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# *FOMC Preview*

## *Fed set to hike – focus on outlook for 2017*

**Senior Analyst**
Mikael Olai Milhøj
+45 45 12 76 07
milh@danskebank.com

**9 December 2016**

Investment Research

www.danskemarketsequities.com

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# *Fed about to raise rates for the second time*

- In line with consensus, **we expect the Fed to raise the Fed funds target range 25bp to 0.50%-0.75% from the current 0.25%-0.50% at the FOMC meeting next week**, as economic data have improved, the labour market is tightening and financial markets are calm. **Markets have fully priced in such a rise.**

- Since everyone expects a Fed rate rise, the most interesting question is how many hikes to expect next year from the Fed. **We expect the median 'dots' to stay unchanged, signalling two hikes in 2017 and three in 2018**, as many FOMC members have said that they want to analyse Trump's actual economic plans before taking action. Also we think the FOMC members will be reluctant to raise the 'dots' prematurely, as they had to revise them down several times this year.

- For the same reason, we do not expect major changes to the growth, core inflation or unemployment forecasts (the markets also tend to focus less on them). That said, one thing to look for is whether the Fed revises down its NAIRU estimate from the current 4.8%, as the unemployment rate is currently 4.6% but wage growth is still subdued (although it is trending up).

- **We see a chance that the longer-run median 'dot' will be revised down to 2.75% from 2.88% currently**, as it needs only one FOMC member currently indicating an end rate of 3.00% to revise it down for the longer-run median 'dot' to be revised down as well.

- **It is important to remember that the Fed turns more dovish next year due to shifting voting rights** as Loretta Mester, Esther George and Eric Rosengren lose their voting rights. Thus the median 'dot' for next year may actually overestimate the median 'dot' among voting FOMC members.

- There are two vacant seats on the board right now. As President-elect Trump has criticised the low interest rate policy, it indicates he will nominate two hawks, although it is still unclear what he will do in practice, since a too hawkish Fed will hurt his plan to boost growth. **That said, even if Trump nominates two hawks, it is not enough to tilt power to the hawks in 2017.**

# *We expect Fed to hike twice a year in 2017 and 2018*

- We **think it is interesting that in her latest speech Fed Chair Janet Yellen talked about letting the economy run hot** to undo some of the damage to the economy caused by the financial crisis. So, it could be that the Fed wants to let inflation overshoot the inflation target. The Fed is also struggling with credibility, as it has failed to hit the 2% target since 2008 (except for five months).

- **We expect the Fed to hike twice a year, i.e. a total of five rate rises from now until year-end 2018 (including the likely hike next week)** as the doves will only partly offset the expected fiscal boost from Donald Trump in order to let inflation overshoot the 2% target. **To be specific, we expect the Fed to hike in June and December next year.**

- It seems that the markets have bought into the same story, as we have seen a significant repricing of the Fed since the US election. **Markets now price in close to four and a half hikes from now until year-end 2018** against only two hikes before the US election.

- We think the three most important triggers for Fed hikes next year are (see also table on the next page):

1. Higher wage growth to ensure a sustained increase in core inflation
2. Lower unemployment rate (absorbing remaining labour market slack)
3. Higher actual PCE (personal consumption expenditures) core inflation

- **As markets seem fairly priced right now, we do not expect major changes to the Fed pricing**. If anything, we could see a small disappointment, if the Fed (as we anticipate) does not revise up its median 'dots', which could be seen as a dovish hike. That said, there is still room for the markets to price in more Fed hikes, so we expect any eventual rally in the fixed income market to be short-lived and yields to move higher in 3M. We still expect US 10yr yields to reach 3% in 12M. 30Y yields on the other hand are already at 3.12% above the Fed neutral rate and we see scope for a flatter 10Y30Y curve in 2017. See also Yield Forecast Update, 18 November.

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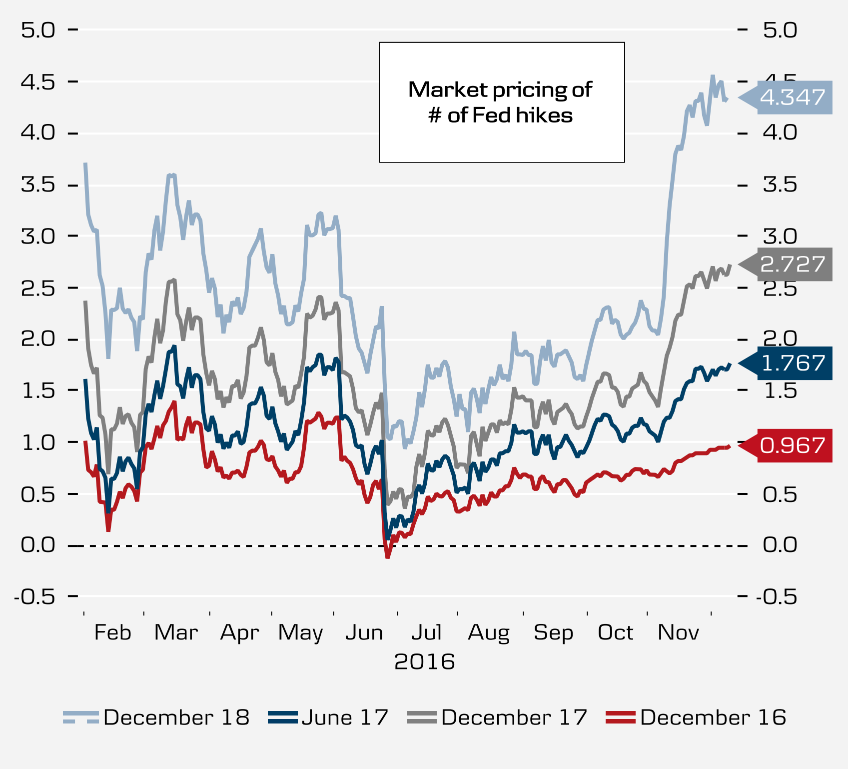
# What to look for next year

| | December hike | Triggers for Fed hikes in 2017 |
|---|---|---|
| **US growth** | √ Picked up in H2 16 after weak H1 16 | Growth to continue above trend |
| **Unemployment rate** | √ Has begun to fall again | Move lower, absorb remaining slack in labour market |
| **Wage growth** | √ Higher wage growth due to a tighter labour market | Wage growth needs to move higher to ensure a sustained increase in core inflation |
| **PCE core inflation** | √ Moved slightly higher this year | Still below 2% target, needs to move higher |
| **Inflation expectations** | √ Moved slightly higher | Still below historical average, higher expectations are very welcome |
| **Financial markets** | √ Calm markets; financial conditions have tightened in recent months but still not as tight as early 2016 | Financial markets to stay calm; financial conditions not allowed to tighten too much, too quickly |
| **Global economy** | √ Synchronised recovery signal across regions | Global recovery to continue; no major slowdown in China |

