8 November 2018

FOMC Review

No change to the Fed's hiking plans

Fed is on autopilot and the destination is neutral

- **As expected, the Fed stayed on hold today and made no major change to the policy signals in the statement.** The Fed usually does not make changes at the interim meetings without updated projections and a press conference. Notice that this was the last meeting without a press conference, as Jerome Powell has said that there will be one for every meeting from 2019.

- **We maintain our long-held view that the Fed is on autopilot and neutral is the destination.** Based on speeches from the FOMC members, most are eager to raise the Fed funds rate to 3%, which is the Fed's estimate of the neutral rate, where monetary policy is neither expansionary nor contractionary. We believe the bar for the Fed to change its strategy is quite high, as the real economy is strong, optimism is high, inflation is on target, the unemployment rate is below NAIRU, wage growth is increasing and fiscal policy is expansionary.

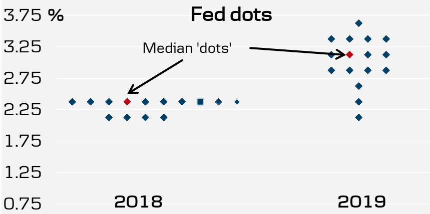
- **We expect the Fed to hike at the meetings in December, March and June, when it would reach the 3%. After that, we believe it will be more stop and go** depending on how the economy is doing. We expect the Fed to hike once more in the second half of 2019, i.e. a total of four hikes from now until year-end 2019. In our view, markets are pricing too dovishly.

- In June, the Fed made what it called a technical adjustment of the interest rate on excess reserves (IOER), as it rose only 20bp, against the increase in the target range of 25bp. The reason was that the effective Fed funds rate was trading too close to the upper end of the target range. Currently, the effective Fed funds rate is trading exactly at IOER, which is only 5bp below the upper end of the range. **This increases the probability that IOER will be raised by only 15-20bp at the December meeting in order to anchor the effective Fed funds rate in the middle of the target range. We look forward to seeing whether the Fed discusses this in the minutes due on 29 November.** The upward pressure on the effective Fed funds rate may also frontload discussions on the future monetary framework (a decision here may come as early as January, when the Fed usually makes changes to how it operates).

- No news from FOMC is not particularly good news for US treasuries, as the Fed remains on autopilot for 3%. Short-term risk appetite sets the direction but the underlying trend is still towards higher US treasury yields. **We continue to target 3.50% on a three- to six-month horizon** (see *FI Research – Next stop is 3.50% for 10Y US treasury yields*, 15 October)**.**

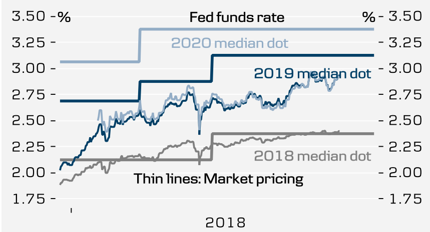
- EUR/USD a tad lower on the no-surprises Fed announcement and **we still look for USD strength to remain towards year-end on the carry and cyclical support the greenback is set to enjoy for some time still** (see *FX Strategy - EUR/USD break of 1.13? Yes - and here's why*, 6 November)..

Median Fed dots still signal one more hike in 2018 and three more in 2019 (in line with our expectations)



Source: Federal Reserve, Macrobond Financial, Danske Bank

Markets are pricing too few Fed hikes in 2019, in our view



Source: Federal Reserve, Bloomberg, Macrobond Financial

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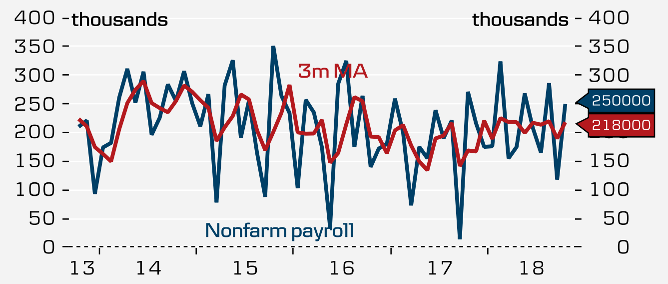
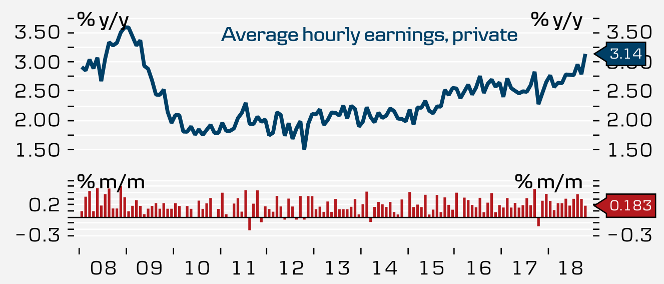
Charts

Solid employment growth



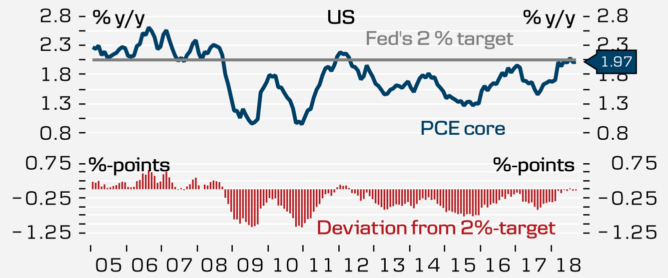
Source: BLS, Macrobond Financial

Highest wage growth since the crisis



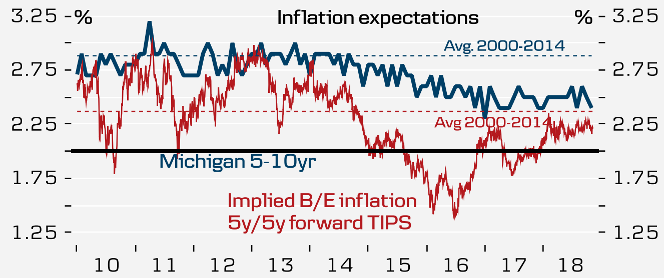
Source: BLS, Macrobond Financial

Core inflation is at target



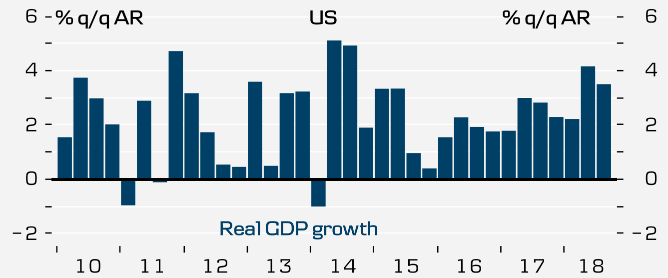
Source: BEA, Macrobond Financial

Market-based inflation expectation still below historical average



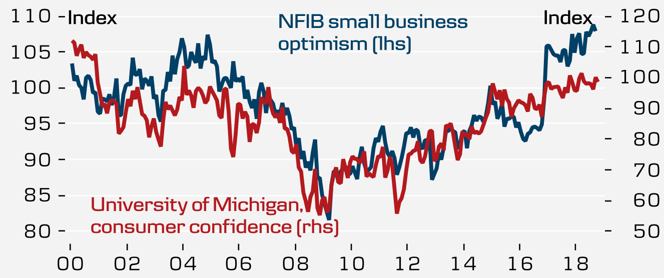
Source: Michigan, Bloomberg, Macrobond Financial

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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