08 December 2017

FOMC preview

Third hike and unchanged dot signals

- **We expect the Fed to hike the target range to 1.25-1.50% at next week's meeting and to continue signalling three hikes in 2018 and 2019.**
- **The tax reform is moving closer, but we do not expect the Fed to change its overall strategy of waiting for its approval before taking it fully into account in the projections.**
- **Jerome Powell is going to stick to the current policy strategy but the FOMC will be less experienced next year, which may be a problem if the economy is hit by a shock.**
- **We expect the US yield curve to flatten further next year, as the short end is pushed up by Fed hikes and the long run is held down by (among other things) a low R-star.**
- **We see EUR/USD staying roughly within the 1.17-1.20 range ahead of year-end but still call for a higher EUR/USD next year.**

Fed is set to hike and keep dots unchanged

We expect the Fed to raise the Fed funds target range to 1.25-1.50% at next week's meeting, in line with market pricing and other analysts. As a rate hike is fully priced in, it is by itself not a market mover and focus is on the updated projections and Janet Yellen's press conference for more information about the director for next year.

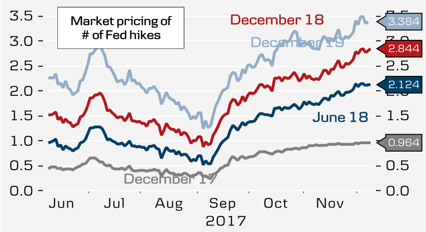
Right now, it seems like the Fed is on autopilot although it has become slightly more concerned about the persistent low inflation. Hence, **we do not expect any major changes to the 'dots' for next year, which are likely to continue signalling three hikes.** We also believe the 2019 median dot to be unchanged at three additional hikes although this is more uncertain. Usually, the market reaction to changes to dots further out is more limited than changes to the near term. The projections for inflation, growth and unemployment are usually less important, which we expect to be broadly unchanged, except for unemployment, which will be revised down, as the current rate of 4.1% is what the FOMC thought would be the level by year-end 2018. We may see a further decline in the Fed's NAIRU estimate, which is currently 4.6%.

Another question for next year is whether we will see further downward revisions to the longer-run dot (which is the Fed's median estimate of the natural rate). Yellen has indicated she believes monetary policy is not far from being neutral at the moment and that further hikes are dependent on an increase in the natural rate driven by higher trend growth. As we are not many hikes away from the current level of the longer-run dot of 2.75%, the theme about the end of the Fed's hiking cycle becomes increasingly important. Right now, the markets are buying into the idea of further hikes next year (now almost two hikes are priced in) but markets expect the hiking cycle to end earlier than the Fed indicates currently.

Recent US research

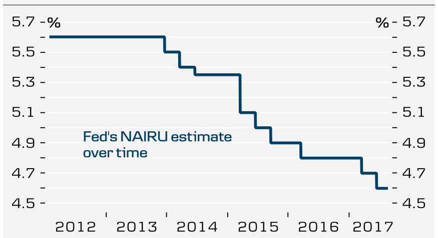
FOMC minutes: Core members still want to hike in December

Markets have priced in nearly two further hikes next year after a December hike



Source: Federal Reserve, Bloomberg, Danske Bank, Macrobond Financial

Fed has lowered its NAIRU estimate several times



Source: Federal Reserve, Macrobond Financial

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Also, the Fed's view on the tax reform may attract attention. So far, the Fed's strategy has been to wait for the tax reform to pass Congress before taking it into account (although a few FOMC members have already) but Fed Chair Yellen is likely to be asked about it at the ensuing press conference.

Powell to stick to current policy strategy near term

In terms of the dots, it is of course important to stress that **uncertainty about monetary policy next year is higher than usual as the Fed will undergo big changes in terms of voting FOMC members**. In our view, Fed Chair nominee Powell's approval in the Senate will be 'plain sailing' but there are still four empty seats in the Board of Governors (Trump has nominated one more, Marvin Goodfriend, just recently). Also, voting rights among regional Fed presidents will change in the New Year.