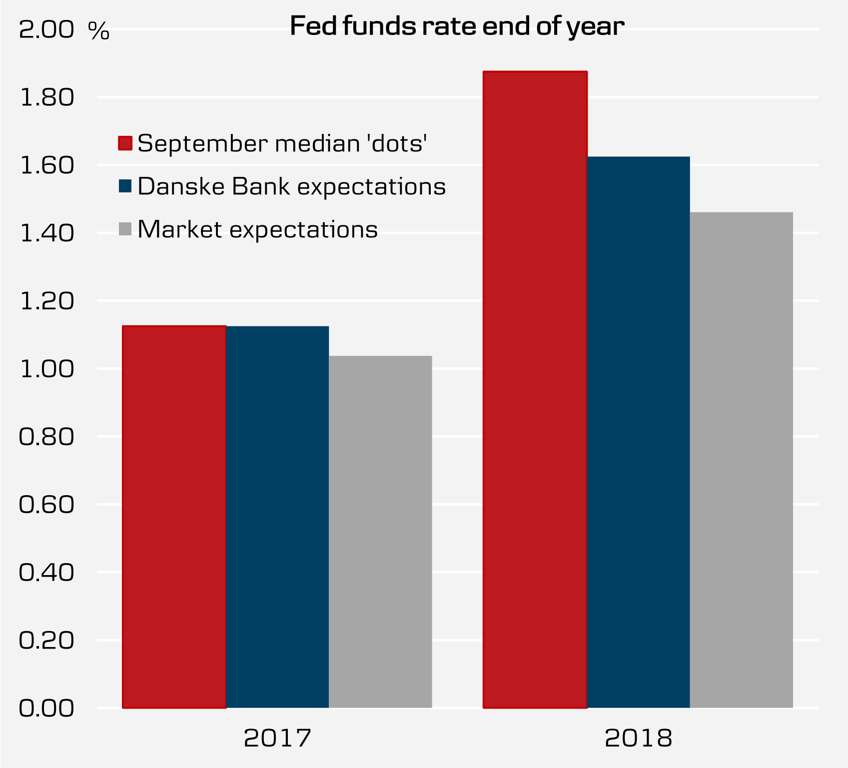
# Significant repricing of Fed since the US election

## Markets have priced 4.5 hikes before year-end 2018




*Source: Bloomberg, Federal Reserve*

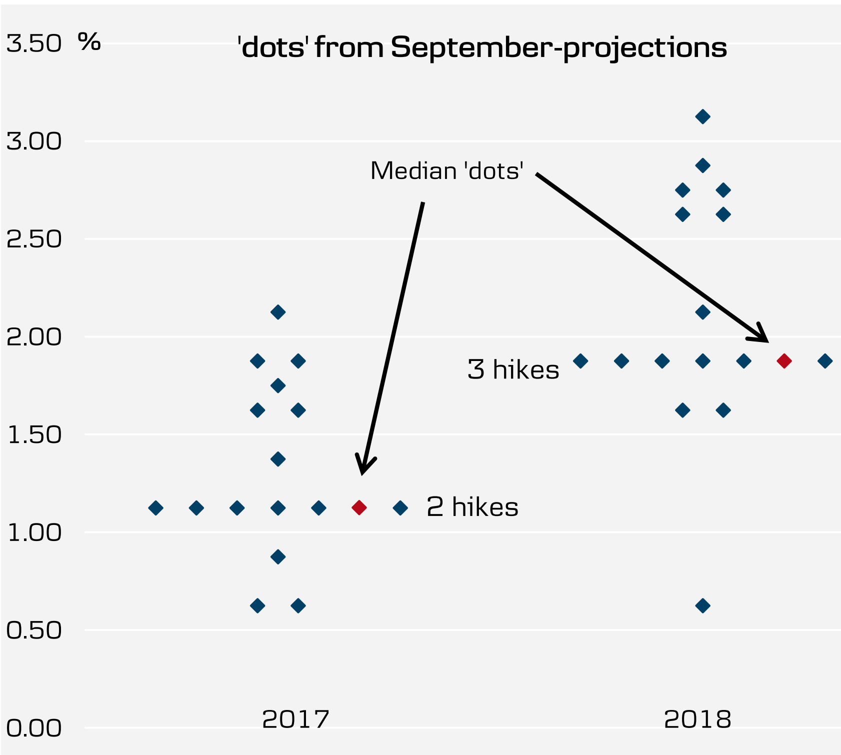
## Still room for slightly higher US rates




*Source: Bloomberg, Federal Reserve, Danske Bank*

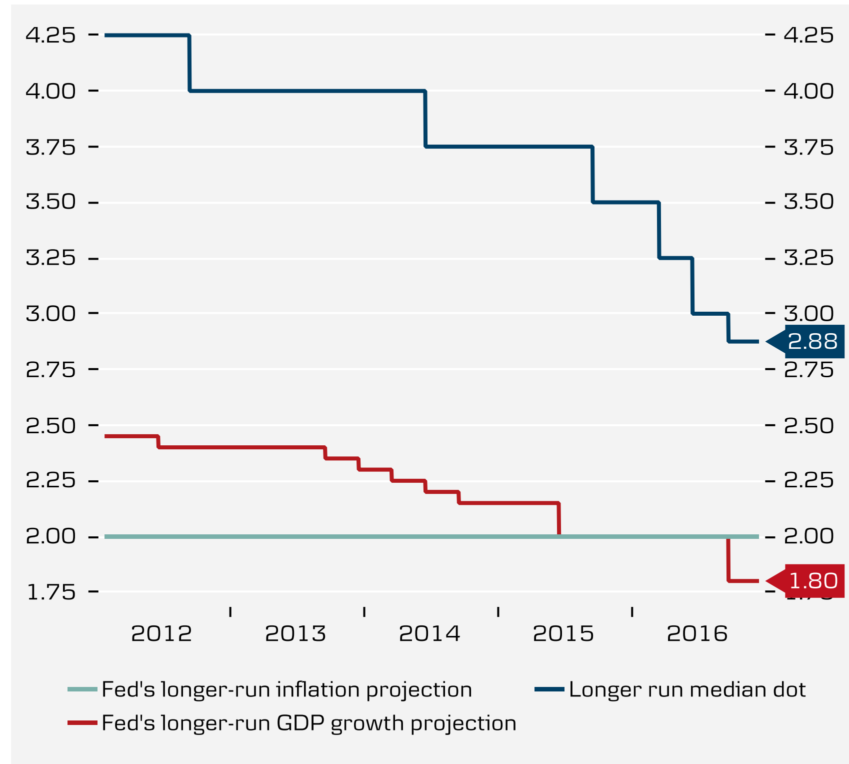
# We expect unchanged median 'dots' for 2017 and 2018 – longer-run 'dot' could be revised down slightly

September median 'dots'




