23 November 2016

FOMC minutes

Fed set to move in December - we expect it to only partly offset fiscal boost from Trump next year

No new information in the FOMC minutes

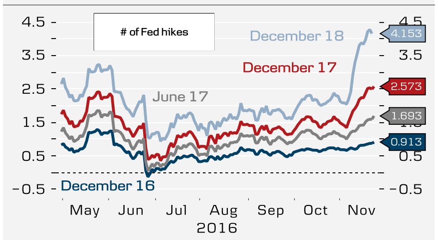
The FOMC minutes from the November meeting were quite a non-event, mainly because much has happened since the meeting. The FOMC's November statement stated that the case for a rate hike *'has continued to strengthen'* but that the Fed would like *'some further evidence of continued progress toward its objectives'*. As we wrote in our *Flash Comment US: Solid jobs report makes a December hike very likely*, 4 November, **we think the higher wage growth and lower unemployment rate in the jobs report for October were sufficient 'further evidence' for the Fed to feel comfortable raising rates in December (regardless of the election result)**. The combination of the market rally on the back of the Trump victory and strong US economic indicators for Q4 has only made the case for a December hike even stronger. This is also the reason why the markets have priced in a Fed hike in December with certainty.

Since everyone expects a Fed hike in December, the most interesting question is how many Fed hikes to expect next year? Unfortunately, the minutes did not gave us any new information. Markets have bought into the story that Donald Trump will boost growth through infrastructure spending and tax cuts; we have seen a significant repricing of Fed. Markets now price in more than two and half hikes from now until year-end next year – before the election markets priced in only one and a half Fed hikes. **Markets expect four hikes from now until year-end 2018 against only two hikes before the US election.** The reason is that markets expect the Fed to partly offset the fiscal boost from Trump. Despite the fact that the US output gap is already nearly closed, it is important to remember that the FOMC turns more dovish next year due to shifting voting rights. Many of the dovish members (including Fed Chair Yellen) have said that it may be a good idea to let the economy run a bit hot (with core inflation above the 2% target) to undo some of the structural damage to the economy caused by the financial crisis. **While the 'median' dots in the September projections indicated two hikes in 2017 and three in 2018, we expect two Fed hikes each year.**

Still, it is worth highlighting that uncertainty is elevated, as we do not know how Donald Trump will be as President. In Trump's latest video update he talked mostly about tougher immigration rules and withdrawing from free trade deals and did not mention economic policy at all. It could be an early warning sign that one should not get over optimistic on how growth-friendly Trump actually is. While we think the US economy was expected to pick-up pace in the short-term regardless of the election result, a smaller than expected stimulus package from Trump may lower the growth expectations for late 2017 and 2018 and hence the Fed may hike more gradually than currently expected. On the other hand, there is also the risk that the fiscal boost may overheat the economy too much, which would force the Fed to hit the brakes.

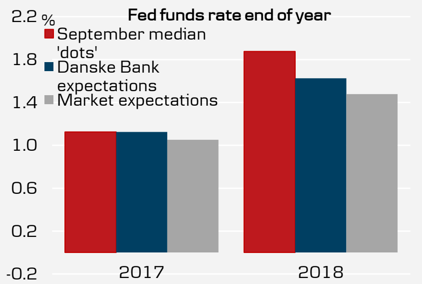
While Trump's fiscal policy is likely to add to the reflation case for the US, this would, in our view, play out even with more expansionary fiscal policy, see our *Strategy piece* from Friday.

Significant repricing of Fed since the US election



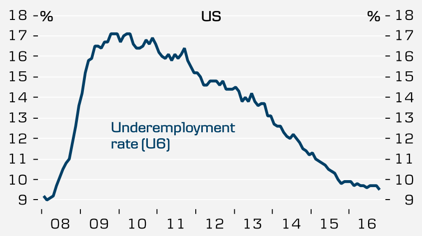
Source: Bloomberg

Still room for higher short-term US yields



Source: Federal Reserve, Danske Bank Markets

Doves argue there is more slack left in the labour market as the under-employment rate has stopped falling



