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FOMC Review

Hawkish Fed even without Trump's fiscal boost

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Fed hiked and sounded more hawkish than expected

- **As expected, the Fed hiked the target range by 25bp to 0.50%-0.75% from 0.25%-0.50% previously.** The statement explains the hike by stronger growth in H2 16, a tighter labour market, higher (although still low) inflation expectations and higher inflation. As this was largely as expected, focus quickly shifted to the 'dots'.

- Against expectations, **the median 'dot' for next year was revised up to three hikes from two hikes previously, while the median 'dot' for 2018 was unchanged at three hikes.** It was the first time since September 2014 that the Fed revised up its 'dots'. The USD strengthened and US yields moved higher on the back of the hawkish surprise from the Fed.

- **The more hawkish Fed came as it now expects higher growth next year (revised up to 2.1% from 2.0%) and a lower unemployment rate (revised down to 4.5% from 4.6%).**

- **Also, Fed Chair Janet Yellen sounded more hawkish at the press conference than previously.** Although she said that the changes to the 'dot plot' were *'really very tiny'* (suggesting that we should not over-interpret small changes), she highlighted two very important things which had a hawkish twist, in our view:

  1. **She said at the press conference that *'I never said that I favour running a high pressure economy'*,** thus distancing herself from the idea to let the economy run hot/let inflation overshoot the 2% target, which she mentioned in her speech in October.

  2. **She indicated that the Fed has not fully taken Trump's fiscal plans into account, which could result in further Fed hikes than currently indicated by the 'dots'.** She said explicitly that *'at this point that fiscal policy is not obviously needed to provide stimulus to help us get back to full employment*', indicating that the output gap is already nearly closed.

- **For the first time ever, the longer-run 'dot' (the Fed's view on the so-called 'neutral rate'/'equilibrium rate') was revised back to 3.00% from 2.88%.** The long-run NAIRU and real GDP growth estimates were unchanged at 4.8% and 1.8%, respectively.

We expect two hikes next year but risk is now skewed towards three hikes

- **We stick to our view that the Fed hikes twice next year (June and December) but risk is now skewed towards three hikes.**

- **It is still important to remember that the Fed turns more dovish next year due to shifting voting rights** as the hawks Loretta Mester, Esther George and Eric Rosengren lose their voting rights. Thus the median 'dot' for next year may actually overestimate the median 'dot' among voting FOMC members.

- **Another thing which could cause the Fed to hesitate in hiking is the recent tightening of financial conditions** due to the stronger USD and higher US yields. The slowdown in H1 16 was partly explained by too tight financial conditions, which hurt growth. **Also, weaker US data, weaker global growth and financial turmoil have postponed Fed hikes previously.**

- **The number of Fed hikes now depends on what strategy Donald Trump pursues with respect to implementing his economic plan, as the Fed will respond to more expansionary fiscal policy by raising rates faster.** If Trump wants to implement a comprehensive and permanent economic plan, it will take longer, see also page 19 in Five Macro Themes 2017, 1 December.

- **As the Fed wants to analyse the actual economic plan, it may be the case that the Fed only tightens monetary policy gradually to begin with before increasing the hiking pace.** In other words, the hiking pace may be much less smooth than during previous hiking cycles. As an example, assuming that Donald Trump finalises his economic plan by the end of Q2 17, it could be the case that we see one Fed hike in H1 17 and two in H2 17.

- **Based on the more hawkish Fed, markets now price in 2¼ hikes by year-end 2017 and slightly more than four hikes by year-end 2018.** The next full Fed hike is priced in by June.

- We still think the three most important triggers for Fed hikes next year are:

   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 expenditures) core inflation

USD: We believe the USD will strengthen broadly near-term

- **The USD strengthened broadly, which was as expected given the surprisingly hawkish shift** by the Fed expecting three hikes in 2017.

- In particularly, the JPY weakened sharply driven by its historical high negative correlation with US rates.

- EUR/USD also dropped but at the time of writing has stayed within the recent 1.05-1.09 range.

- **Strategically, we believe the USD will strengthen broadly near-term supported by rising US growth and rate expectations** particularly versus rates-sensitive currencies such as the JPY.

- **We continue to see EUR/USD as a 'sell-on-rallies',** where we are likely to see a test and break of the 1.05 level near-term. We forecast EUR/USD at 1.05 in 1M and 1.04 in 3M.

- **Longer-term, we continue to expect EUR/USD edging higher towards 1.08 in 6M and 1.12 in 12M** on valuation and the record large eurozone-US current account differential.

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US yields: we still see the curve flattening further

- The rate hike and the new 'dots' that imply three new rate hikes next year coupled with the higher longer-run estimates might at first glance look hawkish.

- However, listening to Yellen it is obvious that she does not put too much weight on the change in the 'dots'. But importantly she did underline that she had never recommended to let the economy 'run hot' as an experiment and that the Fed had not fully taken Trump fiscal policy into account.

- **Hence, if the economy develops in line with expectations over the next couple of months, we should expect the market to increasingly price in a third hike in 2017**. Currently, 2 ¼ hikes are priced for 2017.

- US FI sold-off after the announcement and the curve flattened 5y10y and 10y30y with 30Y yields moving only modestly higher. The latter probably reflecting that 30Y are already above the neutral rate.

- **The market reaction in the next couple of days and weeks will very much hang on how risk appetite reacts to the Fed decision.**

- **Looking ahead, we still see the US curve flattening further and especially 2Y, 5y and 10Y yields moving higher as the market slowly prices in a higher probability that the Fed plans to hike three times in 2017.** We keep the view that 10Y US Treasury yields will move towards 3.0% in 2017.

- However, we expect the way ahead will be bumpy. The curve is already quite steep and the Fed rotation indicates a more dovish Fed next year. Remember, despite the 'dots', Fed policy is still data dependent.