*Source: Federal Reserve*

Neutral rate revised down from 4.25% to 2.88%




*Source: Bloomberg, Federal Reserve, Danske Bank*

# In our view, the Fed will turn more dovish next year due to shifting voting rights among regional Fed presidents

| | 2016 | 2017 | |
|---|---|---|---|
| Hawkish | Lacker | Lacker | *Richmond* |
| | George | George | *Kansas city* |
| | Mester | Mester | *Cleveland* |
| | Rosengren | Rosengren | *Boston* |
| | Harker | Harker | *Philadelphia* |
| Neutral | Lockhart | Lockhart | *Atlanta* |
| | Williams | Williams | *San Francisco* |
| | Powell (B) | Powell (B) | *Board* |
| | S. Fischer (B) | S. Fischer (B) | *Board, Vice chair* |
| Dovish | Kashkari | Kashkari | *Minneapolis* |
| | Kaplan | Kaplan | *Dallas* |
| | Yellen (B) | Yellen (B) | *Chairman* |
| | Tarullo (B) | Tarullo (B) | *Board* |
| | Evans | Evans | *Chicago* |
| | Dudley | Dudley | *New York* |
| | Bullard | Bullard | *St. Louis* |
| | Brainard (B) | Brainard (B) | *Board* |
| Vacant | Vacant (B) | Vacant (B) | *Board* |
| | Vacant (B) | Vacant (B) | *Board* |

Voting member (B) Board Member

Source: Danske Bank

# Fed leans towards letting the economy run a bit hot

*'The natural next question is to ask whether it might be possible to reverse these adverse supply-side effects by* ***temporarily running a "high-pressure economy,"*** *with robust aggregate demand and a tight labor market'*

*Fed Chairman, Janet Yellen, October 2016*

*'I see benefits to trying to engineer policy to allow for the strong possibility of* ***inflation overshooting*** *its target'*

*Charles Evans, October 2016*
*Chicago Federal Reserve*

*'Fed's 2% inflation target is* ***not a ceiling****'*

*William Dudley, November 2016*
*Fed Vice-chairman*

Source: Federal Reserve

# *Macro charts*

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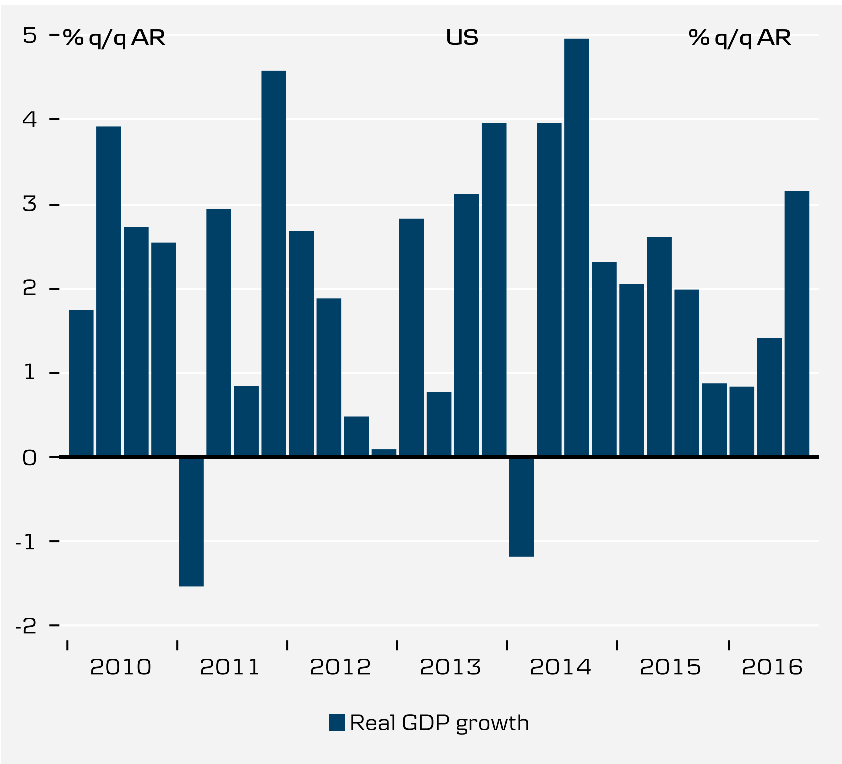
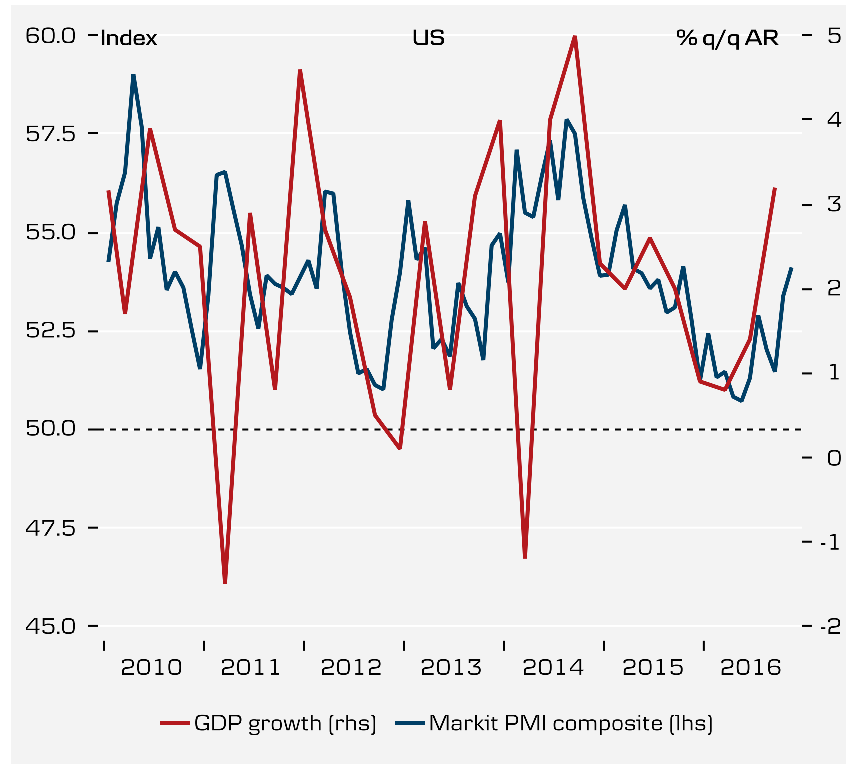
# Growth has rebounded after a slowdown in H1 16

