

Flash Note

March Fed review – Mr. Middle Ground

Chair Powell validates Yellen rate-hiking pace of one per quarter

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The Federal Reserve raised rates as expected by 25bps, bringing the interest rate on excess reserves to 1.75%.

The underlying tone was slightly hawkish, especially due to stronger confidence in the growth outlook, in part due to the December tax cuts. Growth forecasts were revised up, so were the rate-hike forecasts (for 2019 and 2020).

Overall, Chair Powell left the impression he validated the 'routine' of one rate hike per quarter, as he sees it as a good middle ground between a strong labour market but a more subdued inflation picture.

Powell's press conference supports our view of four Fed rate hikes this year and two more next year, especially as there is no sign of a growth slowdown. But US trade policy's rhetoric needs to be scrutinised.

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On 21 March, the Federal Reserve hiked rates by one quarter point, as widely expected, nudging the interest rate on excess reserves (IOER) to 1.75%.

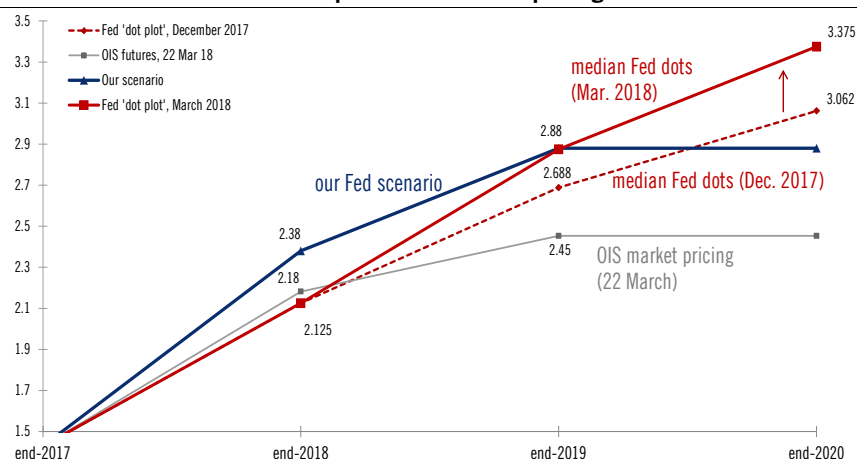
Chair Jerome Powell's press conference and the accompanying material – in particular the forecasts for future rate hikes (the 'dots') – revealed a slightly hawkish tone, mostly due to policymakers' increased confidence in the growth outlook. Powell in particular highlighted the likely boost from tax cuts and fiscal easing, as well as the improved global growth picture, and the still-accommodative financial market conditions.

By contrast, while Powell mentioned there had been a discussion about the more forceful trade policy from the Trump White House, he hinted that it was premature in affecting policymakers' outlook.

While giving no precise hints about the timing of the next rate hike, it was clear that Powell favours keeping the now engrained routine of one rate hike per quarter. What prevents a faster rate hike path is the ongoing fragility in productivity, and the still-loose relationship between the economy's reduced slack and inflation.

We see no reason to change our Fed scenario that sees three additional rate hikes this year and two more in 2019. The next hike should therefore occur in June, especially as growth data should remain solid (but one needs to be watchful of Trump's trade actions and rhetoric).

Chart 1: The Fed's December dot plot versus market pricing and our own forecast



Source: Pictet WM – AA&MR, Federal Reserve (pricing as of 22 March 2018)

Fed meeting in detail: dots crept up, echoing higher growth

The key highlight of the March Fed meeting was policymakers' **increased optimism in the growth outlook**, which reverberated in their forecasts for future rate hikes.

Even if the median dot for 2018 still showed three rate hikes expected for 2018 as a whole, mathematically it was **very close to show four hikes** (eight policymakers eyeing a rate of 2.125% or below by year-end, and 7 eyeing 2.375% and above). In fact, the average was 2.19%.

Had Trump's nominee for a Fed Board seat, Marvin Goodfriend, been confirmed in the Senate, the 2018 dot number would have probably moved up to four. (Goodfriend's confirmation process seems to have stalled, with no fixed date for the vote. There are only three Governors confirmed out of seven available seats and still no Fed Vice Chair).

The 2019 and 2020 median dots did move up: from 2.688% to 2.875% for end-2019, and from 3.062 to 3.375% for end-2020.