What to look for next 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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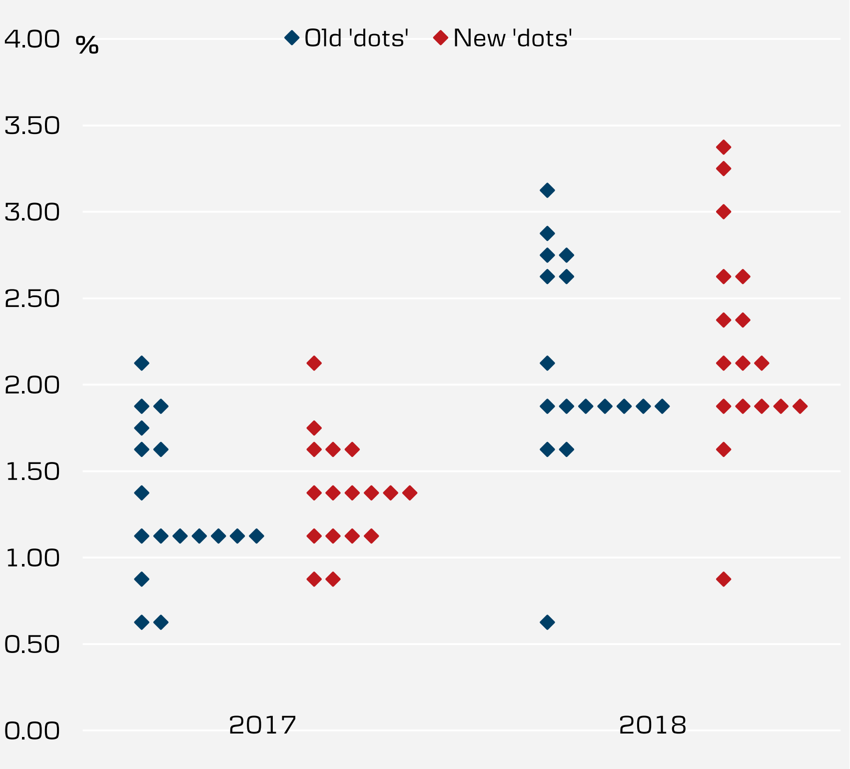
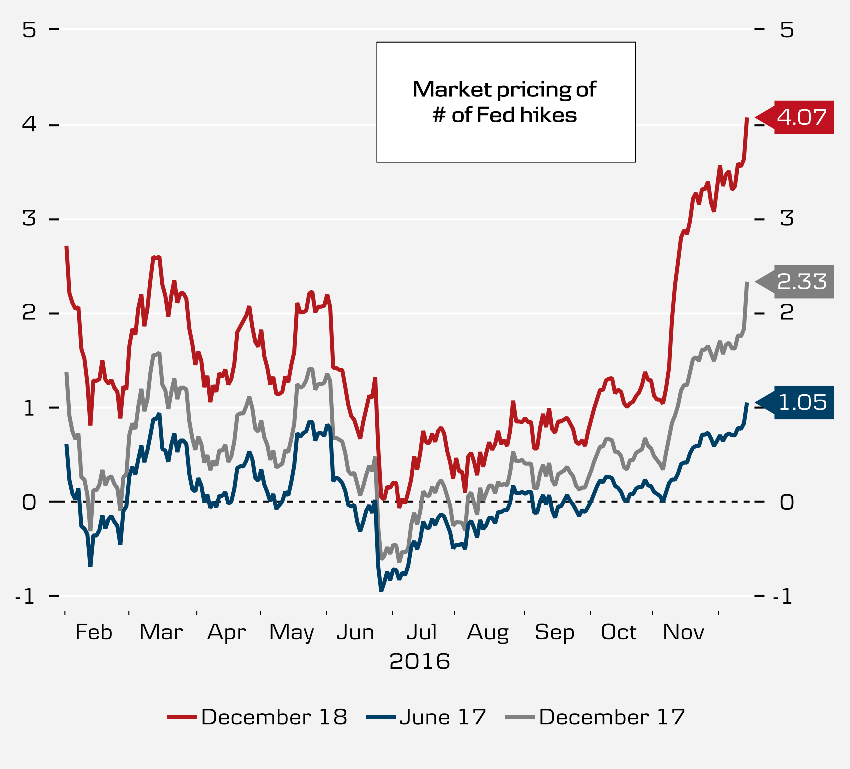
Fed now signals three hikes both in 2017 and 2018

Median 'dot' for 2017 revised up to three hikes



Source: Bloomberg, Federal Reserve

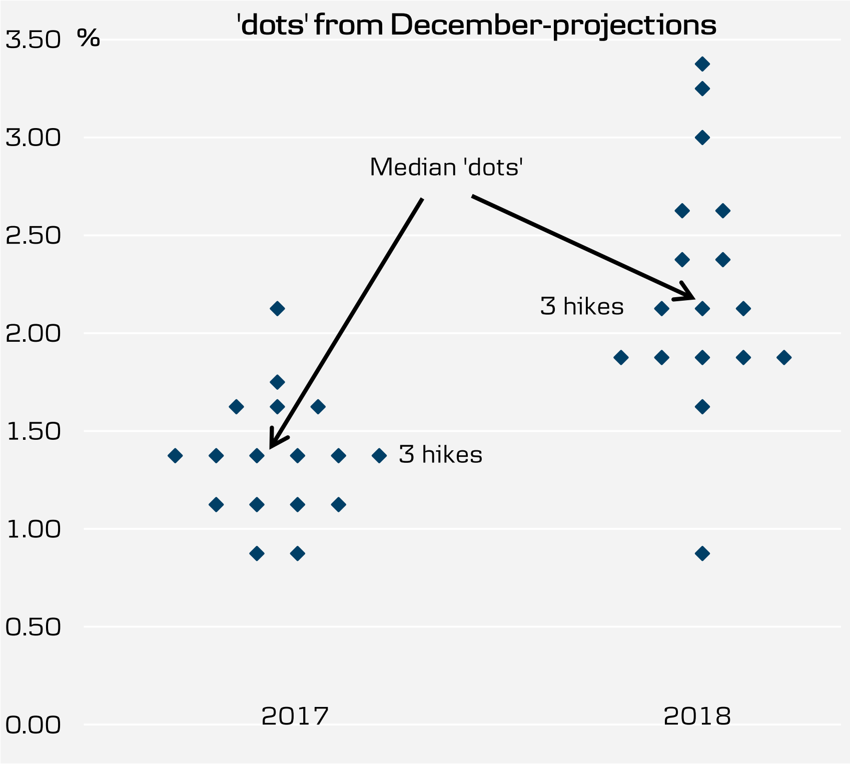
Markets have priced more than two hikes in 2017



Source: Bloomberg, Federal Reserve, Danske Bank Markets

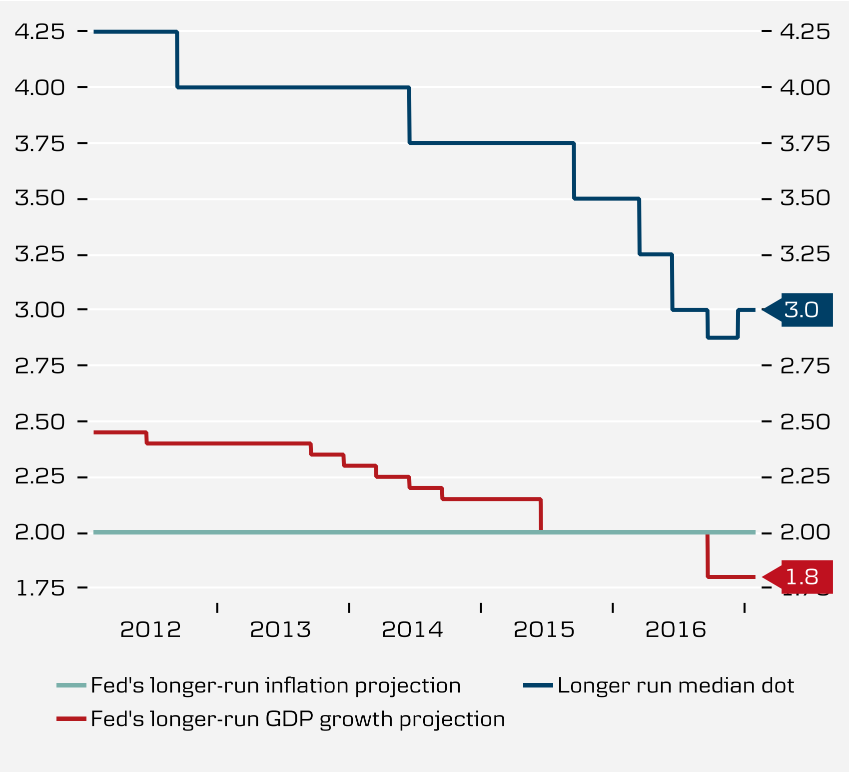
Yellen told us not to put too much weight on small changes to ‘dots’