GDP growth picked up in Q3 after three weak quarters




Source: BEA

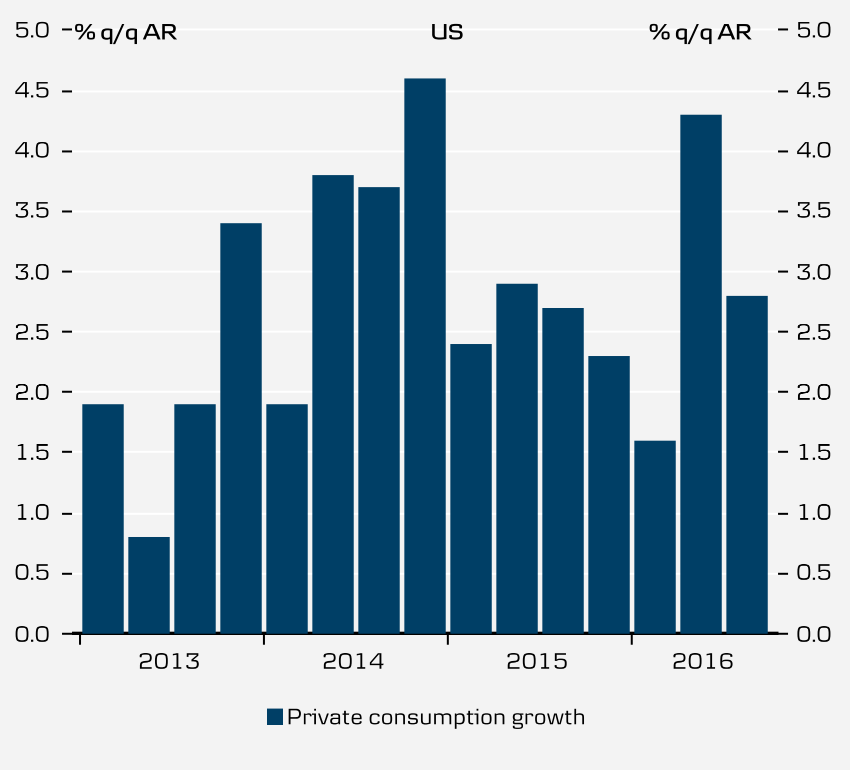
Growth has continued at an above trend pace in Q4




Source: BEA, Markit Economics, Danske Bank

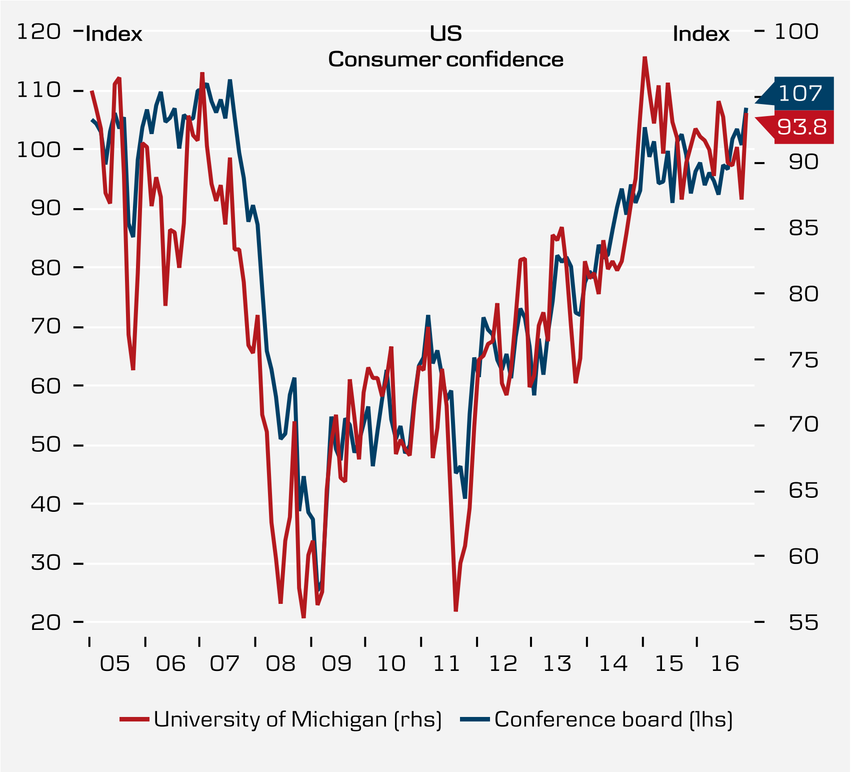
# Private consumption the main growth engine

## Solid private consumption growth




*Source: BEA*

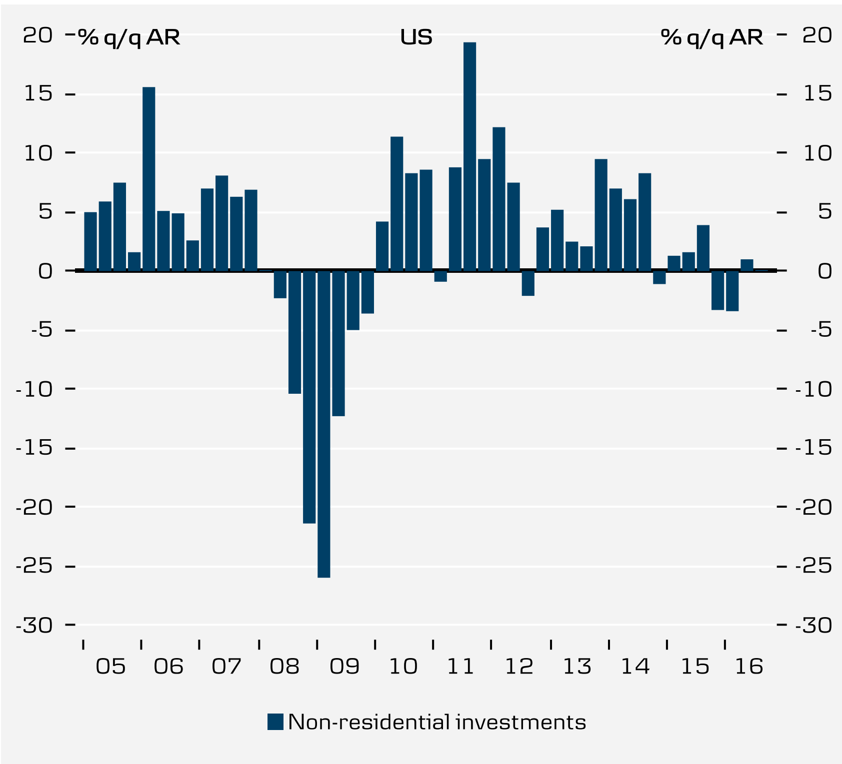
## Consumer confidence still high (around pre-crisis levels)




*Source: University of Michigan, Conference Board*

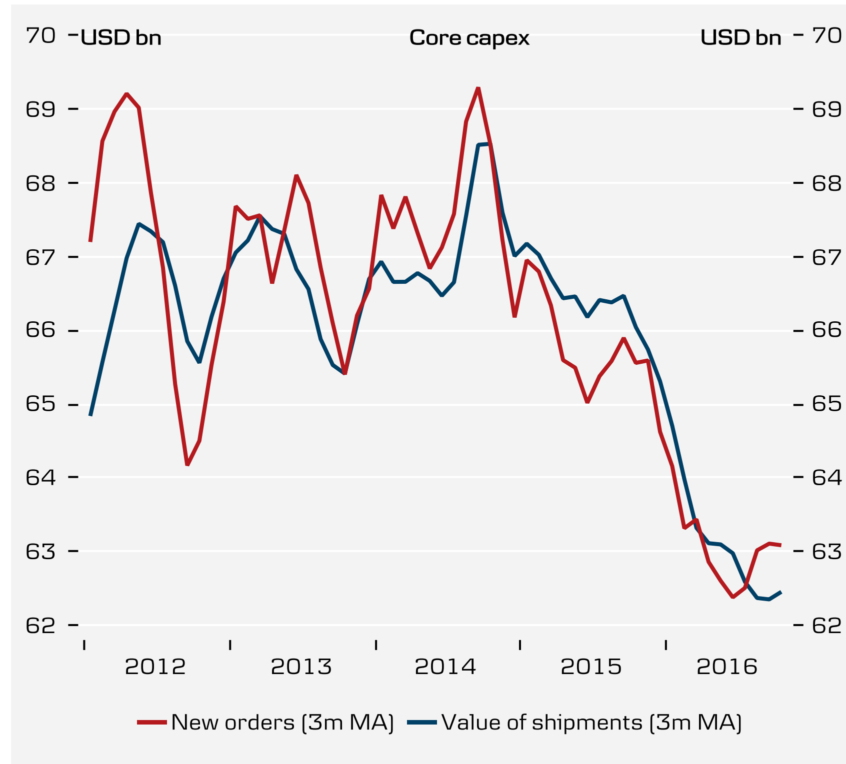
# Have investments bottomed out? We think so