Source: US Bureau of Labour Statistics

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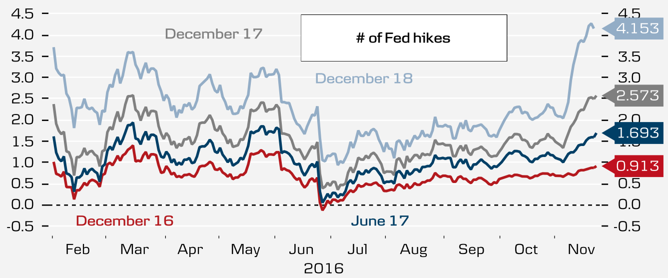
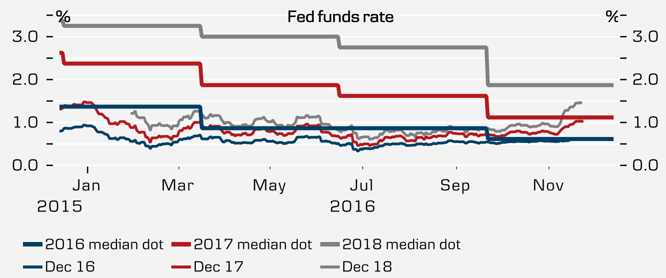
FOMC chart book

Significant repricing of Fed



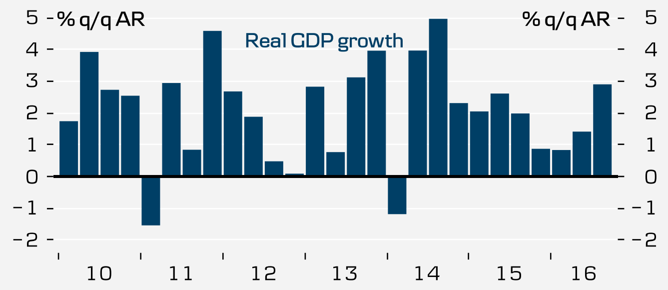
Source: Bloomberg

Still not priced as hawkish as Fed dots



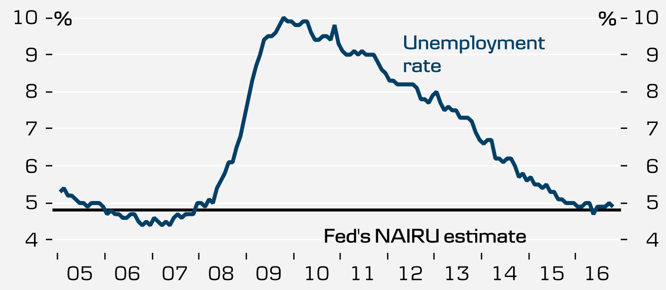
Source: Federal Reserve, Bloomberg

GDP growth picked up in Q3 after three weak quarters



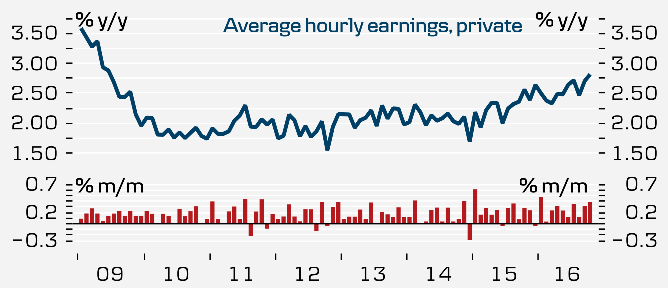
Source: BEA, Danske Bank Markets

Unemployment rate fell to 4.9% in October – has made the Fed more confident about hiking in December