Fed signals three hikes in 2017 and 2018



Source: Federal Reserve

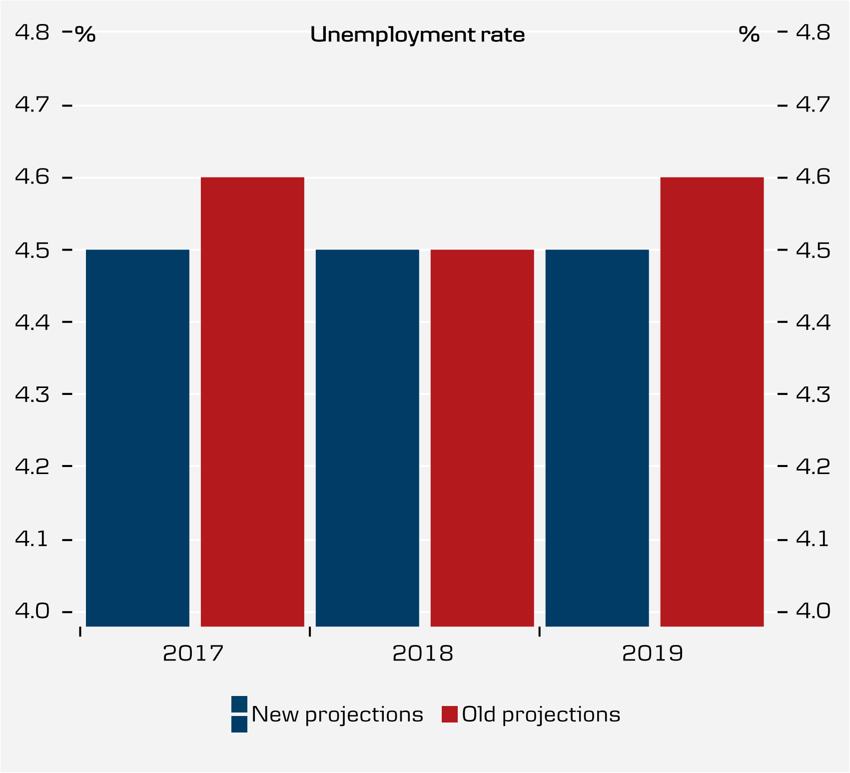
First upward revision to longer-run ‘dot’ ever



Source: Bloomberg, Federal Reserve, Danske Bank Markets

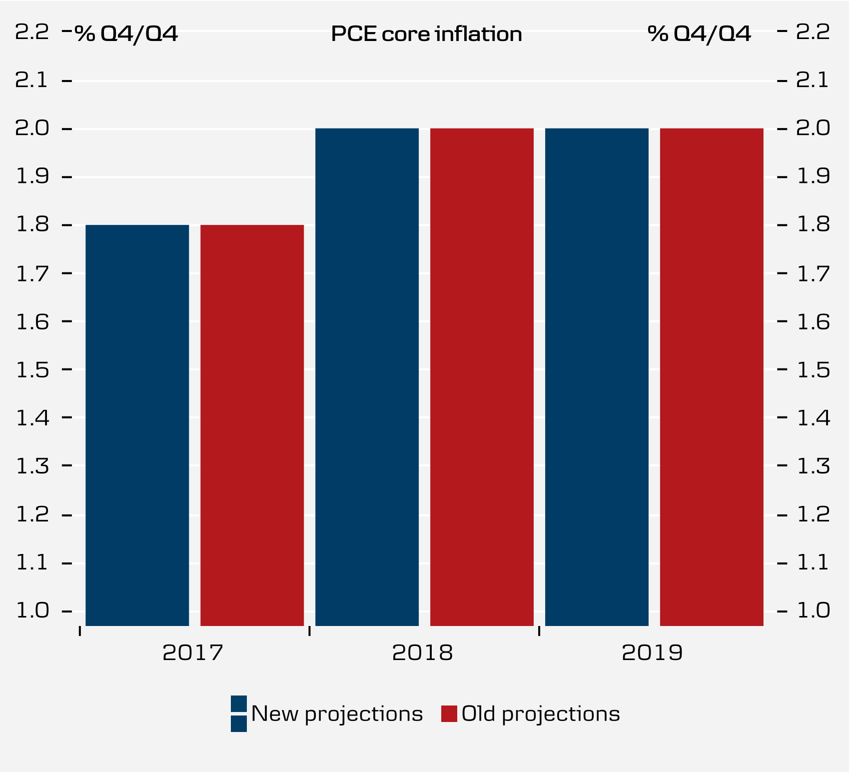
Fed more hawkish on expectations of higher growth and lower unemployment rate next year

Expects slightly lower unemployment rate next year



Source: Federal Reserve

PCE core inflation unchanged – no overshoot



Source: Bloomberg, Federal Reserve, Danske Bank Markets

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In our view, still important to remember that the Fed turns more dovish next year due to shifting voting rights

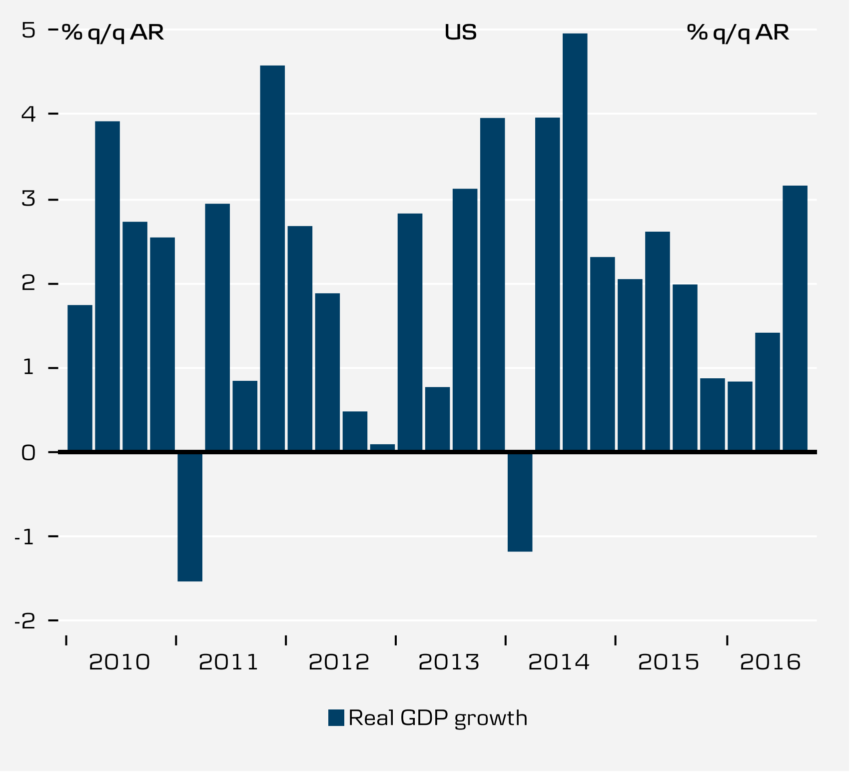
	2016	2017	
Hawkish	Lacker	Lacker	*Richmond*
	George	George	*Kansas city*
	Mester	Mester	*Cleveland*
	Rosengren	Rosengren	*Boston*
	Harker	Harker	*Philadelphia*
Neutral	Lockhart	Lockhart	*Atlanta*
	Williams	Williams	*San Francisco*
	Powell (B)	Powell (B)	*Board*
	S. Fischer (B)	S. Fischer (B)	*Board, 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

