FOMC Minutes

Fed is waiting for more information on 'Trumponomics'

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FOMC members uncertain about 'Trumponomics' – likely to increase hiking pace in 2018

- **The FOMC members think the economic outlook is very 'uncertain' until we get more information about 'Trumponomics'.** The word 'uncertain' is mentioned 15 times versus five times in the minutes from the November meeting.
- The FOMC members think *'growth might turn out to be faster or slower than they currently anticipated'* depending on the policy mix (tougher immigration rules and more protectionism slow growth while infrastructure spending and tax cuts increase growth). ***'Almost all'*** **FOMC members think there are upside risks to their growth forecasts due to the likely fiscal boost, which they have not fully taken into account.**
- **Given the Fed's focus on 'Trumponomics', any comments or tweets from Donald Trump on economic policy will be followed closely.**
- **We stick to our view that the Fed will hike twice this year (June and December) but believe the risk is skewed towards three hikes.** One of the reasons is that the Fed has turned more dovish this year due to shifting voting rights, which mean that we (for now) weight dovish comments more relative to hawkish comments. This year we learned that it does not take much for the (dovish) FOMC members to postpone a hike.
- **That said, we believe the Fed is likely to increase its hiking pace in 2018 (late 2017 at the earliest)**, as we think Trump's fiscal policy is likely to have the biggest growth impact in 2018 due to policy lags (see also *Five Macro Themes for 2017*, 1 December 2016), although much can obviously still happen before 2018.
- The minutes indicate that several FOMC members want to offset the fiscal boost almost fully, as the output gap is already nearly closed. **We now expect the Fed to hike three or four times in 2018 from two previously.**

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Fed slightly concerned about the strong USD and low inflation

- **The FOMC members seem worried about the strong USD**, as the minutes state that *'several others pointed out that a further rise in the dollar might continue to hold down inflation'*. The strong USD means the Fed can be more patient on raising rates. It is important to look out for financial conditions.

- **While most FOMC members think the unemployment gap is almost closed, focus is on inflation, as the Fed has not met its inflation objective for several years.** Core inflation below the 2% remains one of the biggest concerns despite most FOMC members expecting inflation to increase to 2% over the forecast horizon. This is based on expectations that the tighter labour market will eventually push up wage growth (the Fed sees the world through the Phillips curve, see chart on page 15).

- That said, if the unemployment rate falls too quickly, the Fed might need to tighten monetary policy more rapidly.

- **The minutes support our view that triggers for the next Fed hike are (assuming calm financial markets and continued economic growth).**
  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 expenditure) core inflation.

Fed hikes set to have an impact on reinvestment

- We argued in *US monetary policy normalisation tool box stocked and ready for second rate hike*, 12 December 2016, that the Fed is likely to stick to its current reinvestment policy in 2017. It was repeated in the FOMC statement from the December meeting that the Fed will continue to reinvest until the normalisation of the Fed funds rate is *'well under way'.*

- **However, it is interesting, that the minutes state that *'several participants noted circumstances that might warrant changes to the path for the federal funds rate could also have implications for the reinvestment of proceeds from maturing Treasury securities and principal payments from agency debt and mortgage-backed securities'.***

- In the base case with two to three Fed hikes this year, the Fed would continue to reinvest matured securities **However, if the Fed needs to tighten monetary policy even further (four hikes or more), it could be a theme whether the Fed will continue to follow its current reinvestment policy.**

- In other words, it seems as though the FOMC members feel a Fed funds rate above 1.50% is enough for the Fed to be 'well under way' in the normalisation process (1.50% is half of the Fed's estimate of the neutral rate at 3.00%).

What to look for this 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; more expansionary fiscal policy from Trump
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

Source: Danske Bank Markets

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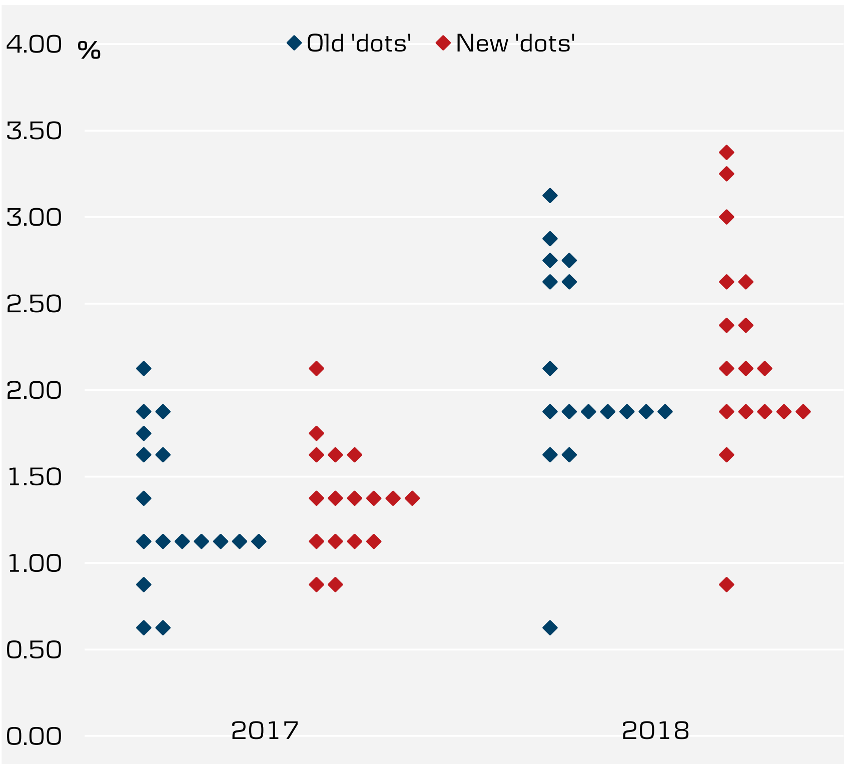
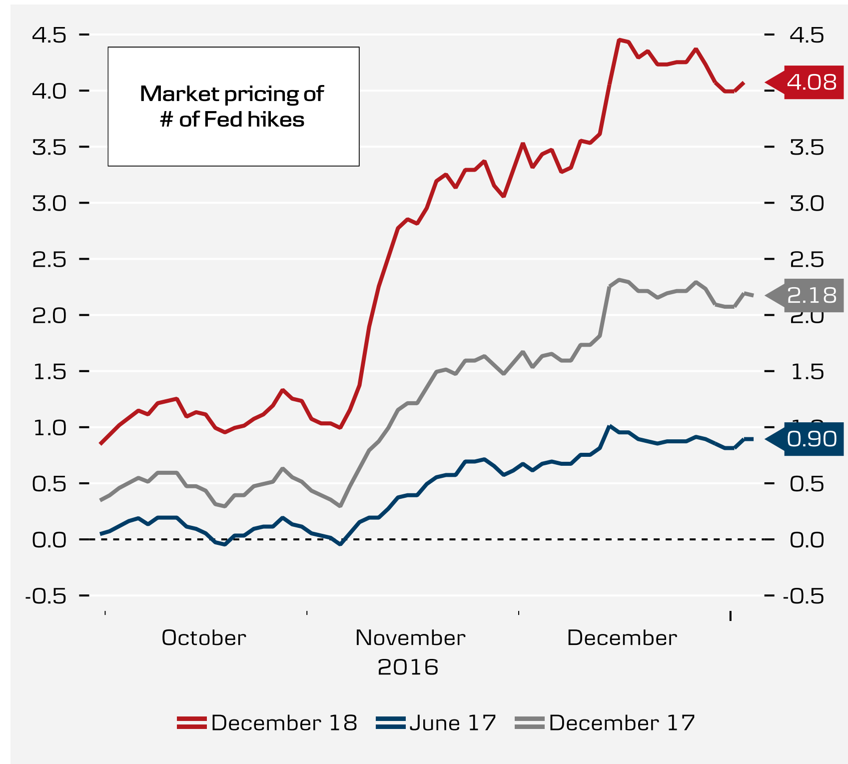
Fed signalled three hikes in both 2017 and 2018