But the Fed policymakers' increased optimism was not reflected in the inflation forecasts. Powell even admitted that the Phillips curve (linking a strong labour market to stronger wages and inflation) was "flat", and that the relationship between the economy's reduced slack and inflation had become "less tight" over time.

This year's core PCE inflation was unchanged at 1.9%, although the 2019 and 2020 forecasts were bumped up slightly, both by 0.1pt to 2.1% (see *Chart 3*).

Meanwhile, Powell was keen to underline his "middle ground" approach to normalising monetary policy and, reading between the lines, his satisfaction with the current pace of one rate hike per quarter.

Chart 2: Fed's median growth forecasts

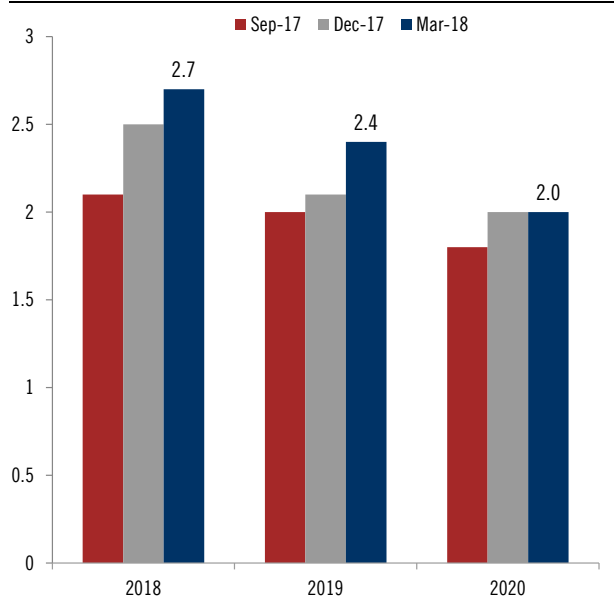
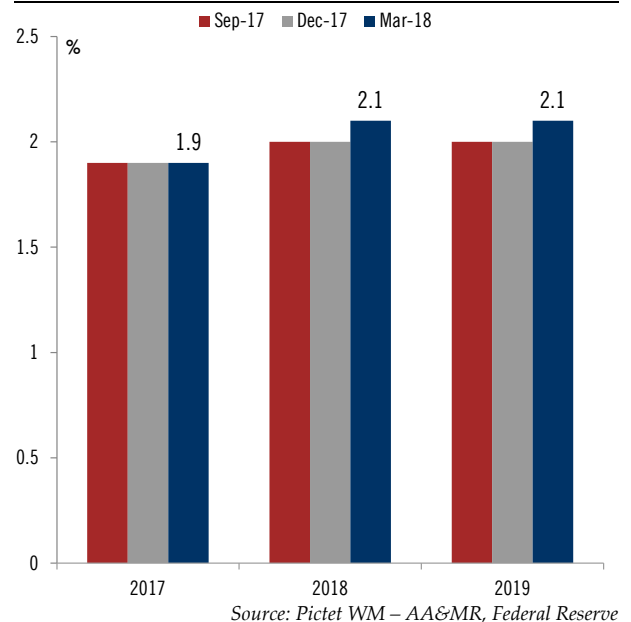
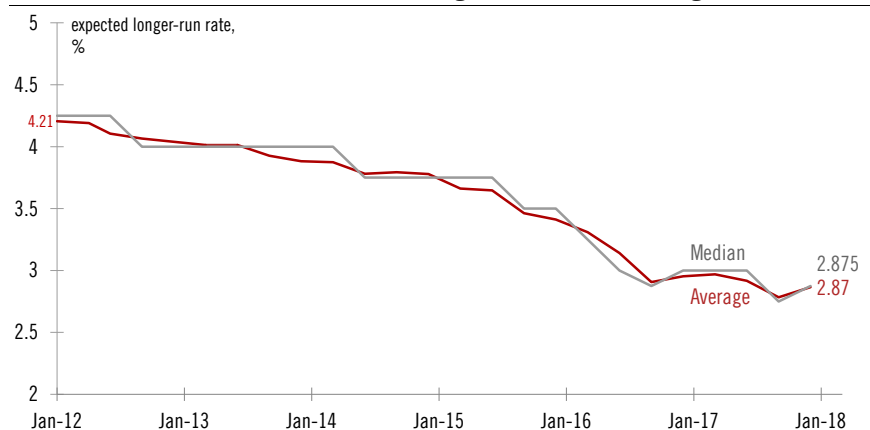