Macro charts

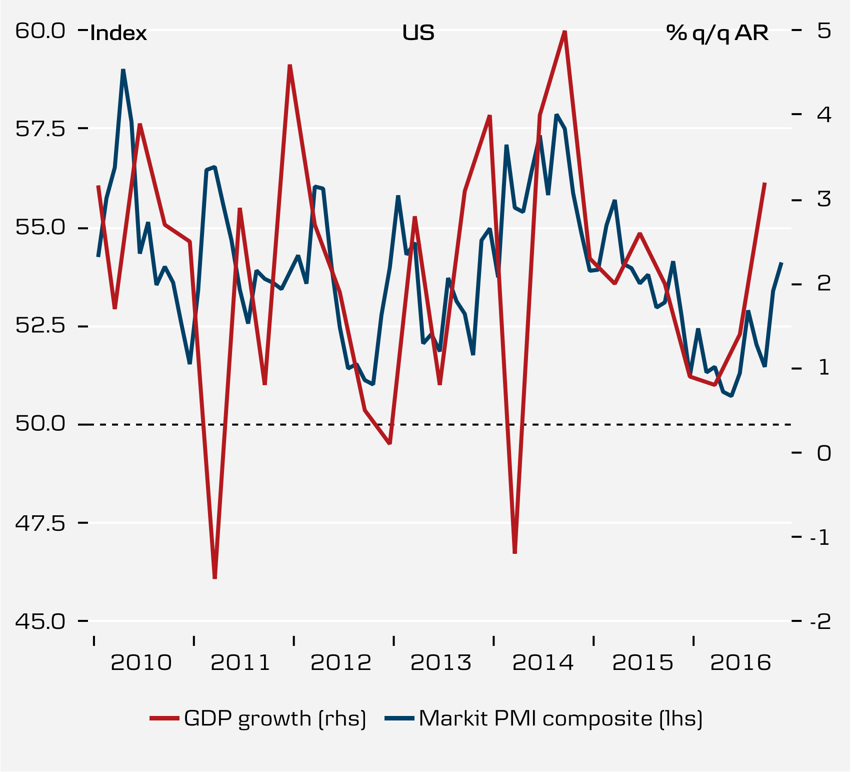
Growth has rebounded after a slowdown in H1 16

Growth picked up in Q3 after three weak quarters



Source: BEA

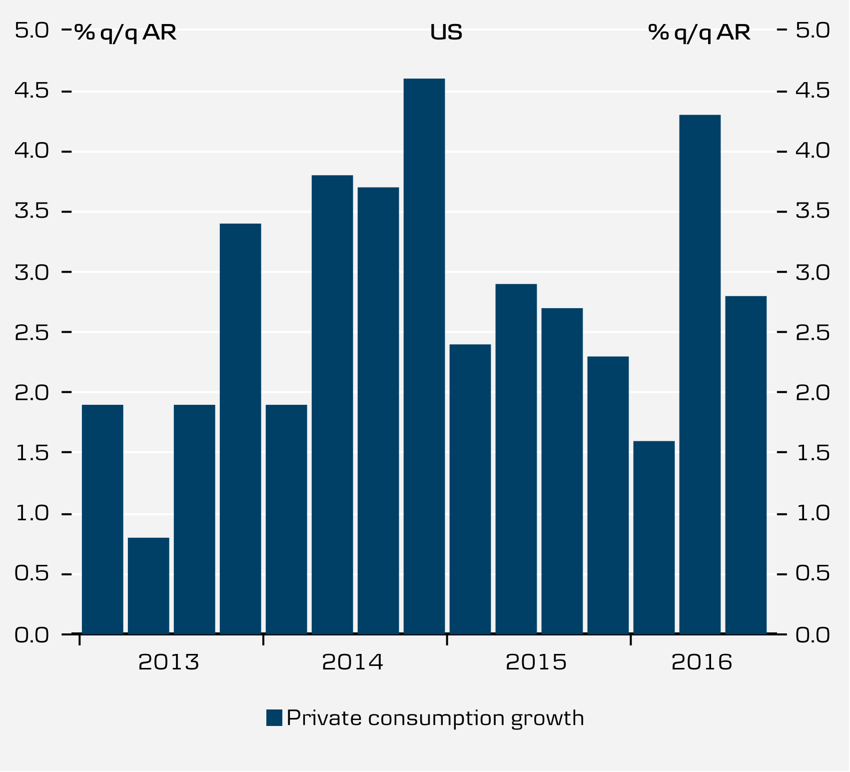
Growth has continued at an above-trend pace in Q4



Source: BEA, Markit Economics, Danske Bank Markets

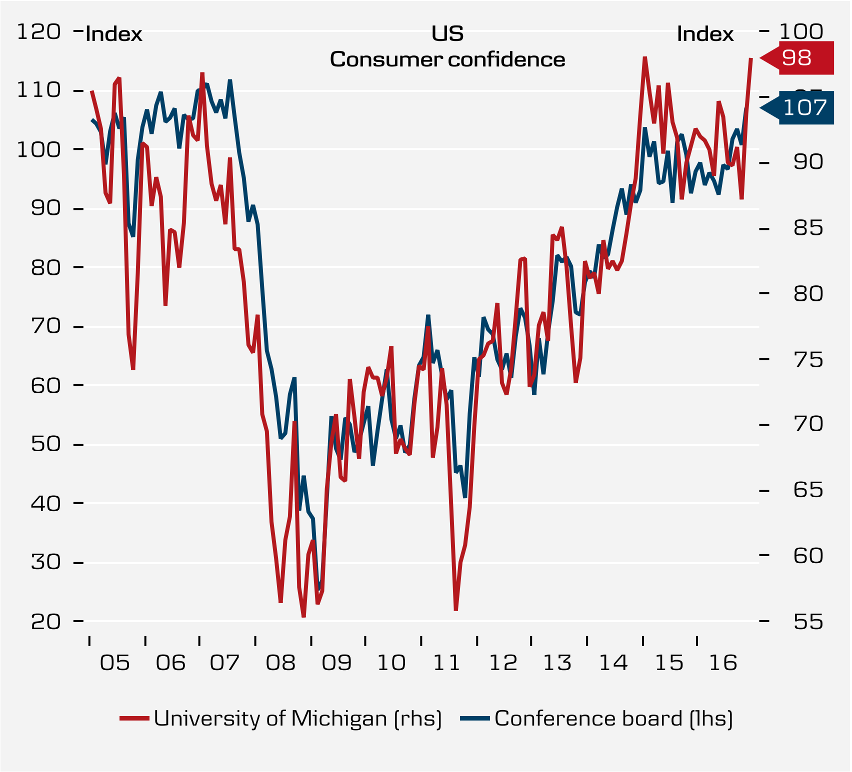
Private consumption the main growth engine