Median 'dot' for 2017 was revised up to three hikes



Source: Bloomberg, Federal Reserve

Markets are pricing more than two hikes in 2017



Source: Bloomberg, Federal Reserve, Danske Bank Markets

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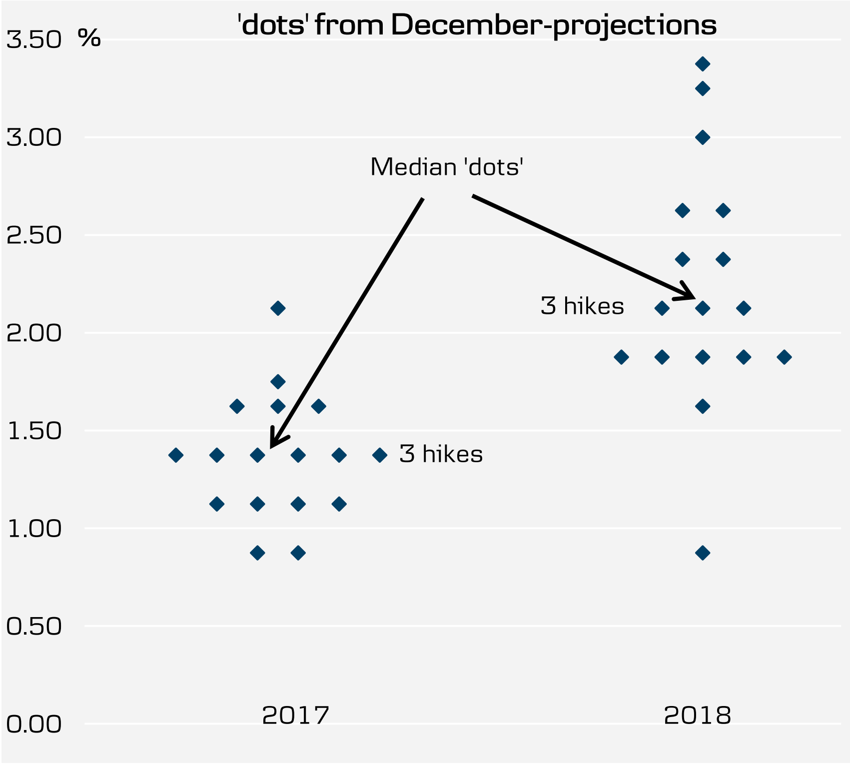
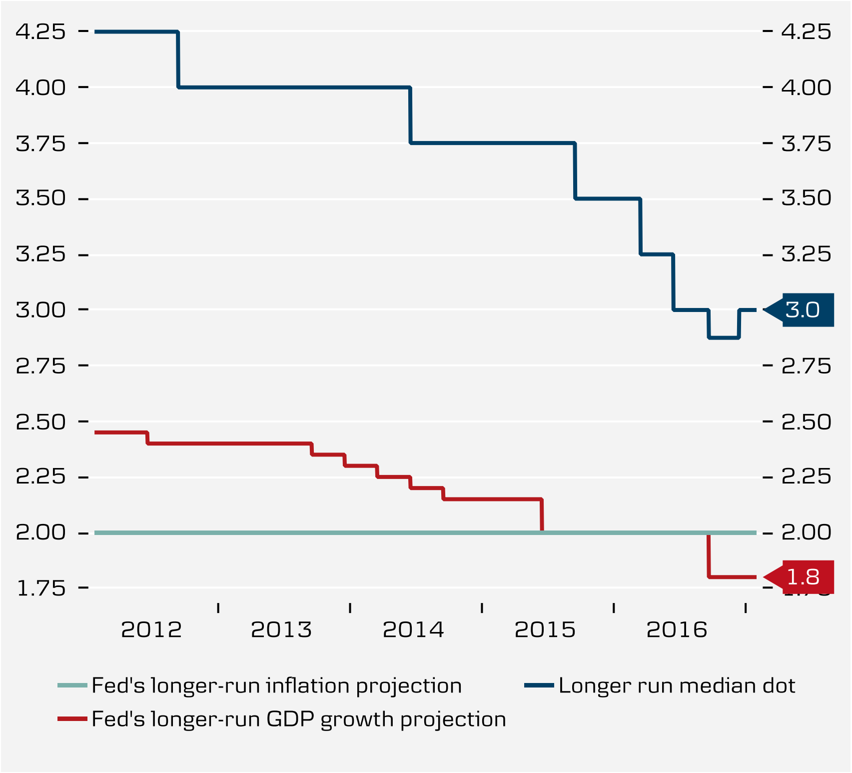
Yellen told us not to put too much weight on small changes to 'dots'