Chart 3: Fed's median core PCE inflation forecasts



Echoing Yellen's talking points about medium-term headwinds, Powell showed a similar anxiety about medium-term drags on US growth – namely, the still uneven labour force participation and low productivity – which somewhat offset his stronger optimism in the near-term growth picture. This balance between positive cyclical and less positive structural forces remains the backbone of the current (very) gradual rate-normalisation.

Chart 4: Evolution of the median (and average) forecast for the longer-run Fed rate



Source: Pictet WM – AA&MR, Federal Reserve.

From a style perspective, however, Powell did show some subtle changes from his predecessor, including more pragmatism and less reliance on formal economic models. He admitted candidly that forecasts of the tax cuts' impact were all over the place, so he would reserve judgement as more data comes in. Still, he "hoped" the impact would be large.

Powell is also less willing to delve into politically sensitive topics. For instance, he craftily avoided the question of the impact of Trump's trade tariffs, just as he did with the question of evaluating the tax cuts during his February congressional testimony. "Too early to tell" seems to be Powell's common response.

Our view: Still expecting four rate hikes this year, two in 2019

The Fed has entered a *de facto* routine of one rate hike per quarter and this routine was confirmed by Powell. Another rate hike of 25bps in June is therefore very likely, especially as the growth outlook appears solid in the near term.

Powell seems to see in one hike/quarter a good balance between the ongoing need to keep moving rates up 'pre-emptively' as the labour market approaches full employment (and in fact, is beyond full employment in the Fed's forecasts) while at the same time the inflation picture remains subdued. Powell hammered on that he continues to see no sign of sudden inflation pickup; as long as that is the case, it is very unlikely that the routine will change.

Another consideration is that Powell's well crafted, precise and careful communication shows much deference to how financial markets are sensitive to the Fed's message and delivery – keeping to a routine is therefore helpful in that regard. Powell seems fearful of upsetting the apple cart. He was already at the Fed during the QE taper tantrum that led to skyrocketing long-term rates, and that probably marked him. Powell hinted he would not add additional press conferences for fears the market takes it as a signal there are more rate hikes in the pipeline.

Another autopilot is the QE assets' partial runoff decided under Yellen, which looks very unlikely to be changed unless economic conditions alter drastically.