Solid private consumption growth



Source: BEA

Very high consumer confidence



Source: University of Michigan, Conference Board

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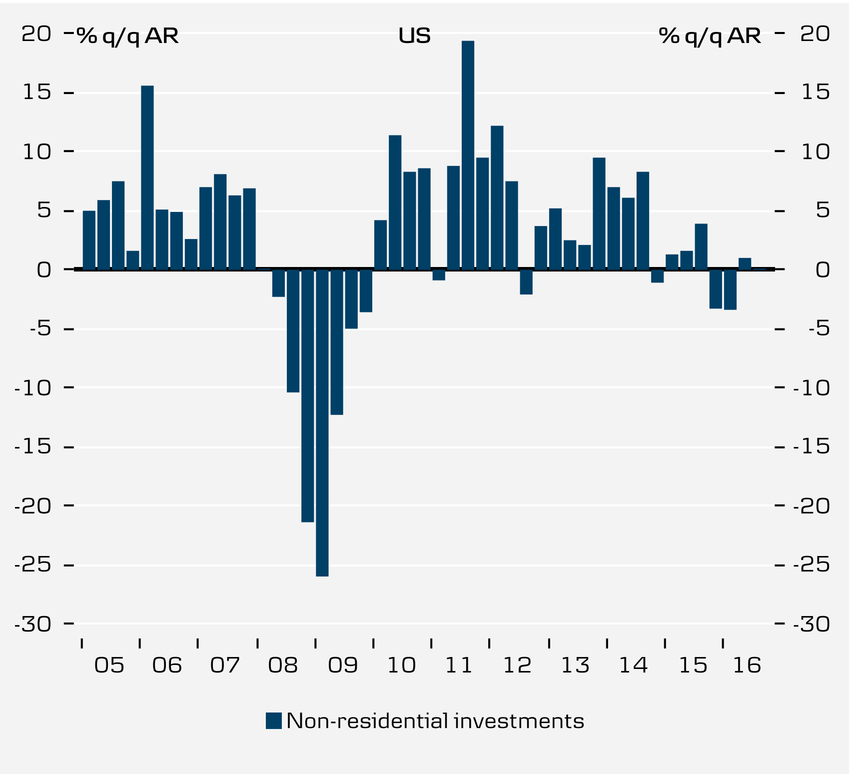
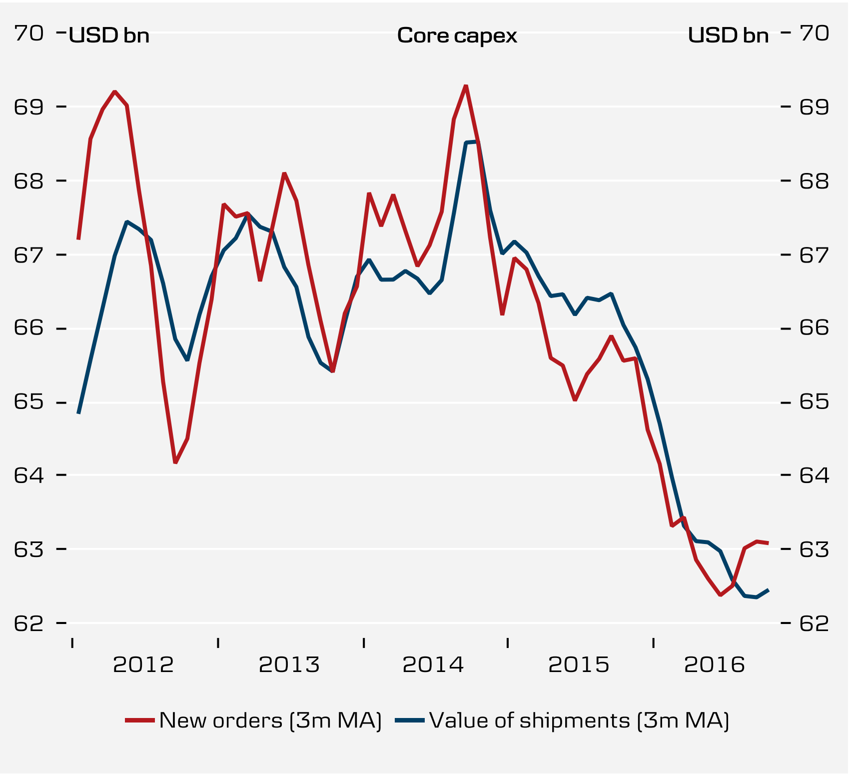
Have investments bottomed out? We think so