Fed signals three hikes in 2017 and 2018



Source: Federal Reserve

First upward revision to longer run 'dot' ever



Source: Bloomberg, Federal Reserve, Danske Bank Markets

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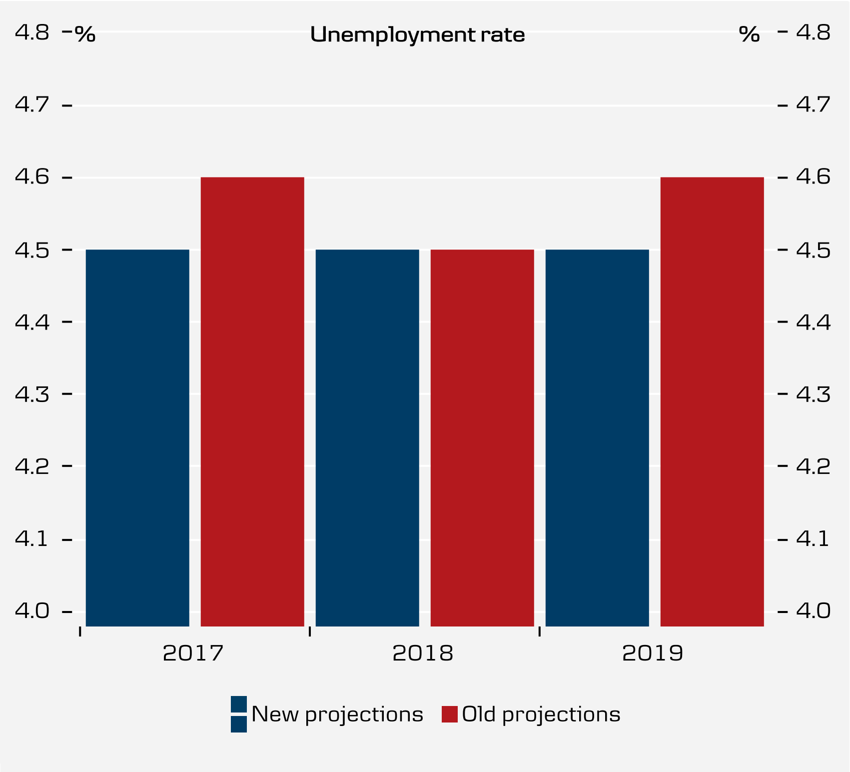
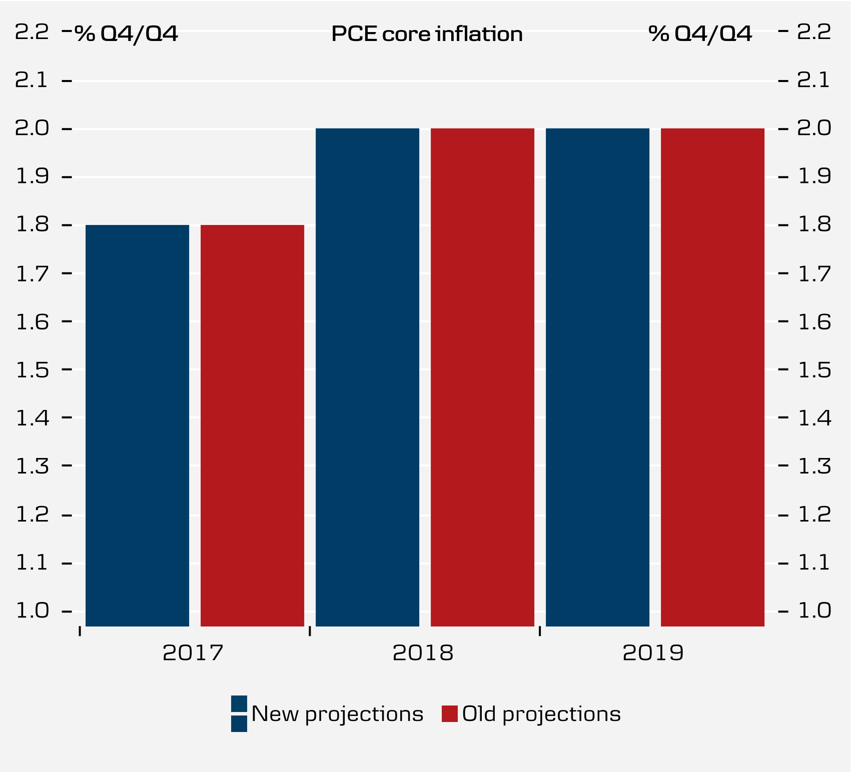
Fed more hawkish on expectations of higher growth and lower unemployment rate next year

Expects slightly lower unemployment rate next year



Source: Federal Reserve

PCE core inflation unchanged – no overshoot



Source: Bloomberg, Federal Reserve, Danske Bank Markets

Fed has turned more dovish this year due to shifting voting rights

	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*

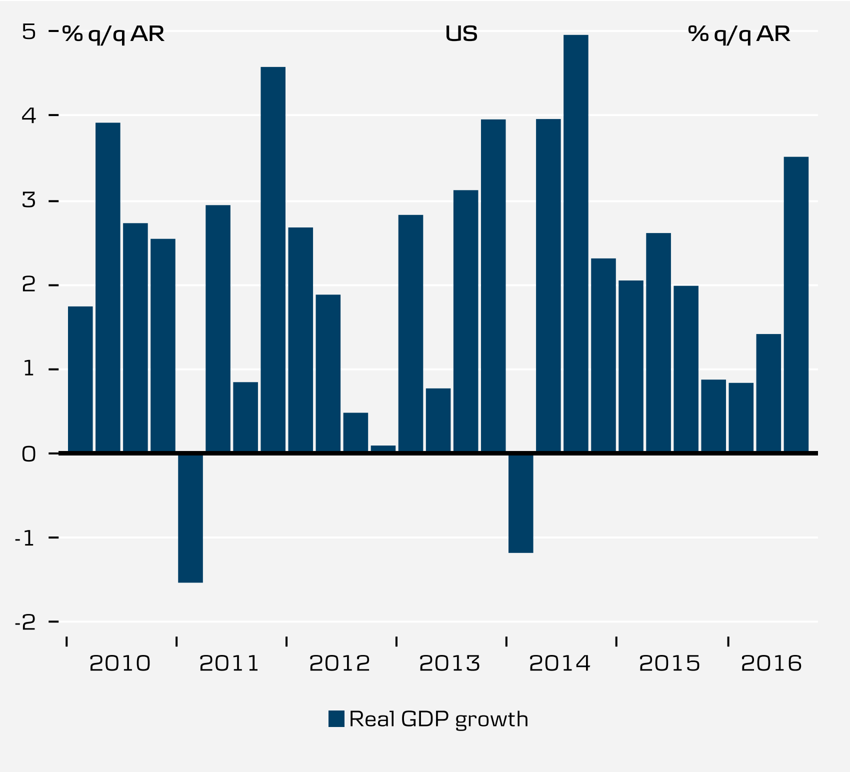
Voting member (B) Board Member

Source: Danske Bank Markets

Macro charts

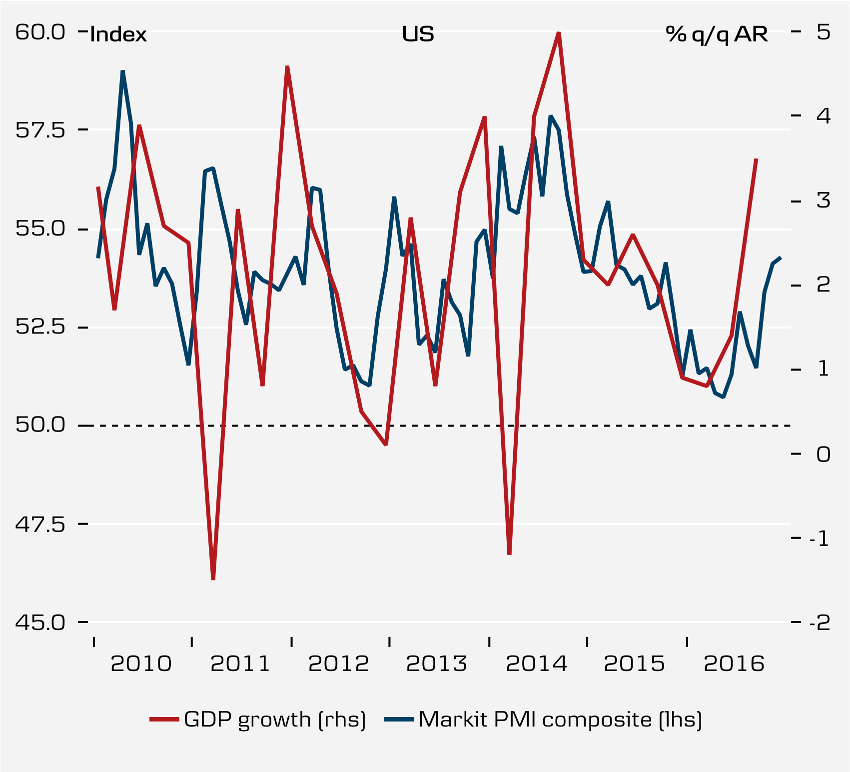
Growth rebounded in H2 16 after a slowdown in H1 16