Powell will most likely stick to the Fed's existing tightening strategy by continuing the gradual hiking cycle. Therefore, short term, the chances are that the Fed will be governed much like under Yellen. What will be more interesting will be how Powell will react should the economy or financial markets be hit by a shock in either direction. Powell is less qualified than Yellen (in terms of academic credentials) and the Fed will be less experienced (Yellen, Tarullo and Fischer had a lot of experience. For more information on Fed composition, see *FX Edge – inexperienced Fed to be a drag on USD*, 30 November).

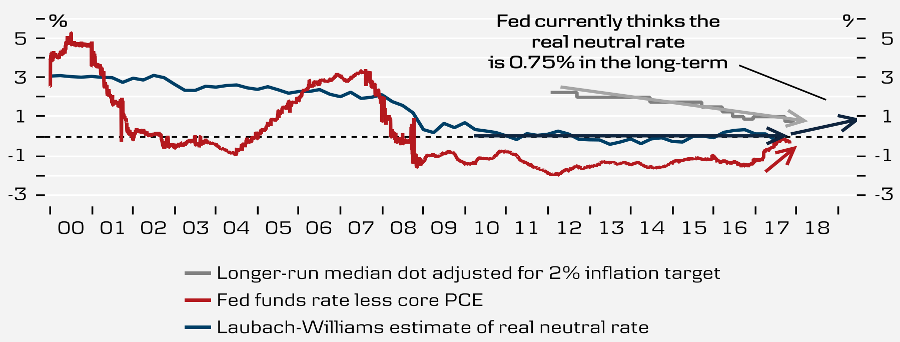
We expect the US yield curve to flatten further

In the fixed income market, the big market theme this year has been the continued flattening of the US yield curve, where for example the 2Y10Y Treasury-curve has flattened more than 70bp in 2017 despite the Fed hiking 'three times' after the December meeting. We argue that two of the reasons have been the consistent focus on R-star and the downward revisions to longer-run dots. If we see the dots unchanged for 2018/19 and a further downward revision to the longer-run dot, we would expect the flattening to accelerate. We are positioned for a 2Y10Y 1Y forward flattener in our *Danske Bank 2018 FI Top Trades*, 6 December. See also *FI Strategy: 'Bond yield conundrum vol. 2*, 30 November.

December hike will not move USD much

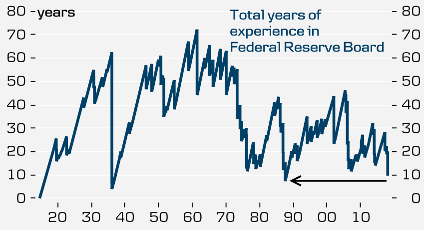
We do not think the Fed will move the USD much with the December hike, albeit the knee-jerk reaction could be for a slightly lower EUR/USD if the dots remain unchanged. We see EUR/USD staying roughly within the 1.17-1.20 range ahead of year-end. The Fed's balance sheet reduction (aka tighter USD liquidity) and/or a positive surprise on the US tax reform could drag the cross slightly lower in Q1, but for 2018 as a whole, we stress that any USD support from Fed hikes will be likely to be dominated by other (EUR-positive) factors. See *FX Top Trades 2018*, 6 December.

Monetary policy close to being neutral and we are not many hikes away from having reached the Fed's estimate of the natural rate



Note: Fed's long-term projection of 0.75% is calculated as: Longer-run dot (2.75%) minus 2% inflation = 0.75%
Source: Federal Reserve, Laubach-Williams, Macrobond Financial data