Non-residential investments have been weak



Source: BEA

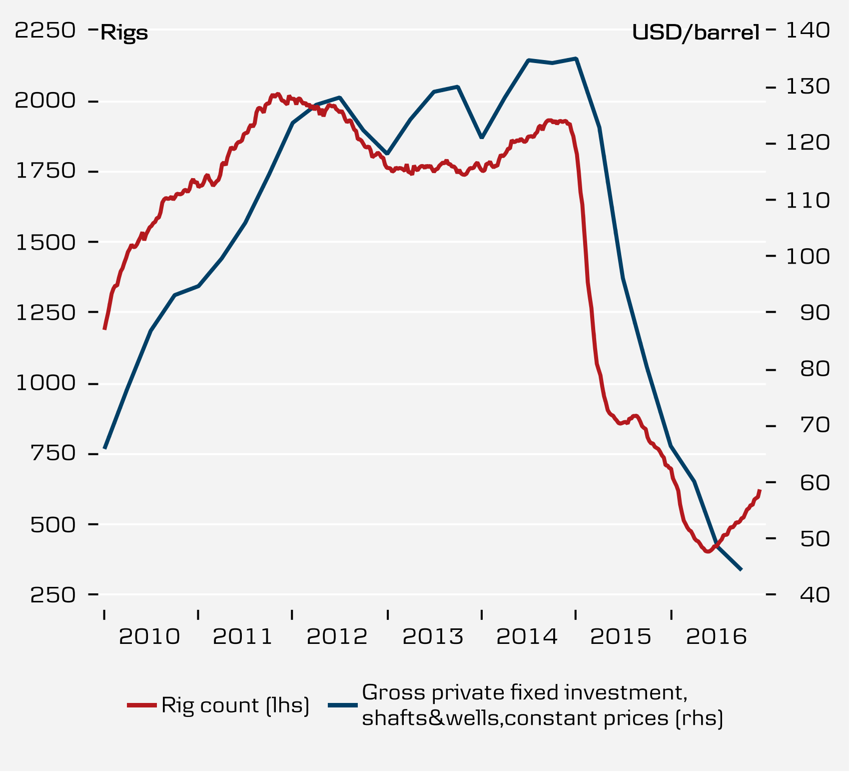
Core capex seems to have bottomed out



Source: US Census Bureau

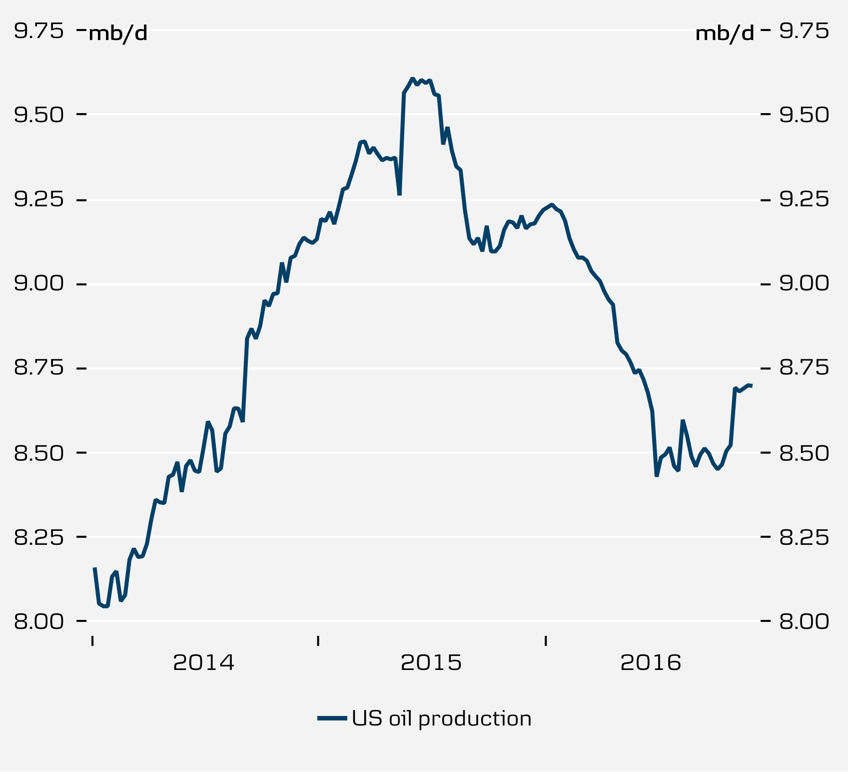
Headwind from lower oil investments is fading

Oil investments to rebound



Source: BEA, Baker Hughes

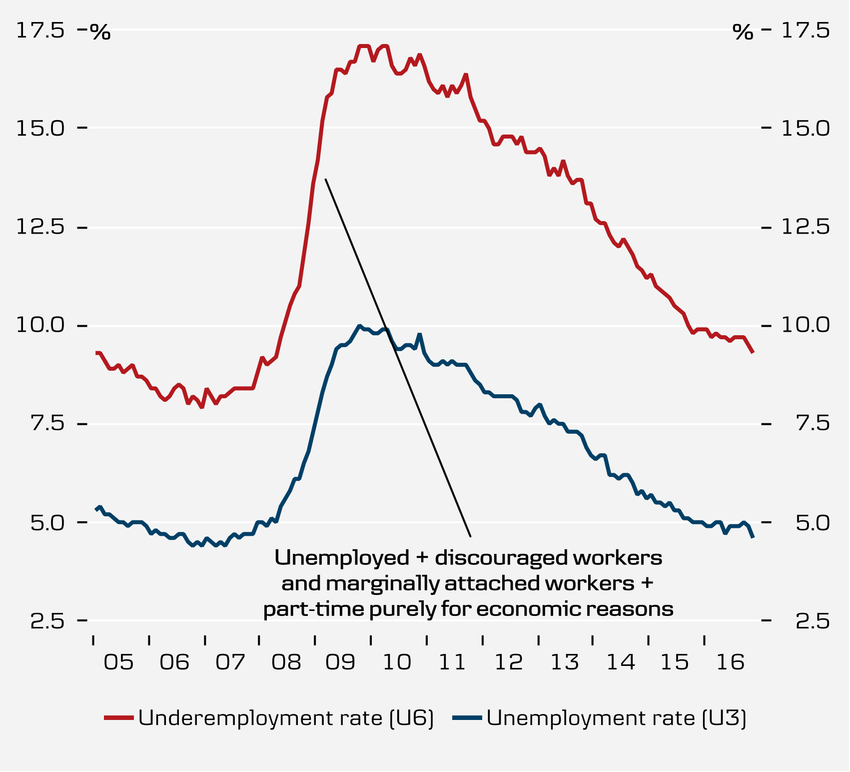
US oil production has increased



Source: EIA

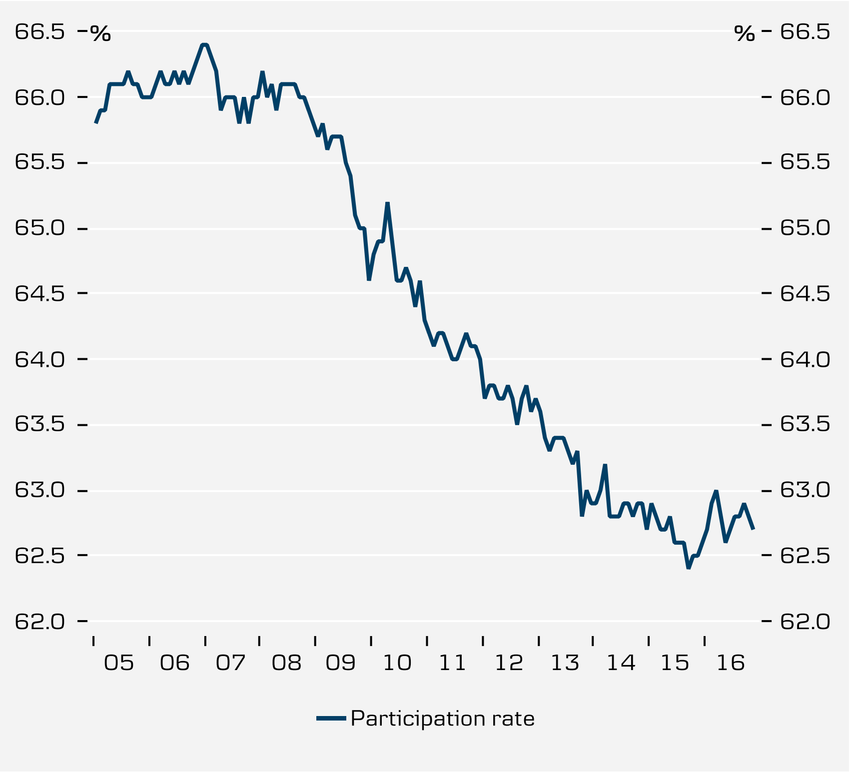
Still a bit more slack left in the labour market