Chart 5: Fed funds rate and 2Y US note yield, since 1990

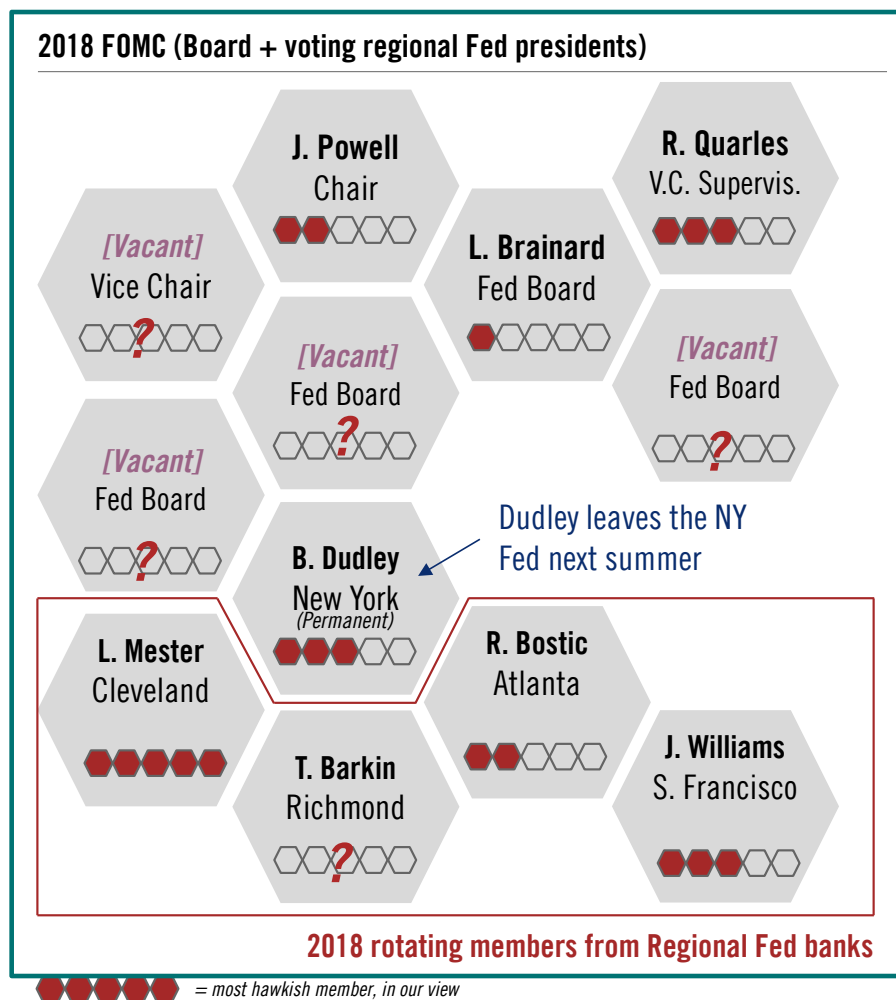


Source: Pictet WM – AA&MR, Federal Reserve.

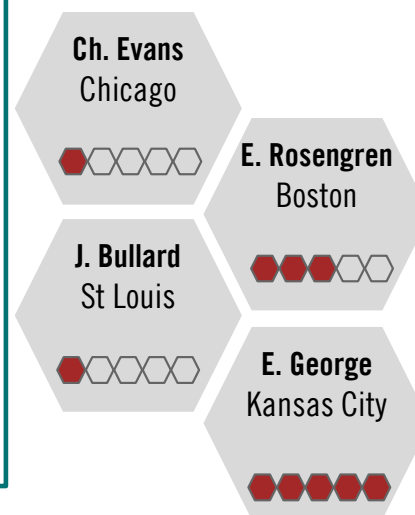
A key upside risk to our Fed scenario of four rate hikes this year would be **much stronger inflation**, coupled with stronger wage growth and a drifting higher of inflation expectations.

A crucial downside risk would be the negative effect that **escalating trade rhetoric** could have on business confidence. This year is supposed to be all about **rising corporate investment**, which we believe will be the main factor supporting to our 3% annual growth forecast for the US. So far, business surveys suggest we are on track for that level of growth but additional uncertainty related to **US trade policy** – particularly towards China – could **upset the apple cart**.

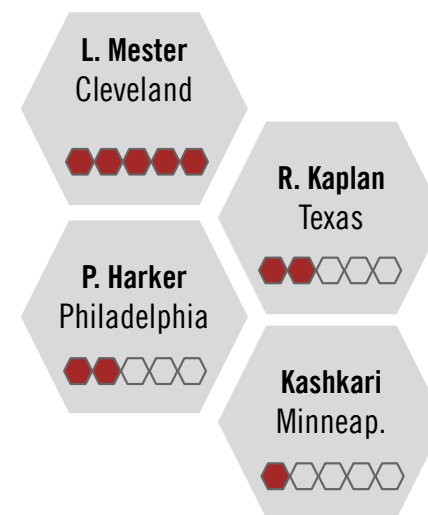
2018 FOMC (and our hawk-dove scale)