## Non-residential investments have been weak




Source: BEA

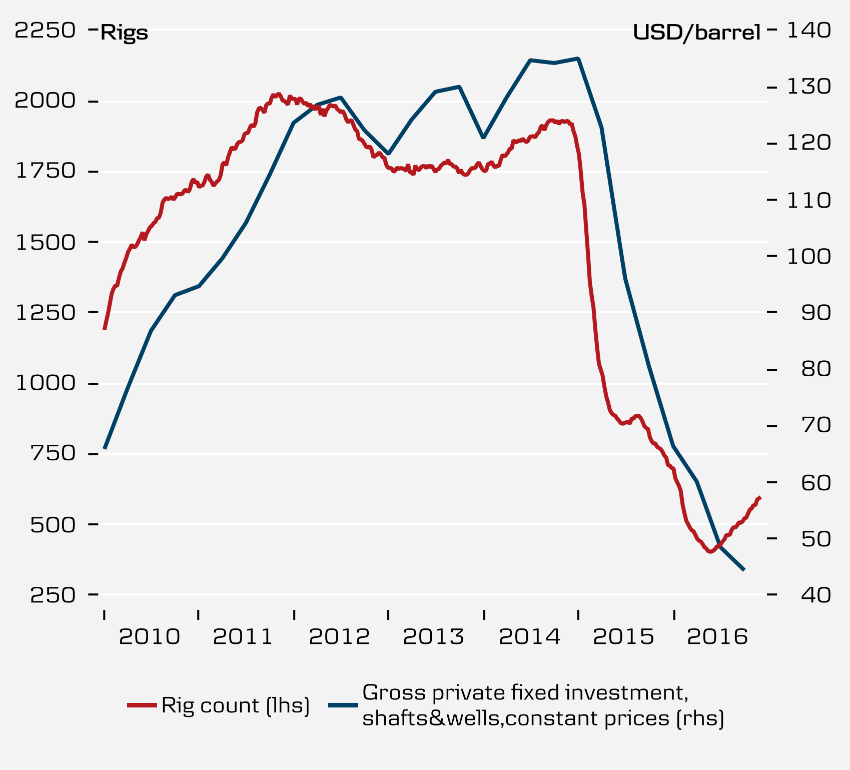
## New orders suggest increasing demand for core capex




Source: US Census Bureau

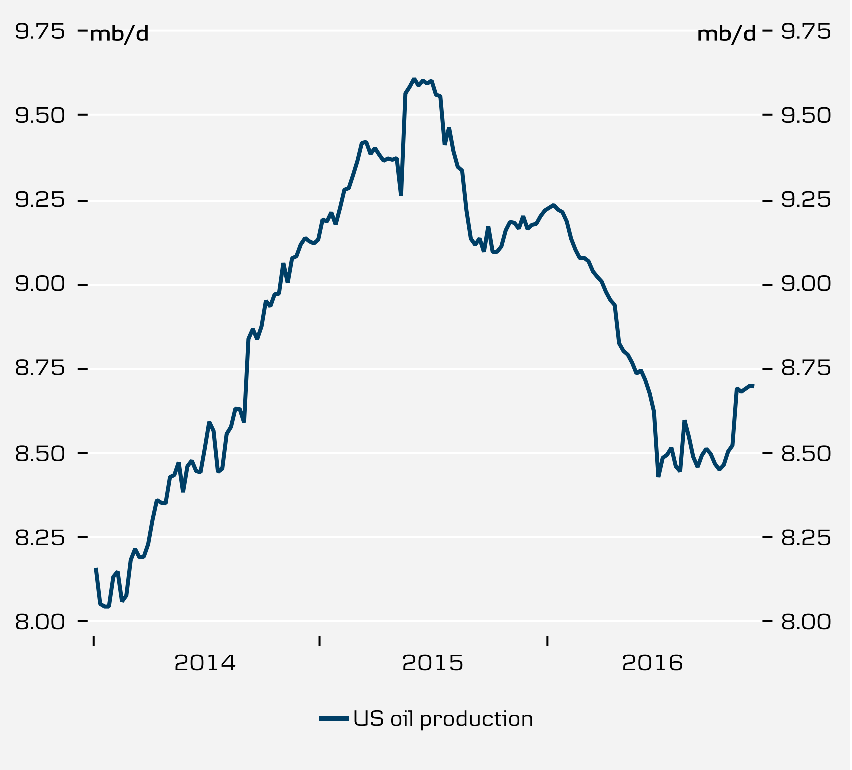
# Headwind from lower oil investments is fading