Growth picked up in Q3 after three weak quarters



Source: BEA

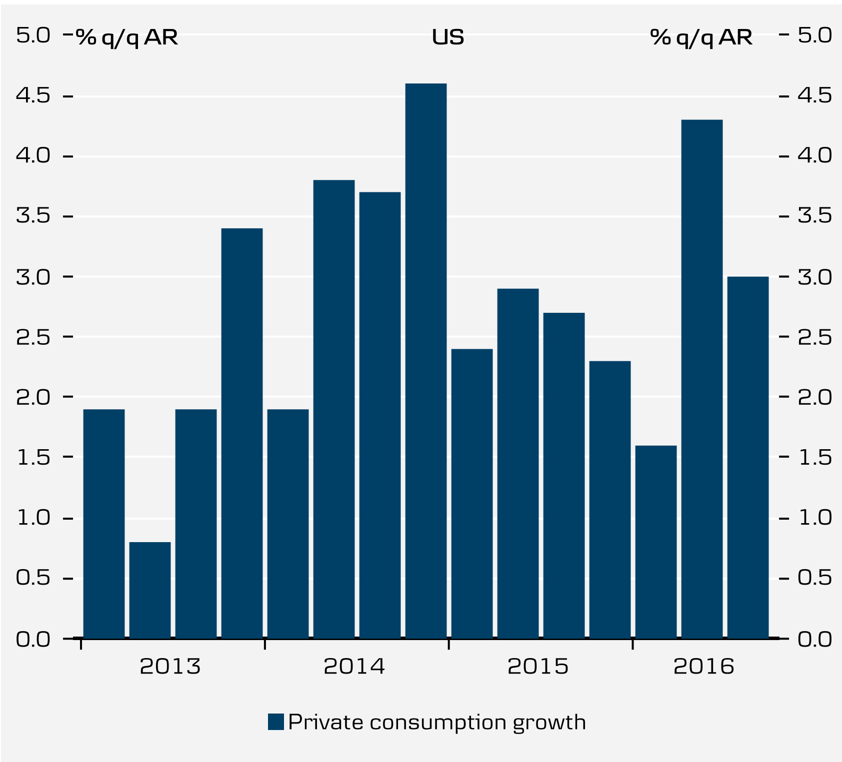
Growth has continued at an above-trend pace in Q4



Source: BEA, Markit Economics, Danske Bank Markets

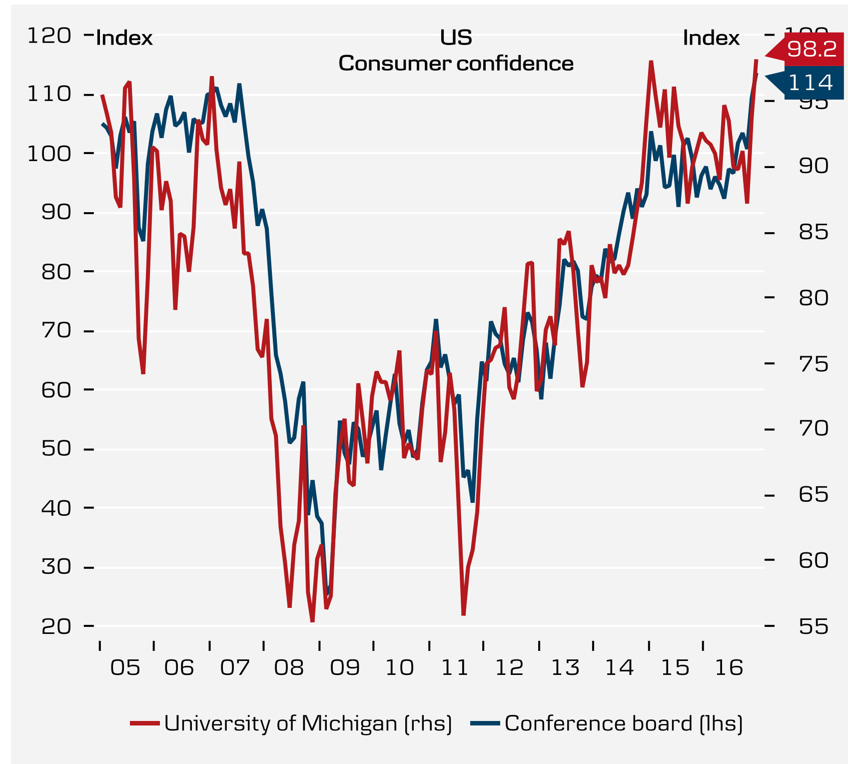
Private consumption the main growth engine

Solid private consumption growth



Source: BEA

Very high consumer confidence



Source: University of Michigan, Conference Board

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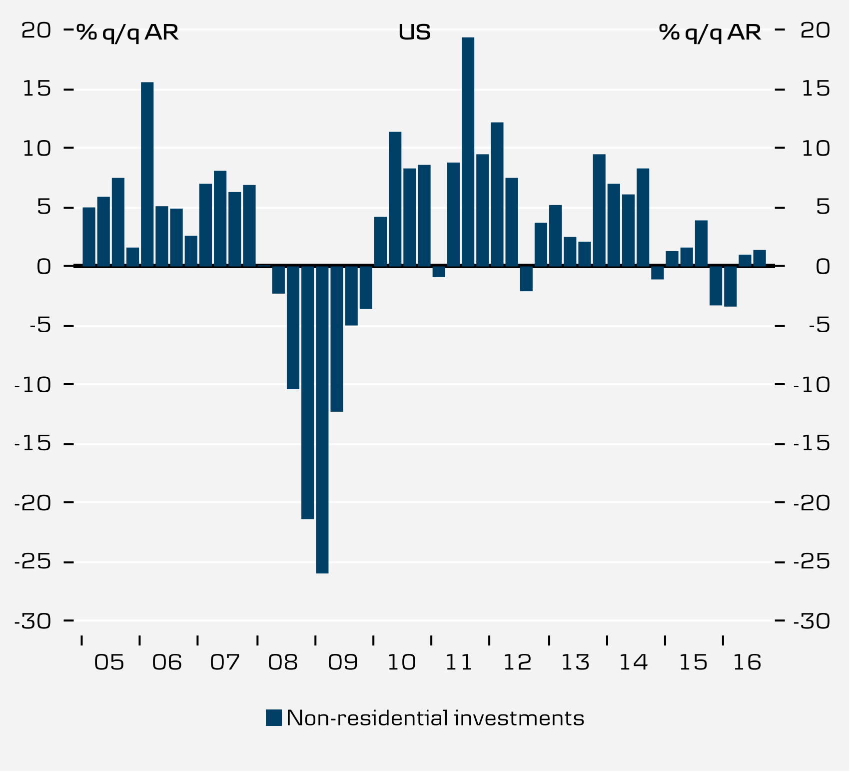
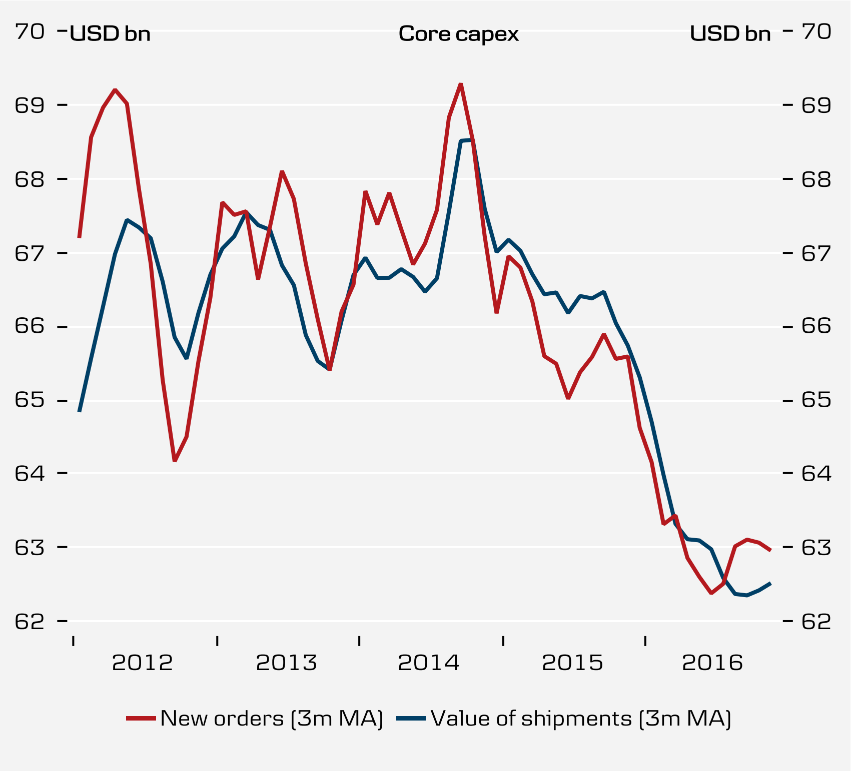
Have investments bottomed out? We think so