Room for lower unemployment rates



Source: BLS

Participation rate has increased slightly



Source: BLS

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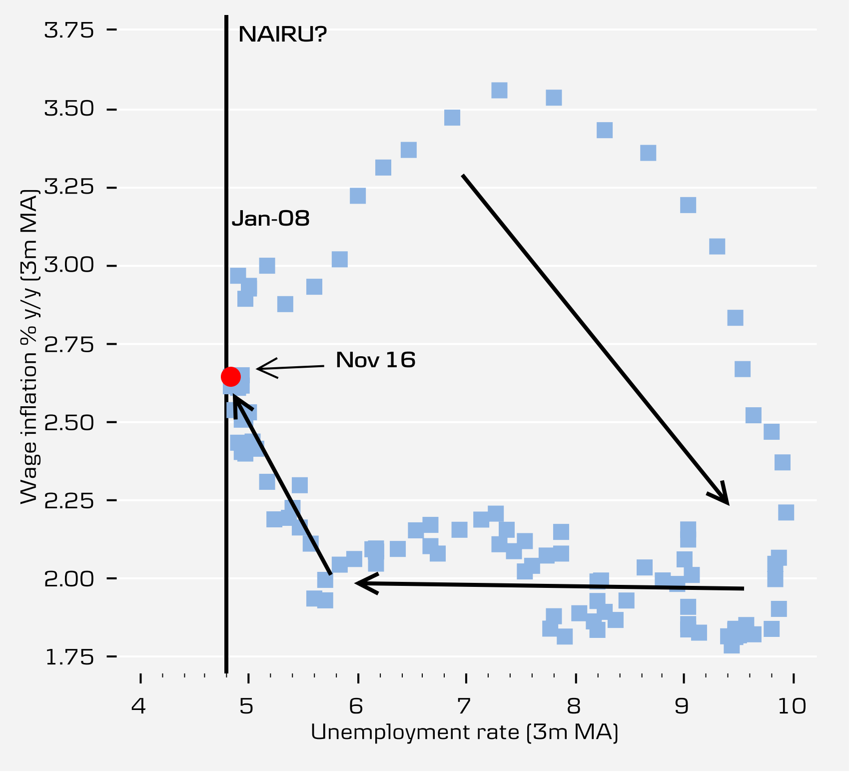
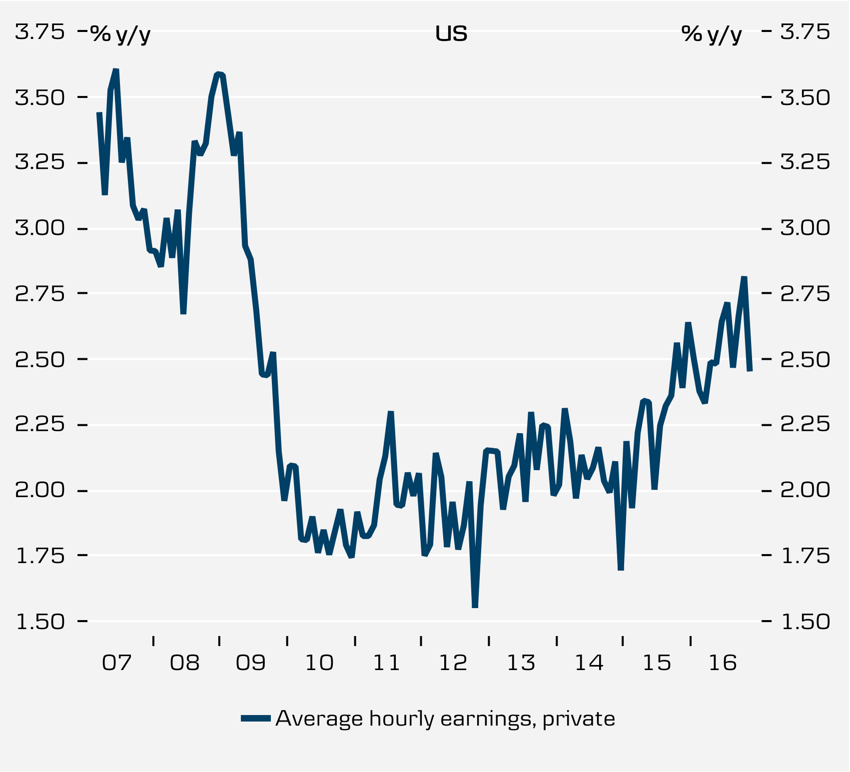
Fed sees the world through the Phillips curve

Tighter labour market => higher wage growth



Source: BLS

Wage growth still needs to move even higher



Source: BLS

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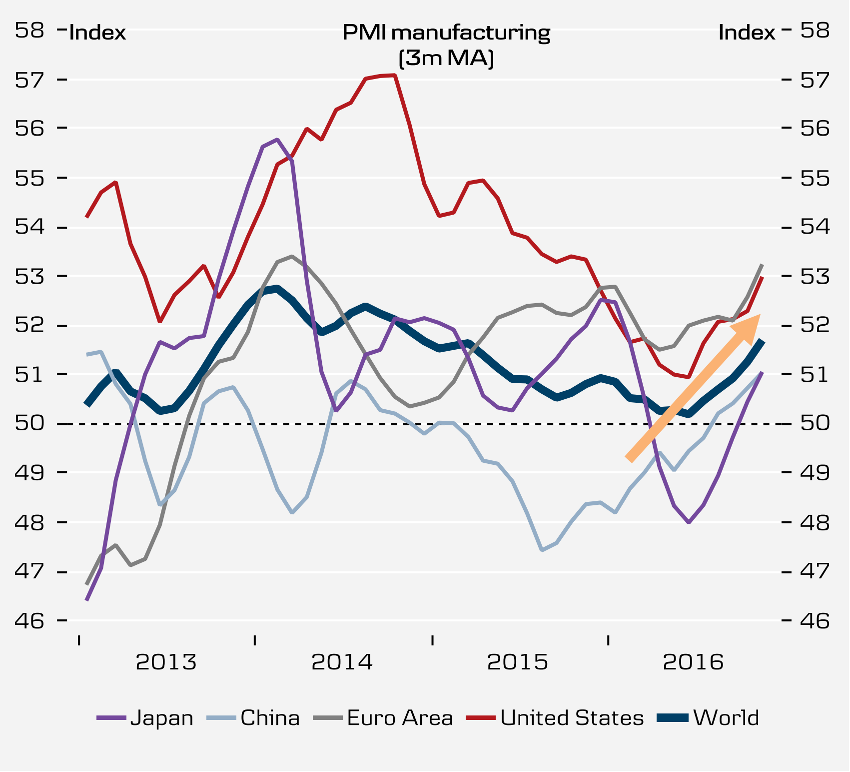
Global business cycle has turned – synchronised recovery signal across regions