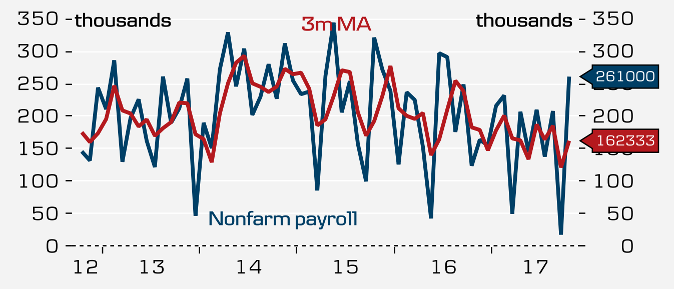
Fed will be less experienced next year



Source: Federal Reserve, Danske Bank calculations, Macrobond Financial

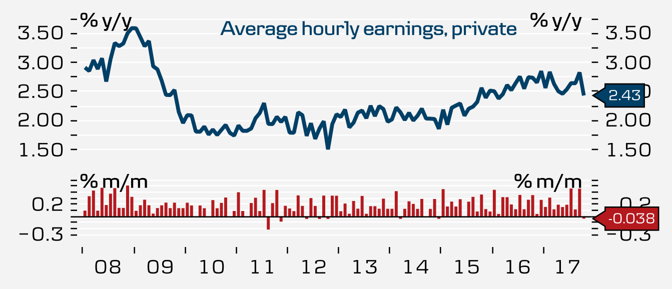
Charts

Employment growth has rebounded after negative impact of hurricanes



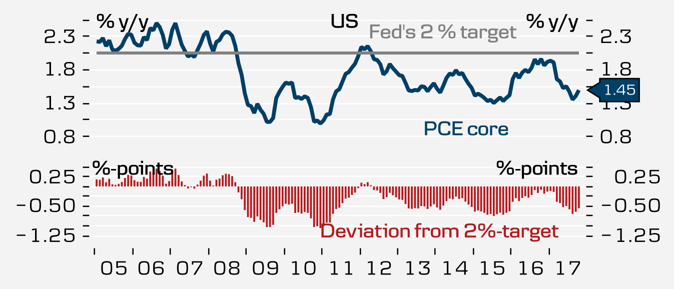
Source: BLS, Macrobond Financial

Wage growth remains subdued



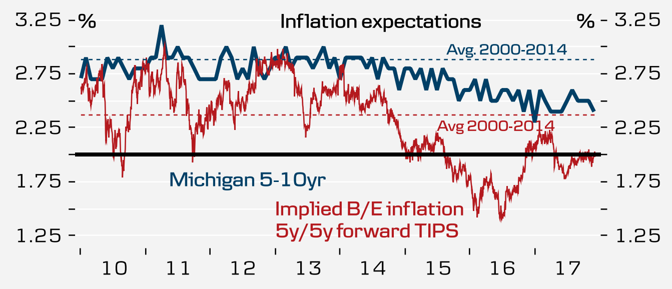
Source: BLS, Macrobond Financial

Core inflation still below 2% target



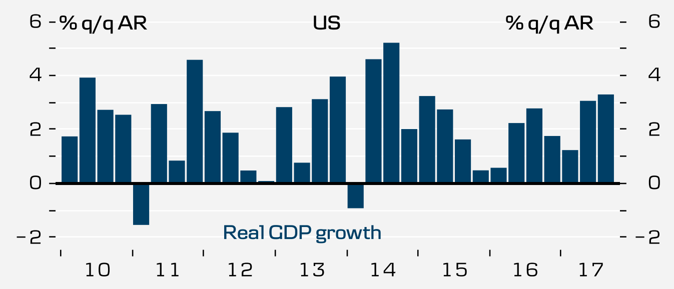
Source: BEA, Macrobond Financial

Inflation expectations are low



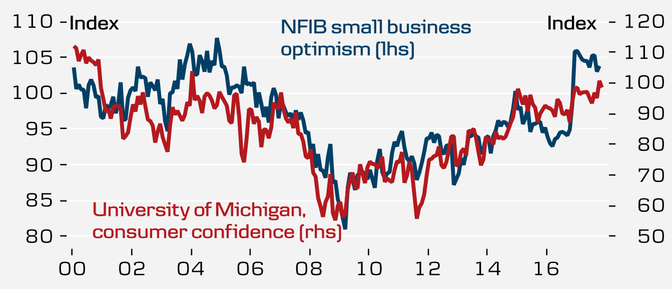
Source: Michigan, Bloomberg, Macrobond Financial

GDP growth has picked up, as investments have rebounded



Source: BEA, Macrobond Financial

Very high optimism suggests the expansion continues



Source: NFIB, University of Michigan, Macrobond Financial

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None.

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