Non-residential investments have been weak



Source: BEA

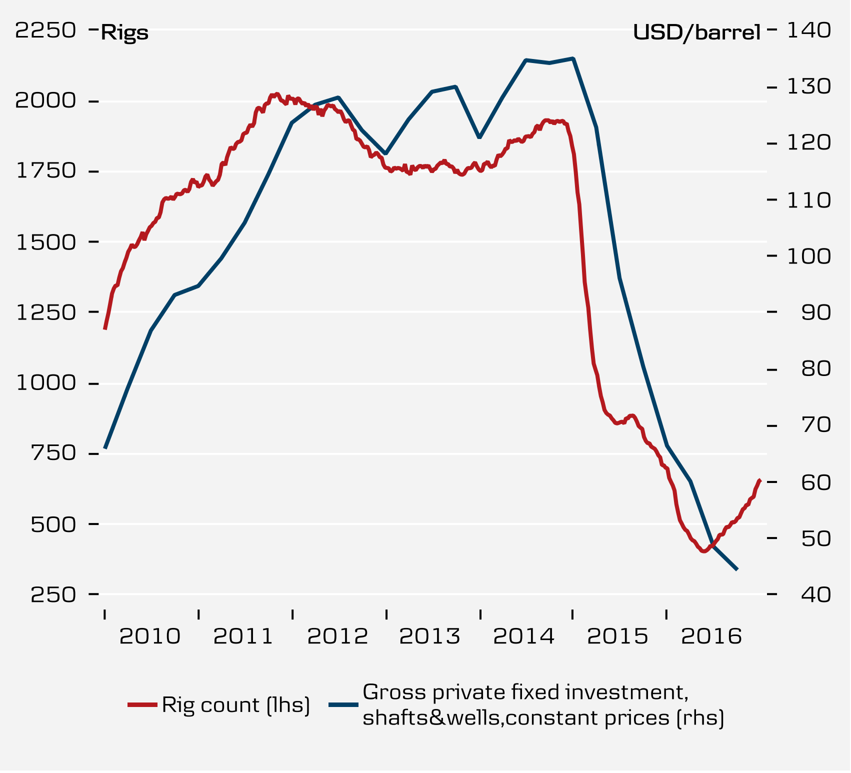
Core capex seems to have bottomed out



Source: US Census Bureau

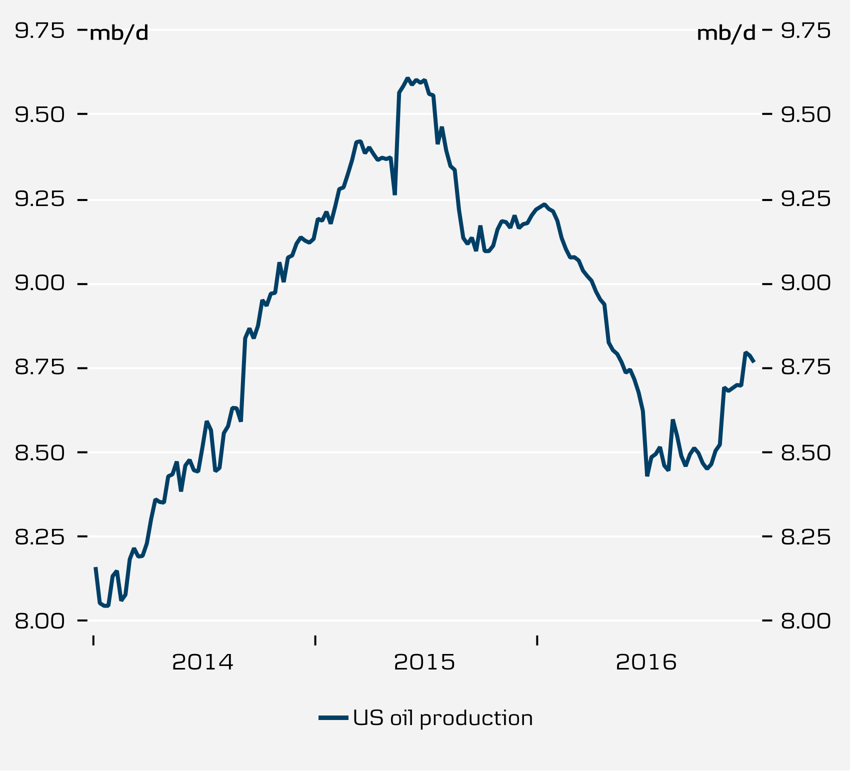
Headwind from lower oil investments is fading

