14 December 2018

FOMC Preview

Fed set to hike again but removing more forward guidance

We expect the Fed to raise rates again when the committee meets next week. This would bring the target range to **2.25-2.50%, i.e. the lower end of the broad range of the estimates of the neutral rate according to the September dots** (2.5-3.0%, with most saying 3.0%). While we think the Fed's base case remains that the gradual hiking cycle will continue a bit further, the Fed will probably remove more of its forward guidance to increase its flexibility (as it did in June), as risks to the rate outlook become more two-sided with the Fed funds rate in the broad neutral range. Do not be surprised if the Fed removes that it *'expects further gradual increases in the target range'* from the statement. It makes sense to get rid of the one-sided rate outlook, as monetary policy becomes more neutral.

We think the Fed will continue to signal three hikes next year but see risks that the 2020 and 2021 dots are lowered. The longer-run dot is likely to be unchanged at 3.00%. In other words, the discussion will soon move from whether monetary policy should become neutral to whether it is a good idea to make it contractionary or not. Keep in mind that just one FOMC member currently indicating the median rates in 2019, 2020, 2021 and in the long-run has to lower their dot in order to lower the median dot. Also keep in mind there will be one more dot this time compared to last time.

Our Fed call has not changed and we think some of the Fed speeches by Powell and Clarida have been over-interpreted. **We still think the Fed is on its way to get to 3.00% by hiking in both in March and June**. The Fed may hike one more time in the second half of 2019 but this is less certain. **When 3% is reached, further hikes will be more 'stop and go' depending on how the economy is doing**. Our Fed call means markets are pricing the Fed too dovishly at the moment. We believe the Fed will end QT in the second half of 2019, probably in either October or December.

Notice that the Fed has some big decisions to make next year. A *press release from the Federal Reserve* on 15 November said that the Fed will review next year the strategies, tools and communication practices it uses to achieve its dual mandate and host a research conference on the subject on 4-5 June 2019. **Basically, the Fed still needs to answer three very fundamental questions: 1) the size of the balance sheet** – when should QT end?, **2) the policy target** – move away from an inflation target to e.g. price level target? (see *Research US: The subtle push for price level targeting continues*, 3 January 2018) and **3) the policy setting** – move from a two-floor system to a corridor system? All three may have long-term consequences for markets.

Note there will most likely be another technical adjustment to the Interest rate on Excess Reserves (IOER), as **IOER would most likely be raised by only 20bp as in June**. The reason is that the Fed has a preference for having the effective Fed funds rate in the middle of the target and right now it is trading only 5bp below the upper end of the target (and equal to the IOER).

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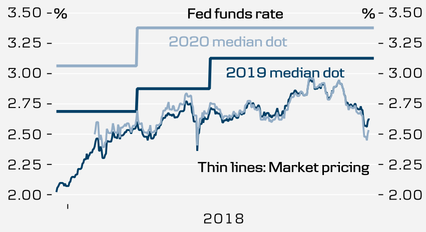
Soft market pricing of Fed



Source: Federal Reserve, Bloomberg, Macrobond Financial

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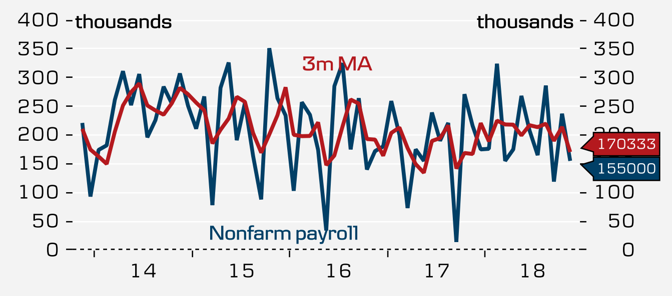
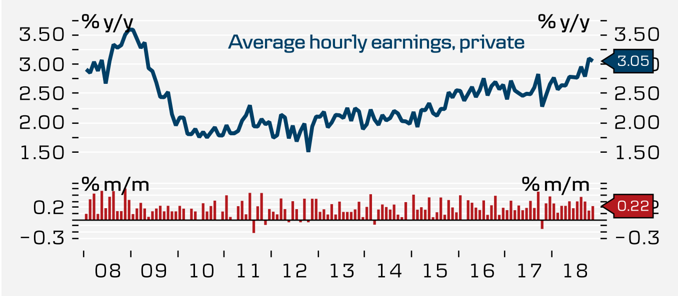
Charts