## Sharp fall in oil investments on the back of the lower oil price




*Source: BEA, Baker Hughes*

## US oil production has increased




*Source: EIA*

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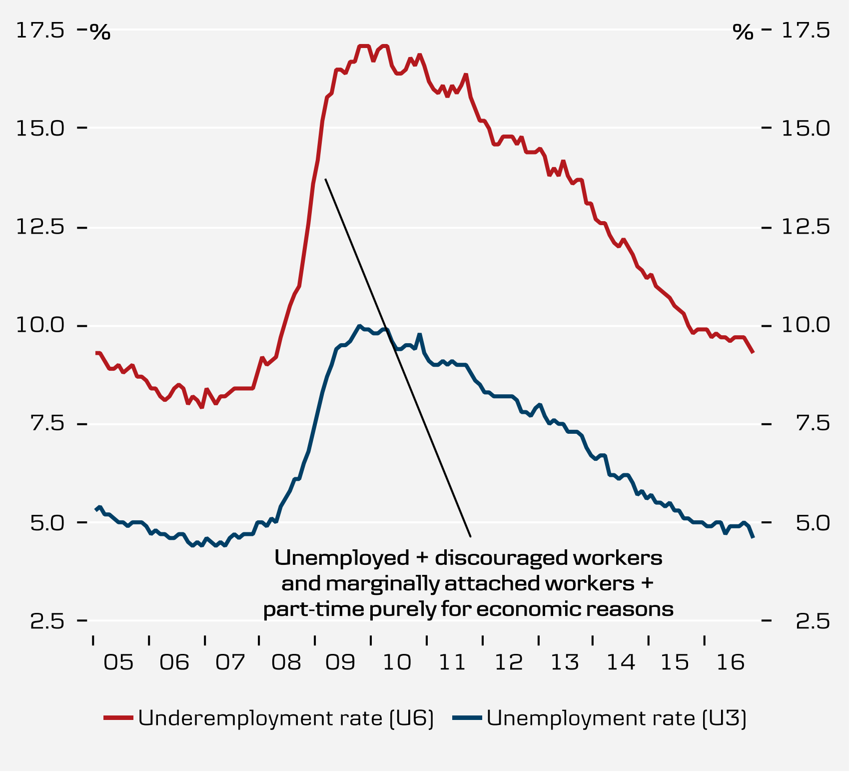
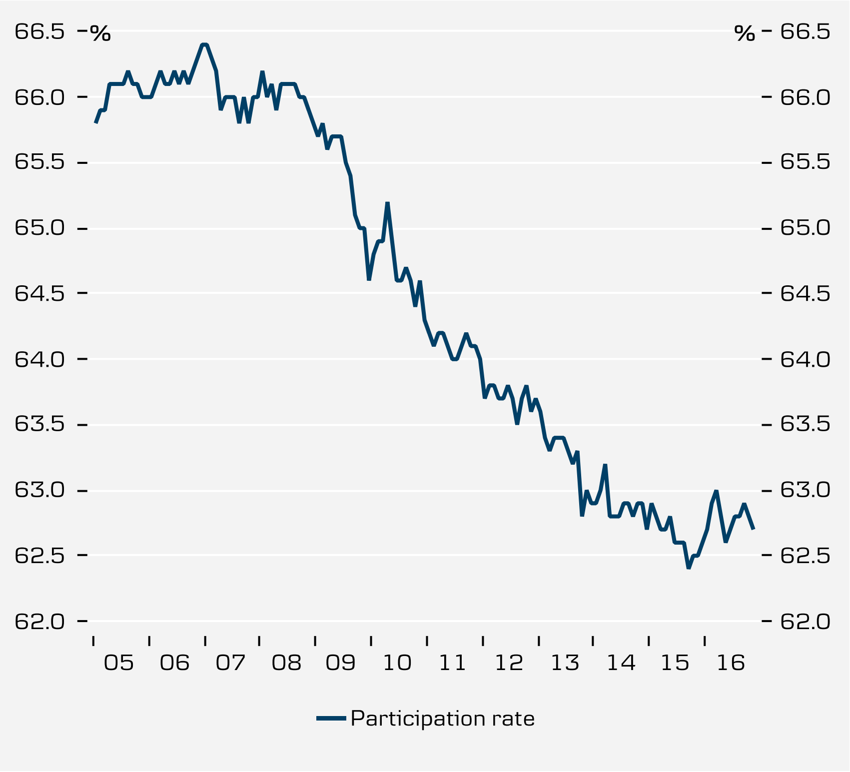
# Still a bit more slack left in the labour market

## Room for lower unemployment rates




*Source: BLS*

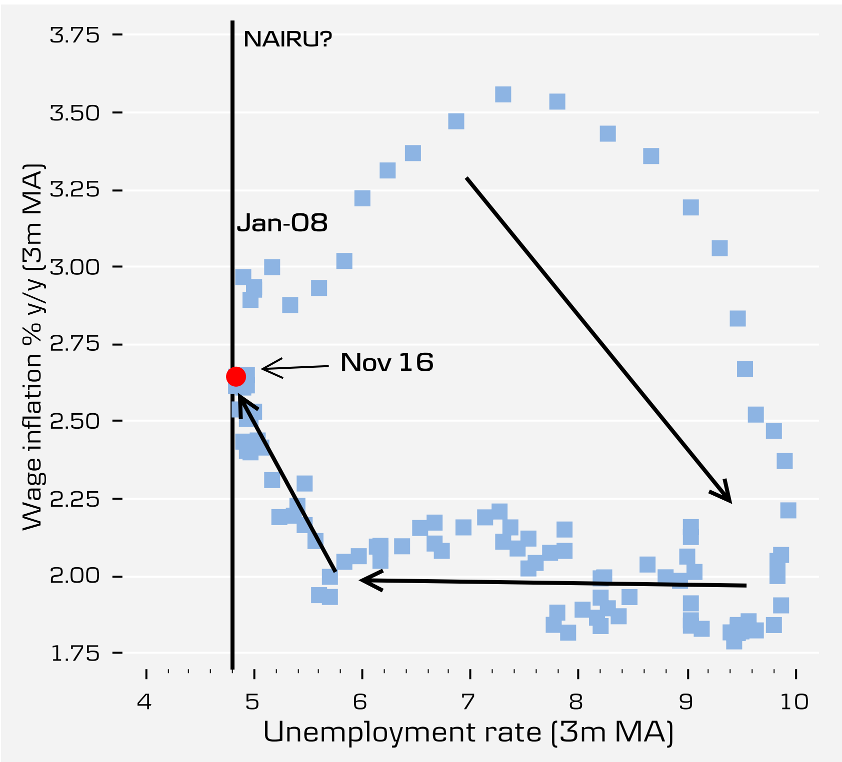
## Participation rate has increased slightly




*Source: BLS*

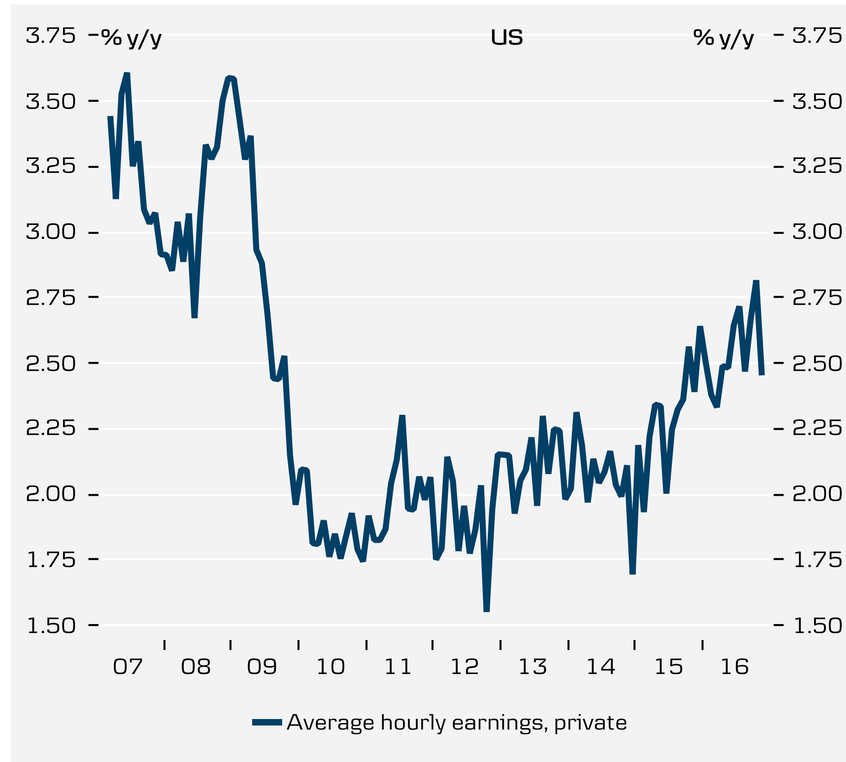
# Fed sees the world through the Phillips curve