Rotating members, 2019

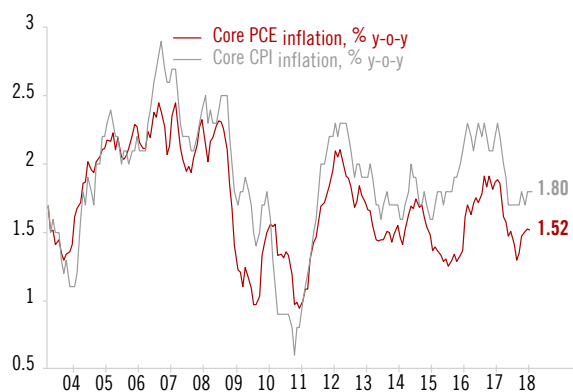


Rotating members, 2020



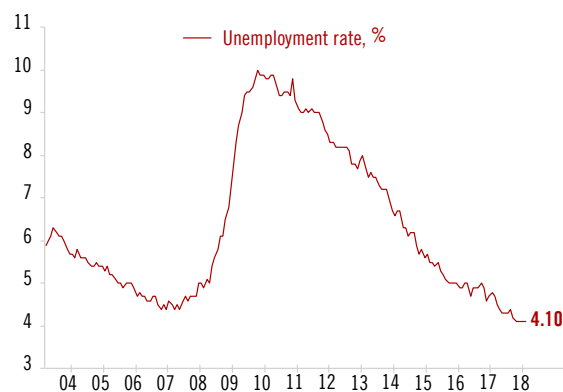
Federal Reserve dashboard

Core inflation (PCE and CPI), % y-o-y



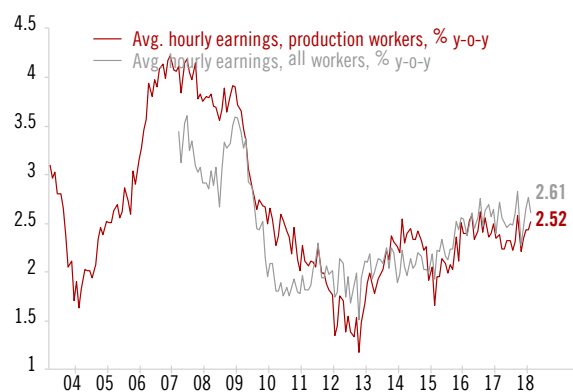
Source: Pictet WM – AA&MR, Factset

Unemployment rate, %



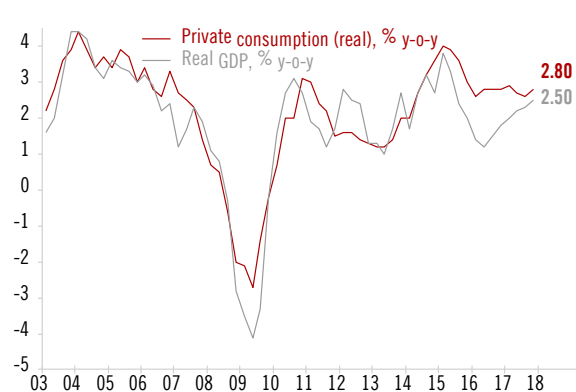
Source: Pictet WM – AA&MR, Factset

Average hourly earnings, % y-o-y



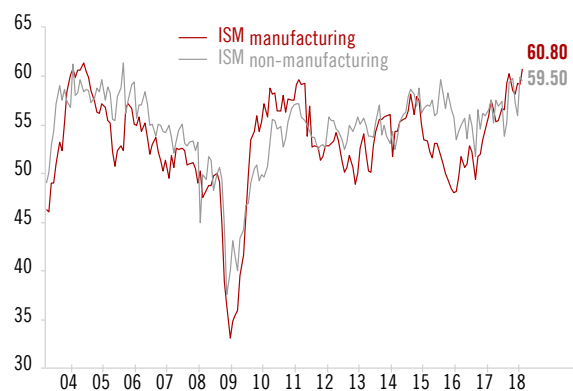
Source: Pictet WM – AA&MR, Factset

Real GDP and consumption growth, % y-o-y



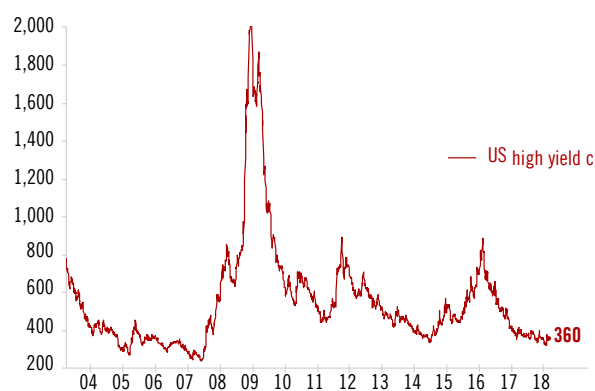
Source: Pictet WM – AA&MR, Factset

ISM business surveys



Source: Pictet WM – AA&MR, Factset

High-yield corporate bond spread, basis points



Source: Pictet WM – AA&MR, Factset

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