Solid employment growth



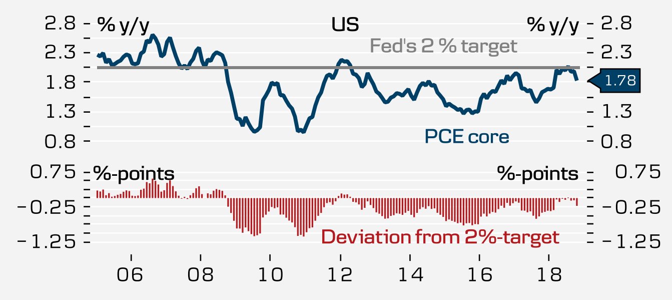
Source: BLS, Macrobond Financial

Cycle-high wage growth



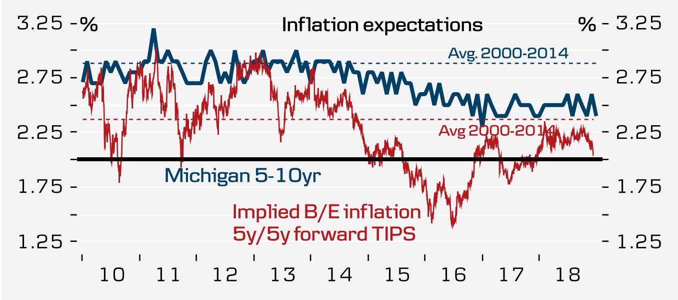
Source: BLS, Macrobond Financial

PCE core inflation has softened recently – no reasons for the Fed to accelerate number of rate hikes



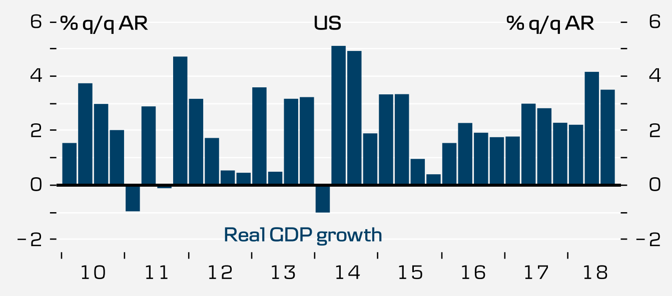
Source: BEA, Macrobond Financial

Market-based inflation expectation still below historical average



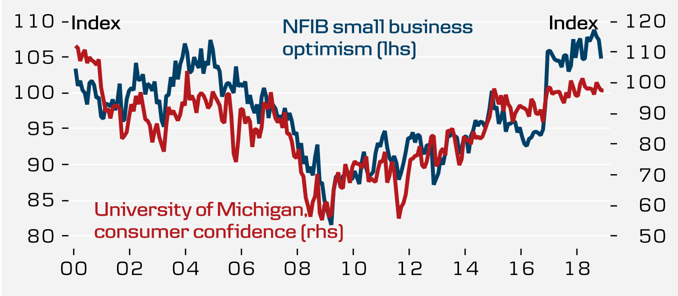
Source: Michigan, Bloomberg, Macrobond Financial

GDP growth has been strong in 2018



Source: BEA, Macrobond Financial

Very high optimism suggests the expansion continues



Source: NFIB, University of Michigan, Macrobond Financial

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This research report has been prepared by Danske Bank A/S ('Danske Bank'). The author of this research report is Mikael Olai Milhøj, Senior Analyst.

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