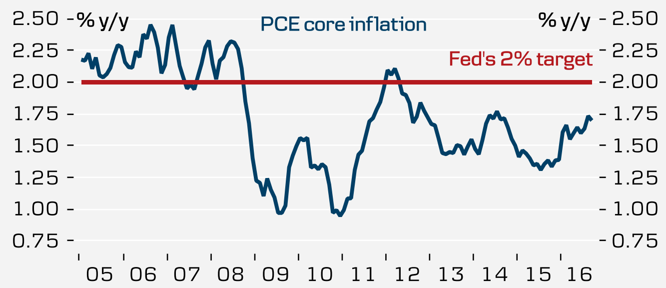
Source: BLS, Danske Bank Markets

Also wage growth picked up in October – highest since the crisis



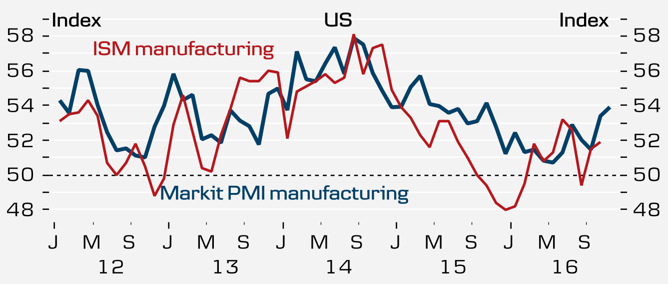
Source: BLS, Danske Bank Markets

PCE core inflation continues to run below 2% target



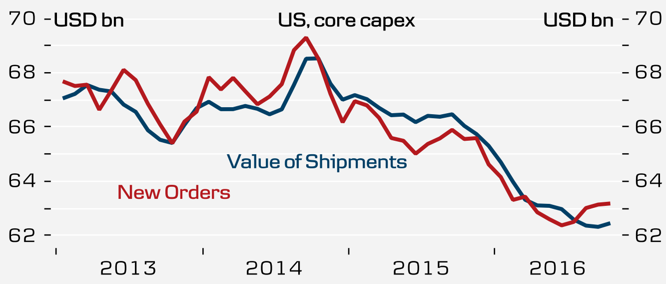
Source: BEA, Federal Reserve

PMIs have picked up further in Q4



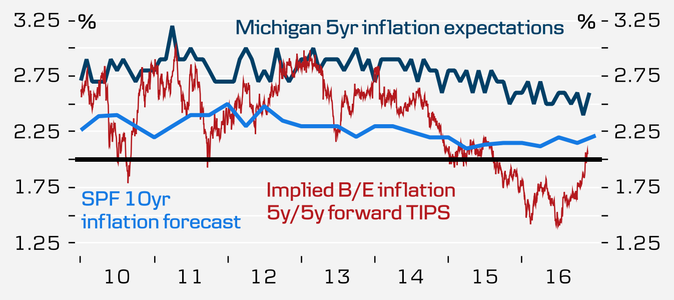
Source: ISM, Markit Economics

Seems like business investments have bottomed out



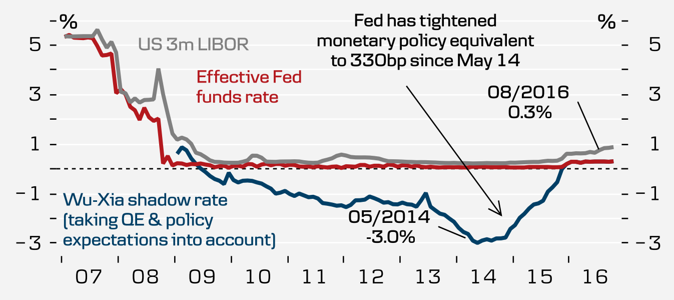
Source: BEA

Market inflation expectations have recovered but still low from an historical perspective



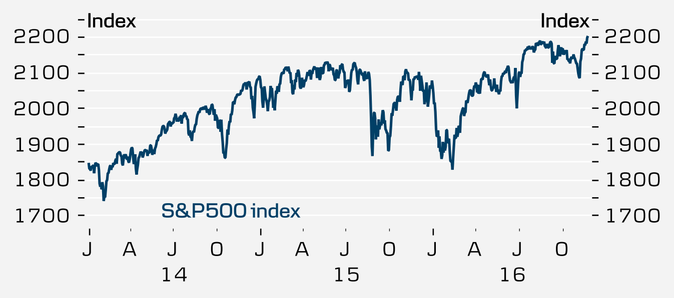
Source: Federal Reserve of Philadelphia, Macrobond Financial, University of Michigan, Danske Bank Markets

The Fed has already tightened monetary policy equivalent to 330bp due to QE tapering and hiking expectations