## Tighter labour market => higher wage growth




*Source: BLS*

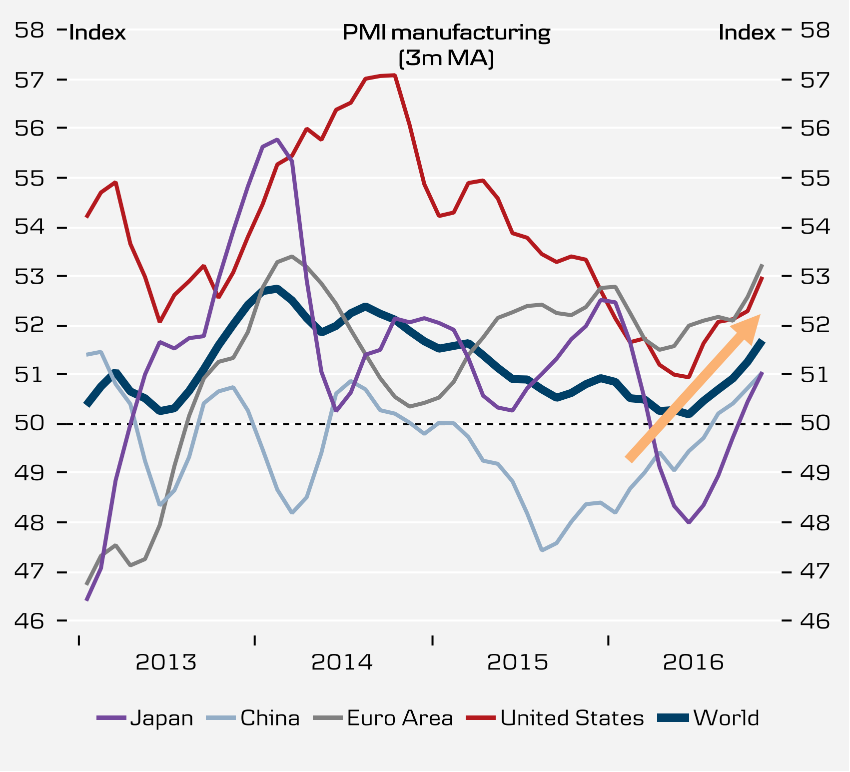
## Wage growth still needs to move even higher




*Source: BLS*

# Global business cycle has turned – synchronised recovery signal across regions

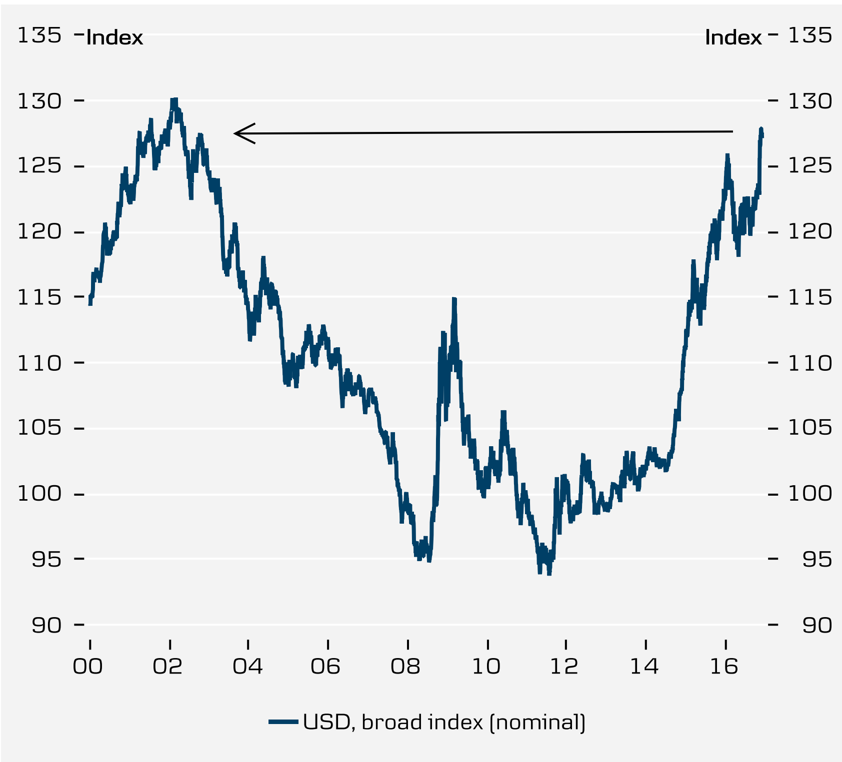
PMIs are trending up across countries




*Source: Markit Economics*

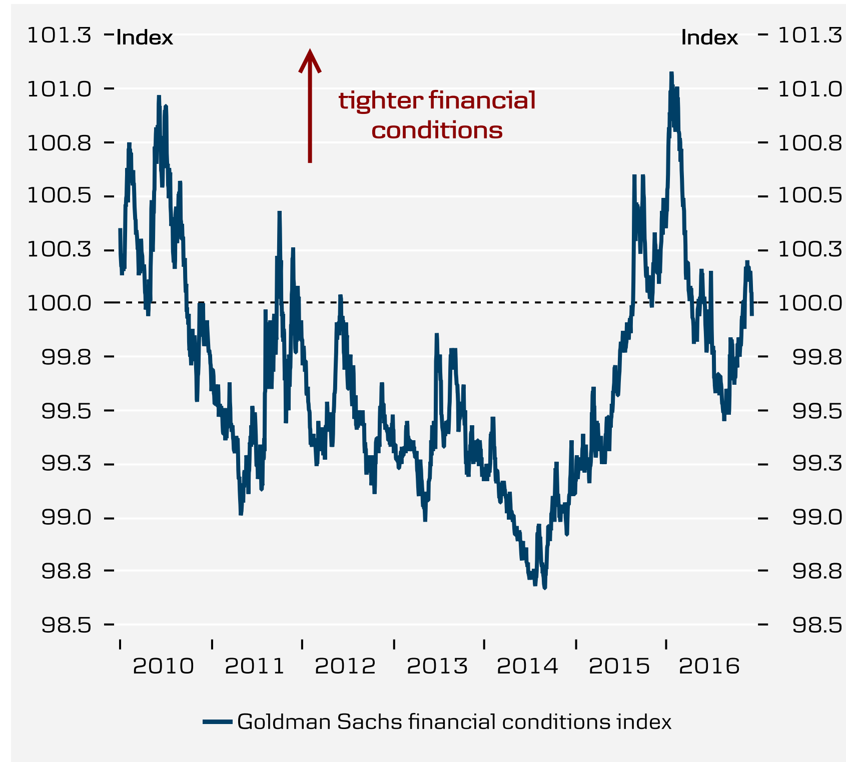
# *Financial conditions have begun to tighten again, partly driven by higher growth (expectations)*

The strong USD is back!




