkish (but less probable) surprise still would be if the Fed dropped the mention that it “continues to closely monitor inflation indicators”. While core PCE inflation has firmed up lately (0.18% m-o-m in December, after 0.09% in November), it is still probably **too early to sound the all clear** or to convey the message that inflation is on a clear upward trend.

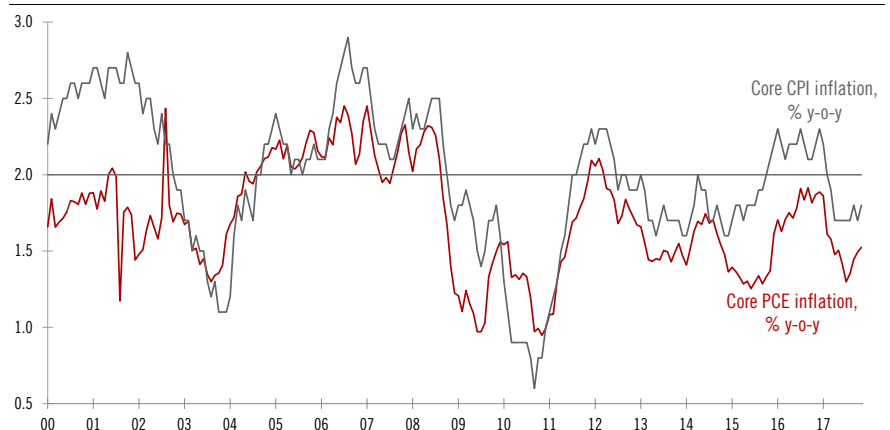
The Fed has been wrong footed so many times in recent years on this score and, in any case, some entrenched Fed doves, perpetually worried about low inflation, will resist the removal of this mention, in our view. They may also plead for **more patience** until one gets more wage data, including from the January payrolls, to be released after the Fed meeting (on 2 February). Average hourly earnings rose a still-subdued 2.5% y-o-y in December, whereas the Fed’s wage comfort zone is 3.0-3.5%.

### Paving the way for a higher 2018 growth forecast

We do not think the Fed will go for a full hawkish surprise just now, for at least two reasons. First, there is a strong desire to achieve a ‘smooth’ transition to Jerome Powell from Janet Yellen, for whom the January 30-31 meeting will be the last meeting as Fed chair. Second, the March rate hike is already well priced in markets, so there is **no need to arm twist the market too much at this stage** (according to Bloomberg WIRP, the March rate hike is priced in with 88% probability).

The Fed can still adjust its communication at its March meeting, if need be. The March meeting would probably be a more appropriate occasion for this given the press conference scheduled afterwards, when the Fed could clarify any change in rhetoric (and also, for instance, discuss its new growth forecasts).

**Chart 2: Core inflation measures (core CPI and core PCE), % y-o-y**



Source: Pictet WM – AA&MR, Bureau of Economic Analysis.

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In conclusion, we think the moderate hawkish tilts to the 31 January statement could pave the way not only for the priced-in rate hike at the March meeting, but also – and more importantly – for an **upgrade in the Fed's 2018 growth forecast** (the December forecast of 2.5% y-o-y looks too low and is likely to be upgraded by at least 0.3 percentage point). The March meeting could also see a move up in the Fed members' **2018 dot plot from three to four rate hikes**.

## No change in long-term Fed strategy

Although analysts will focus on the statement, the major discussion among Fed members at the 30-31 January meeting will be the update of the annual statement on monetary-policy strategy, for this is when the Fed revisits formally its *de facto* flexible inflation targeting regime.

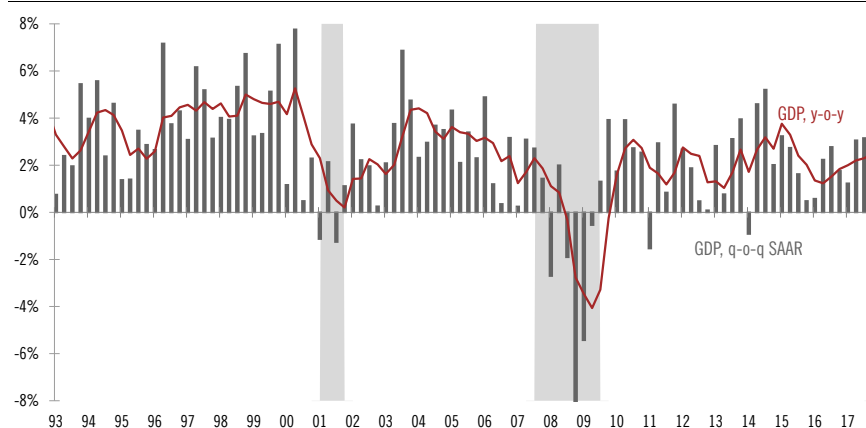
Several Fed officials have raised the question about whether it was time to update the current framework. Some have suggested a move towards nominal GDP targeting, others towards price level targeting. But this is mostly **open-air brainstorming right now**, and the current inflation targeting regime (focused on PCE inflation) is **unlikely to change**. Another reason we see little change in the Fed's policy framework is that Powell probably wants to study the question further. This will take time, especially as there are also **no obvious alternatives to the current regime**.

The minutes of the meeting (released on 21 February) will give crucial clues in this regard.

## Our Fed rate hike scenario: Four rate hikes this year

We have recently changed our Fed scenario, taking into account an **improved US growth outlook** – driven by investment – and recent more hawkish Fed rhetoric. We forecast four 25bps rate hikes this year (in March, June, September and December) and two rate hikes next year (March, June). We think the Fed's dot plot will converge towards our view at the March meeting, when new Fed member projections will be released.

**Chart 3: US GDP growth, % q-o-q SAAR (and y-o-y)**



Source: Pictet WM – AA&MR, Bureau of Economic Analysis.