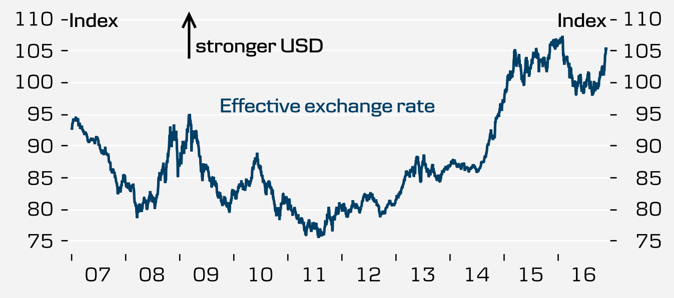
Source: Federal Reserve, Federal Reserve Bank of Atlanta, Macrobond Financial

Markets have rallied post-Trump (against expectations)



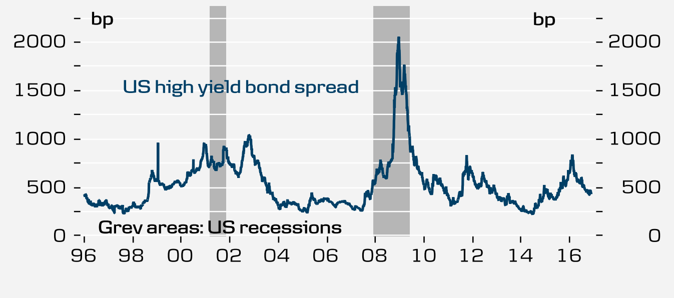
Source: Macrobond Financial

USD has rallied after the election



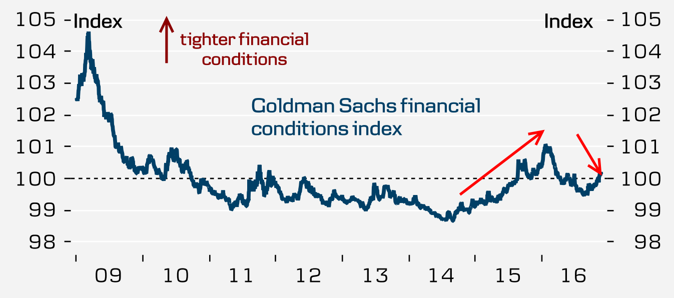
Source: Federal Reserve of Philadelphia, Macrobond Financial, University of Michigan, Danske Bank Markets

Credit spreads have declined



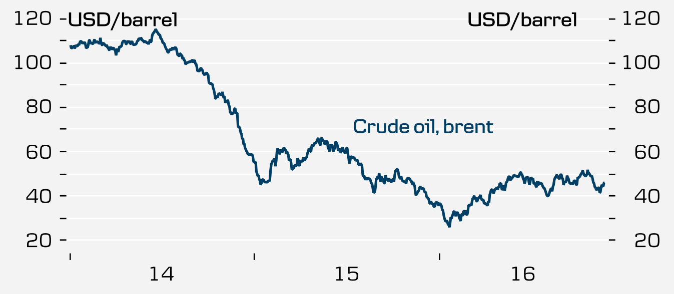
Source: Bloomberg

Financial conditions have begun to tighten slightly



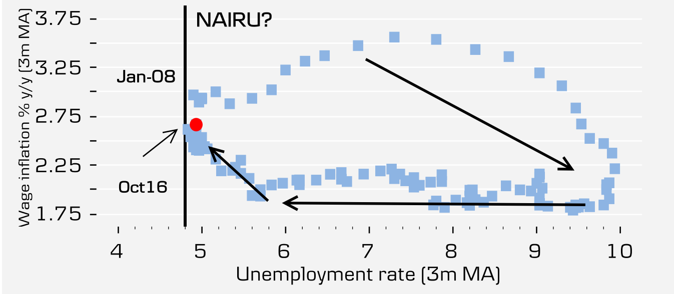
Source: Goldman Sachs, Federal Reserve, Danske Bank Markets

Oil prices range-bound



Source: EIA

Fed sees the world through the Phillips curve



Source: BLS, Danske Bank Markets

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