Oil investments set to rebound



Source: BEA, Baker Hughes

US oil production has increased



Source: EIA

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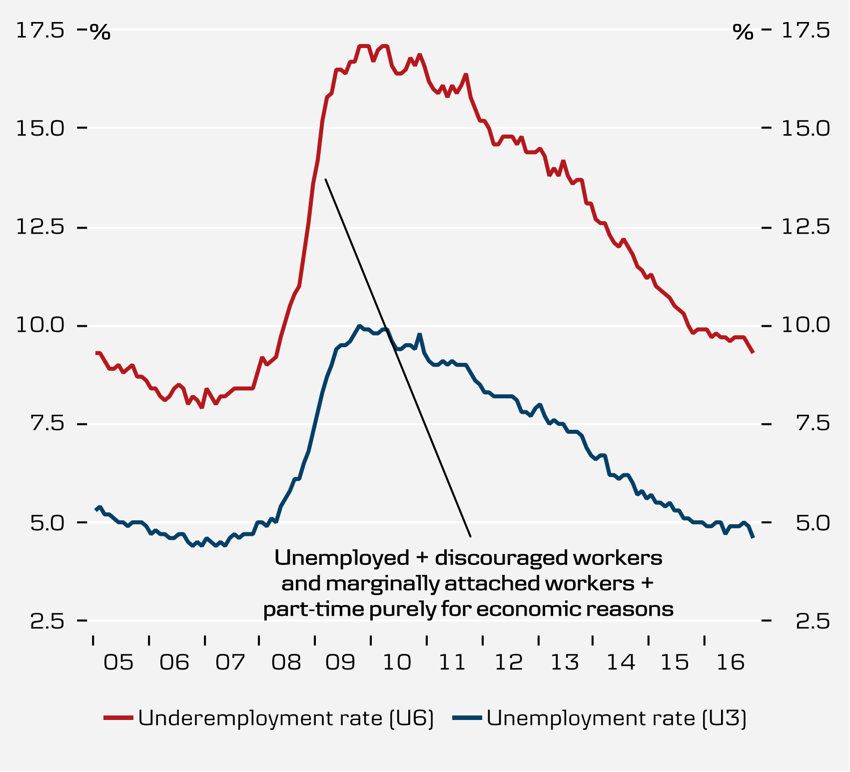
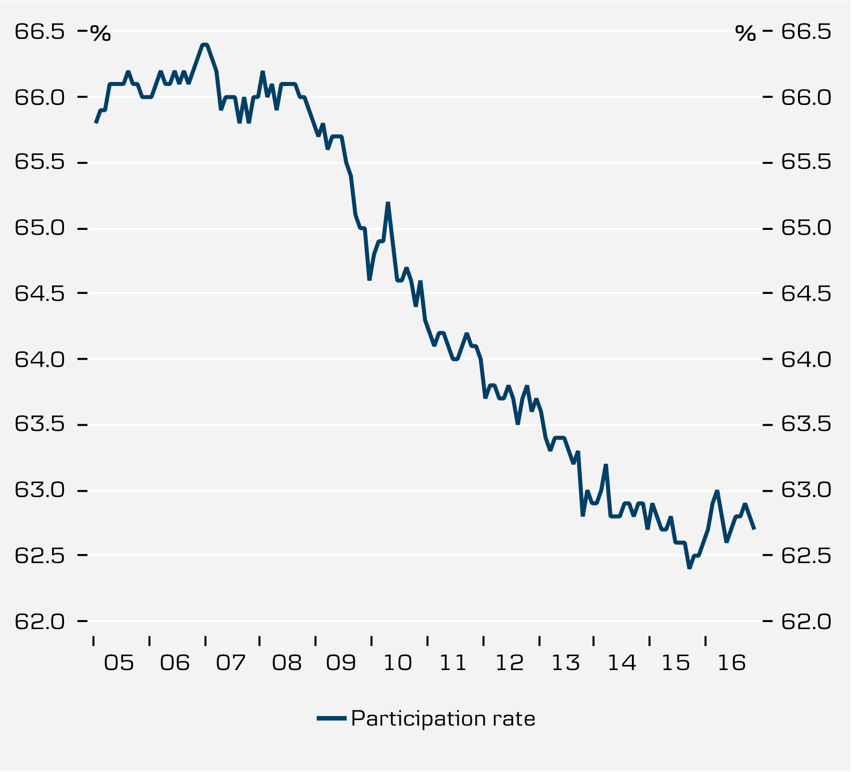
Still a bit more slack left in the labour market

Room for lower unemployment rates



Source: BLS

Participation rate has increased slightly



Source: BLS

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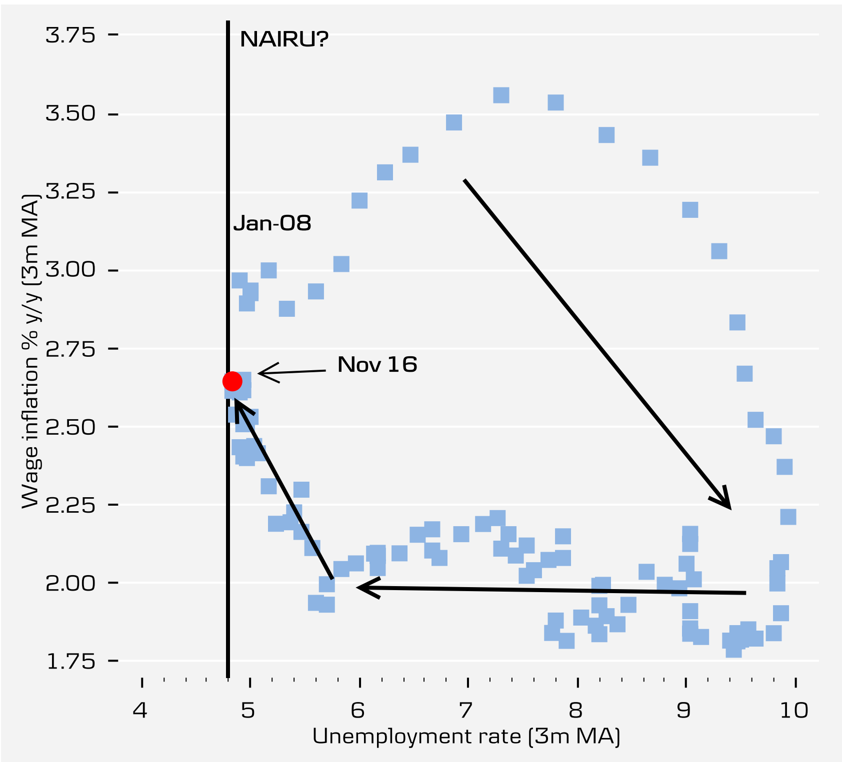
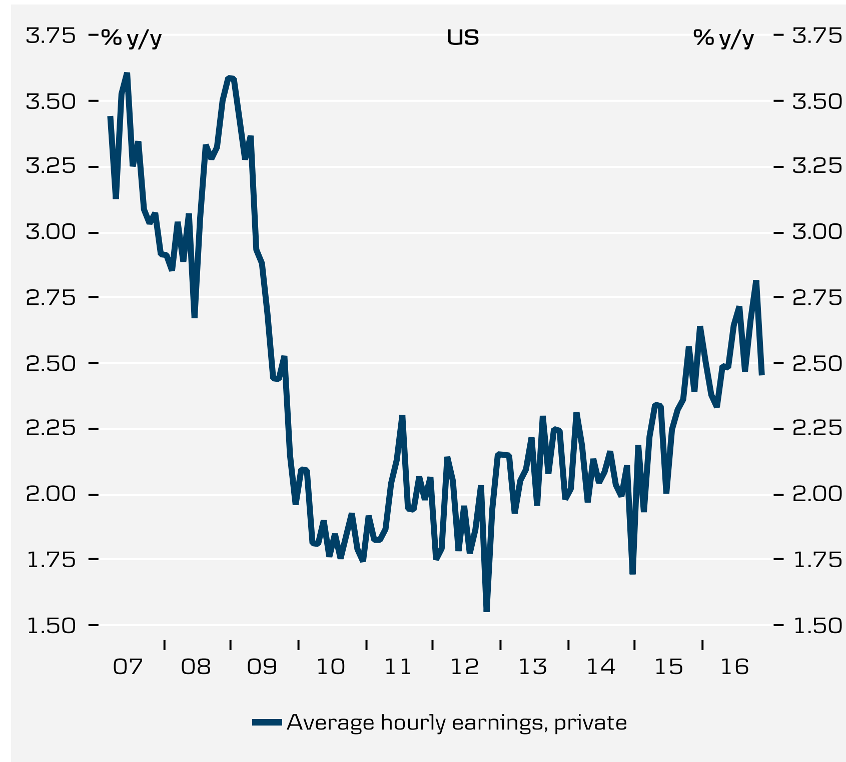
Fed sees the world through the Phillips curve