*Source: Federal Reserve*

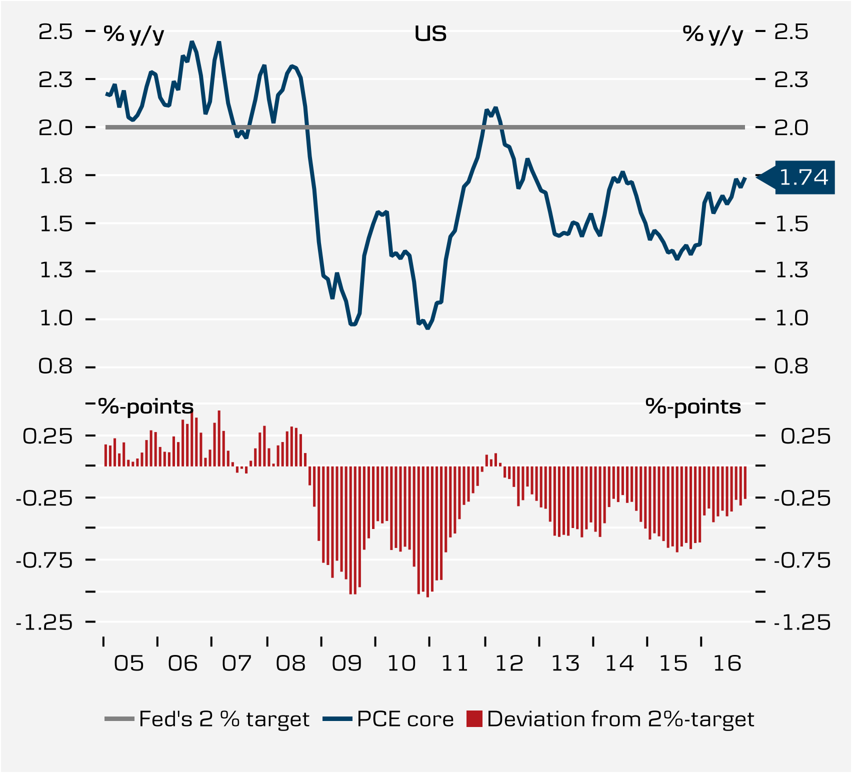
FCI still not as tight as in early 2016




*Source: Goldman Sachs*

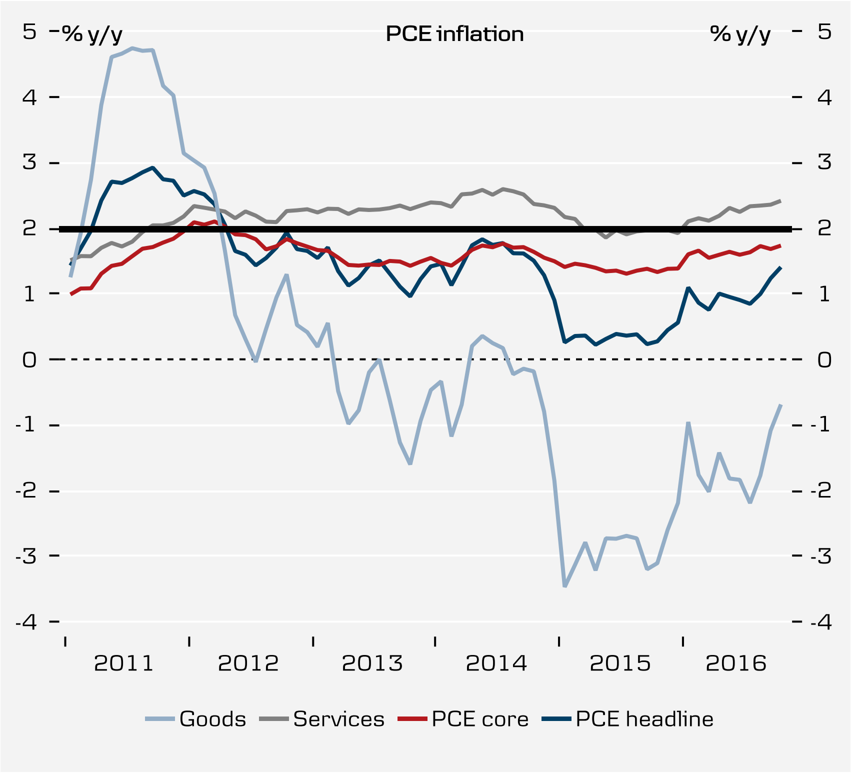
# Actual PCE core inflation still below 2% target

## Fed wants to see actual core inflation move higher




*Source: BEA*

## Goods deflation fading




*Source: BEA*

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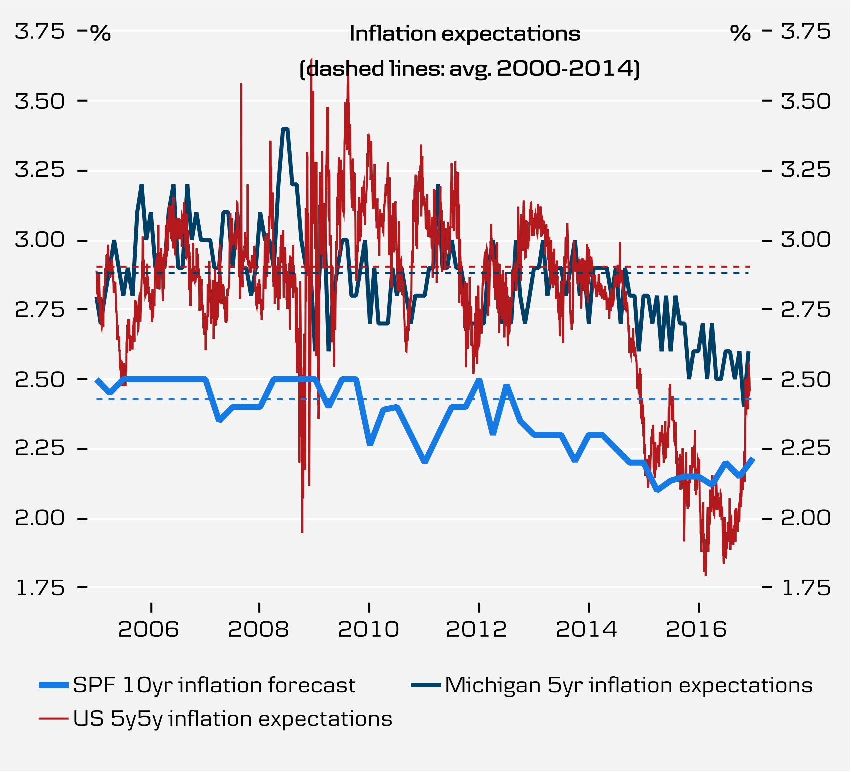
# *Inflation expectations have rebounded*

Inflation expectations still below historical averages




*Source: SPF, University of Michigan, Bloomberg*

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