Flash

Thursday, 21 September 2017

Fed starts with balance sheet run-off

Fed starts its balance sheet tapering programme in October

Fed fund rate remains unchanged

Fed confident in eco outlook. Hurricanes won't damage growth fundamentally…

…and not very concerned about recent low inflation

Fed members (dots) largely stick to their projected rate path in 2017/18

Long run rate lowered but 2020 rate projection above LR rate: Restrictive policy!!

Bonds lose modest ground, dollar rebounds, while equities are little changed

Fed rate path for 2017/18 little changed

The FOMC, as expected, kept its Fed funds target range unchanged at 1-1.25%. The decision was unanimous. The **forward guidance, further gradual increases in interest rates in the next years are needed,** remains in place. Looking to the Fed governors rate projections, **the median rate for the end of 2017, 1.375%, still discounts one more 25 bps rate increase. For end 2018, the median suggests 3 additional 25 bps rate increases (to 2.125%), unchanged from June.** The median projection for end 2019 fell from 2.93% in June to 2.68% now. That means 2 rate increases in 2019. For 2020, the median rate projection is 2.875%, which suggests one final rate increase to lift the FF rate above its projected long run rate of 2.75%, which was lowered from 3% in June. **The Fed actually suggests that its policy will get really restrictive by putting the 2020 projection above the neutral rate.** Of course, 2020 is still far away and lots of unknown events will happen in the mean term.

Going into more detail, the consensus about one more rate increase this year strengthened with 11 out of 16 governors pointing to such an increase. Four governors, similar number as in June, expect unchanged policy this year and one governor forecasts 2 hikes. For 2018, more governors lowered their rate projection, but it didn't affect the median projection.

Balance sheet normalization starts

As widely expected, the Fed announced the start of its balance sheet tapering, notably in October, according to the plan released at the June meeting. There will be a rising cap on the re-investment of maturing assets. It starts with a monthly $10B cap in the first quarter that will gradually go up to $50B/month in a year time. The balance sheet run-off will be gradual and predictable, as to keep market volatility limited. **Chair Yellen reiterated that the balance sheet is a passive measure in its toolkit,** while changing the FF rate is the preferred and prime tool to use. Changes to the balance sheet run-off plan are highly unlikely unless the zero rate band come again into play.

No change regarding growth and inflation

There were no significant changes in the **FOMC statement** on jobs, inflation and inflation expectations. The labour market continues to strengthen, economic activity is moderate, inflation below the 2% objective and inflation expectations little changed. The FOMC inserted a paragraph on the effects of the hurricanes on activity and inflation. They will affect the economy negatively in the short term, but rebuilding activity will follow. Besides volatility, the fundamental course of the economy won't be affected. Similarly, **inflation** may be somewhat higher in the short term, due to higher oil prices, **but it is also a transitory effect.** In her press conference, **Yellen repeated that temporary factors, unrelated to the cycle, affected inflation since spring.** Therefore, inflation will move back to the objective in the medium term, said Yellen. **She still believes that the strengthening labour market will push inflation higher (Phillips curve still alive).** Nevertheless, the FOMC stated again that it monitors closely inflation developments. In her press conference, Yellen admitted that there was uncertainty about the causes of the low inflation.

Attention turns back to rate increases

With the balance sheet normalization on the rails, attention returns to the interest rate path. The dot plot suggests that a December rate hike is still very likely. That's also our expectation, but we think that a number of factors may still interfere and postpone the increase into 2018. First, the impact of the hurricanes on the data will raise uncertainty and make an assessment on growth and inflation more difficult. That may convince the Fed to wait a bit longer. Second, the debt ceiling issue may again cause uncertainty too. On the other hand, there might be more clarity on the tax plans.

Markets react in right direction

The market apparently expected the Fed to lower more extensively its rate increase projections, even as the lowering of the long run FF rate is bond friendly. Of course, the difference between **the Fed's rate path and the market's rate expectations was very large for a long time and that remains so after the FOMC decision and communication.** The market implied probability of a December rate hike increased to 63% from 53% before the meeting. **Market doubts remain though** as the January 2019 FF future trades only up 5 ticks and discounts about two rate increases versus four from the Fed. In the same vein, the Fed's lowered neutral rate is still way above the terminal rate discounted in the FF strip curve or in the OIS curve. **The bond market reaction was clear-cut, but only modest. The yield curve flattened, which is what one would expect given the "hawkish outcome of the meeting,** with 2- and 5-yr yields up 3.8/4.2 bps and the 10- and 30-yr yields respectively up 2.1 and down 1.2 bps.

The dollar gained across the board. EUR/USD fell from about 1.20 to 1.1860 before "rebounding" to just below 1.19. USD/JPY jumped to 112.30 from about 111.30. **Equities made a knee-jerk reaction** with the S&P closing near the highs (above 2500).

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