Tighter labour market => higher wage growth



Source: BLS

Wage growth still needs to move even higher



Source: BLS

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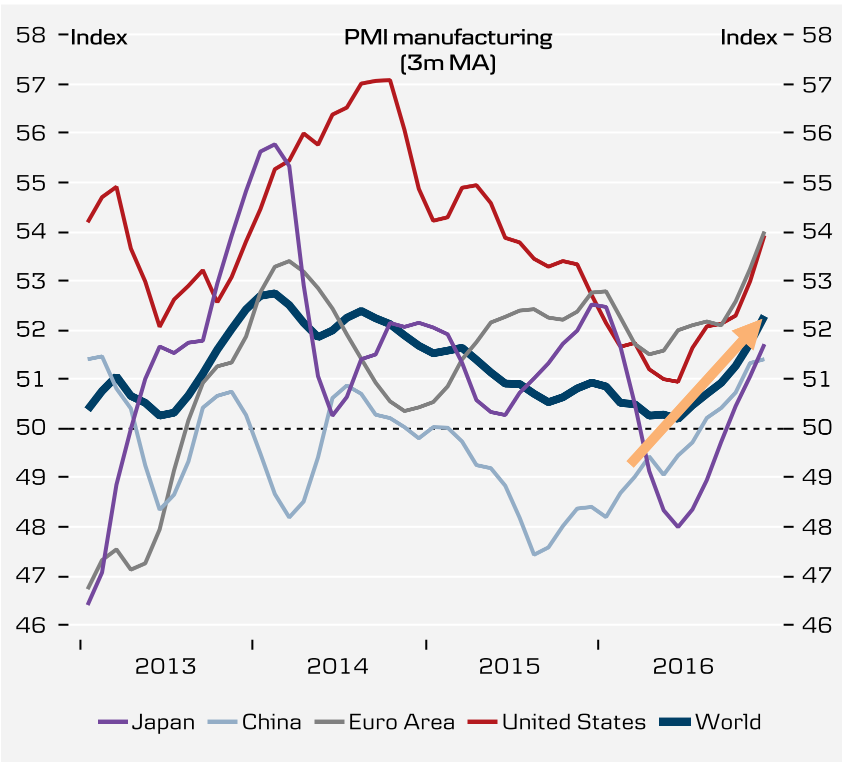
Global business cycle has turned – synchronised recovery signal across regions

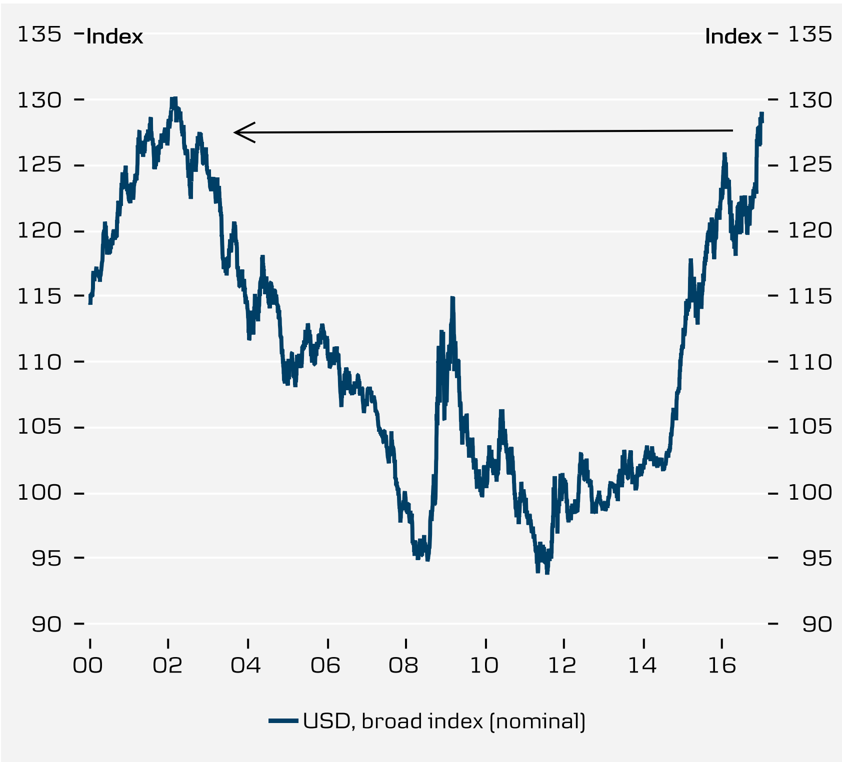
PMIs are trending up across countries



Source: Markit Economics

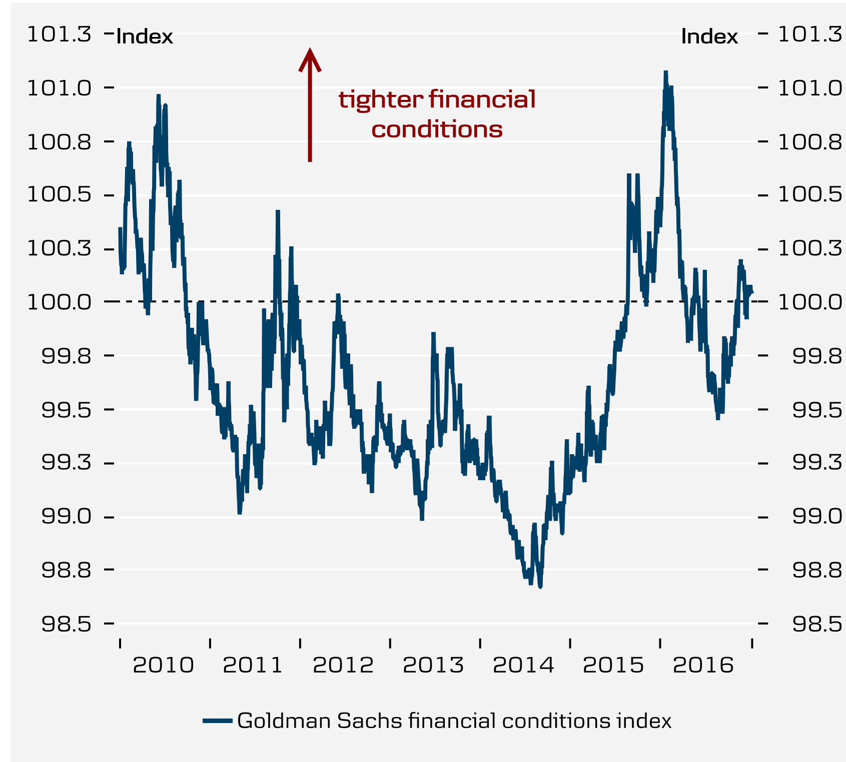
Financial conditions have begun to tighten again, driven partly by higher growth (expectations)

The strong USD is back



Source: Federal Reserve

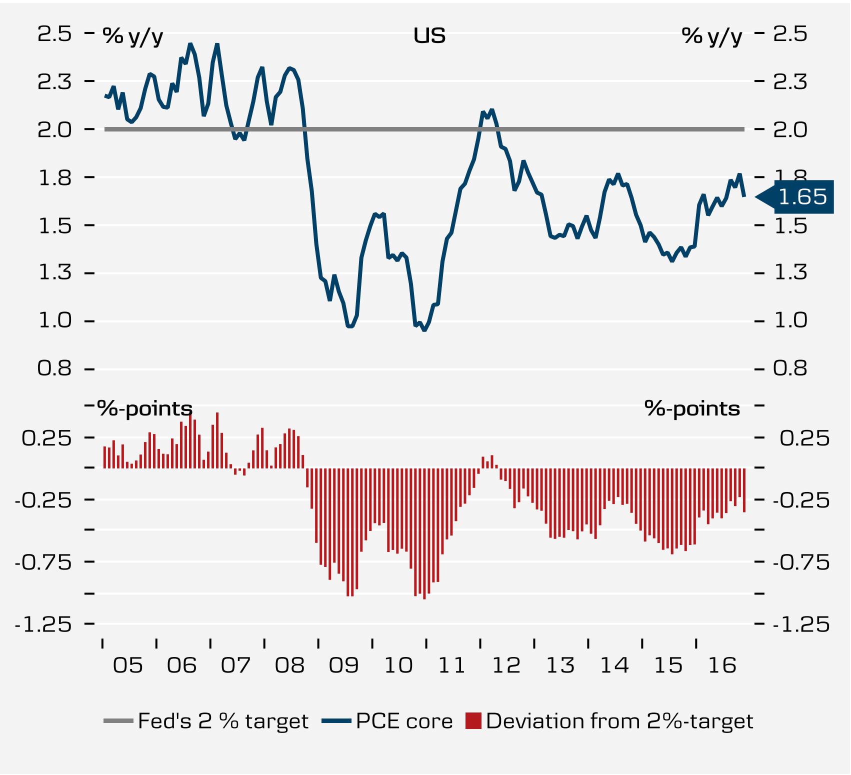
FCI still not as tight as in early 2016



Source: Goldman Sachs

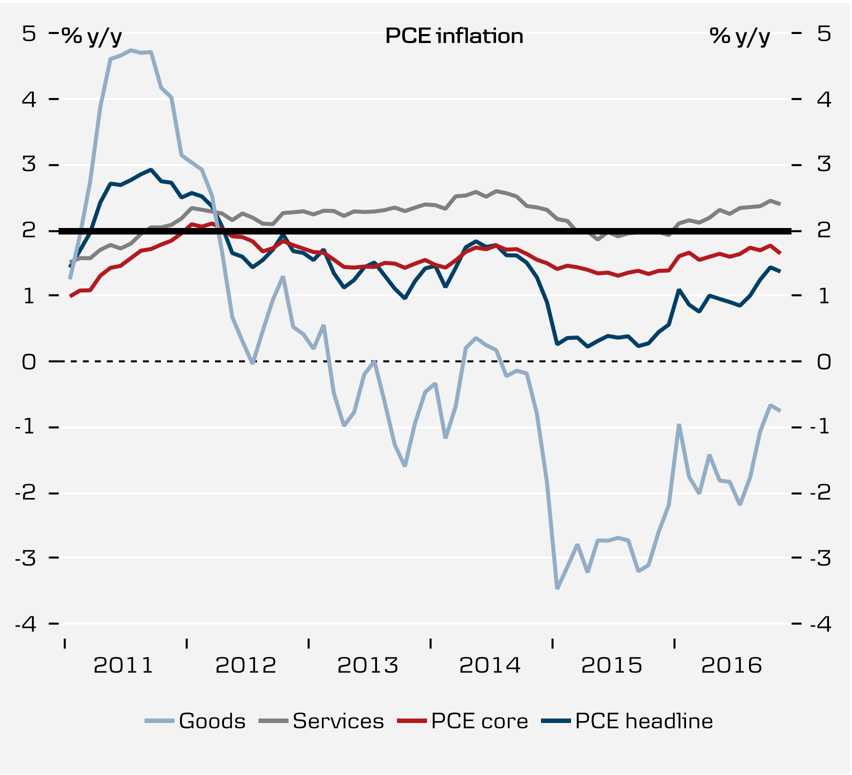
Actual PCE core inflation still below 2% target

Fed wants to see actual core inflation move higher



Source: BEA

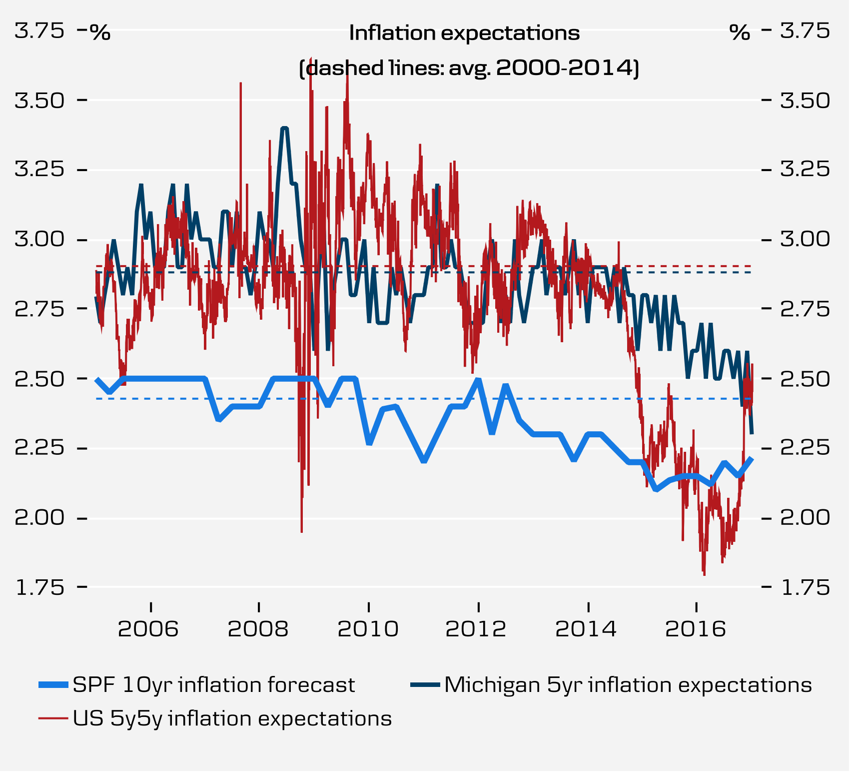
Goods deflation fading



Source: BEA

Inflation expectations have rebounded

Inflation expectations still below historical averages



Source: SPF, University of Michigan, Bloomberg

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