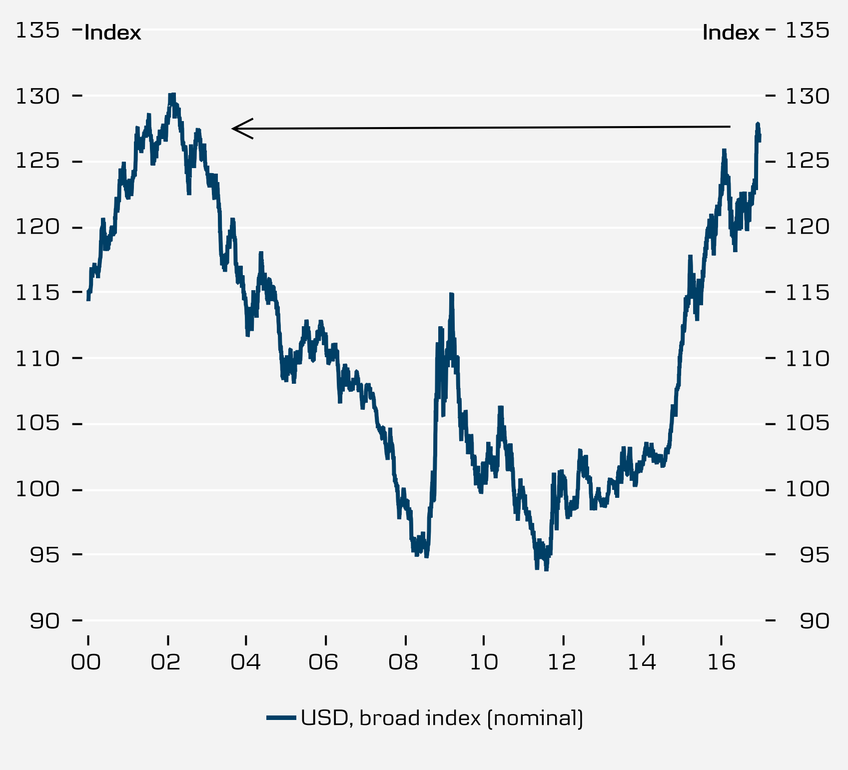
PMIs are trending up across countries



Source: Markit Economics

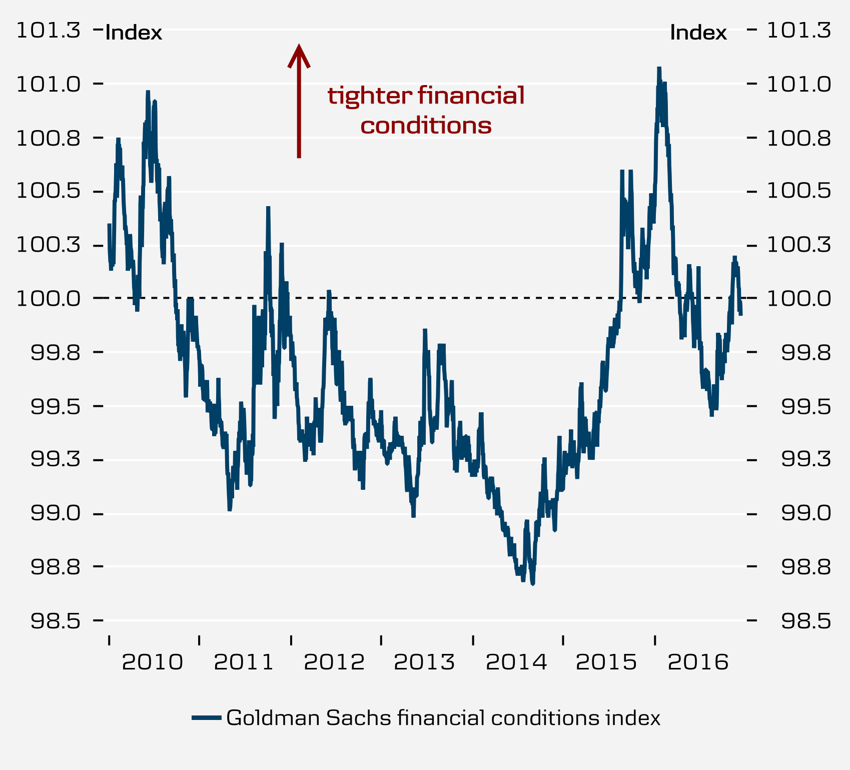
Financial conditions have begun to tighten again, partly driven by higher growth (expectations)

The strong USD is back



Source: Federal Reserve

FCI still not as tight as in early 2016



Source: Goldman Sachs

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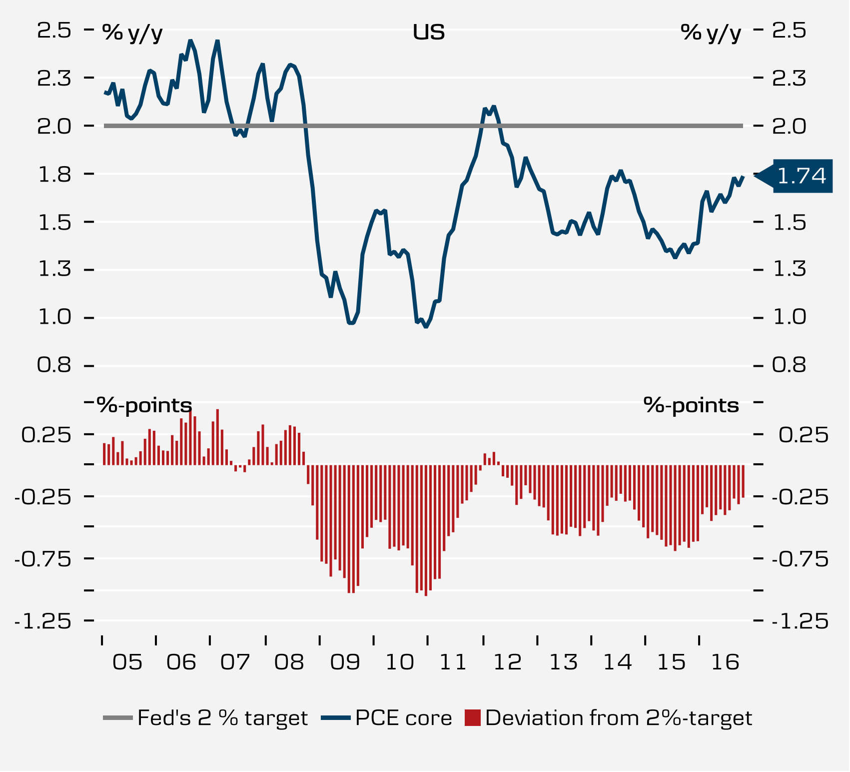
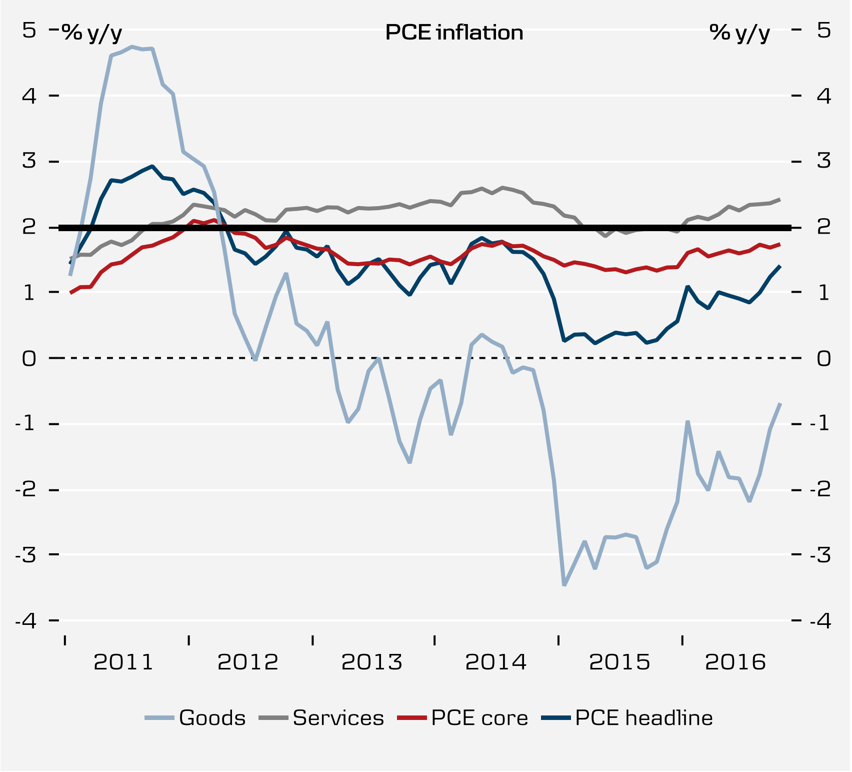
Actual PCE core inflation still below 2% target

Fed wants to see actual core inflation move higher



Source: BEA

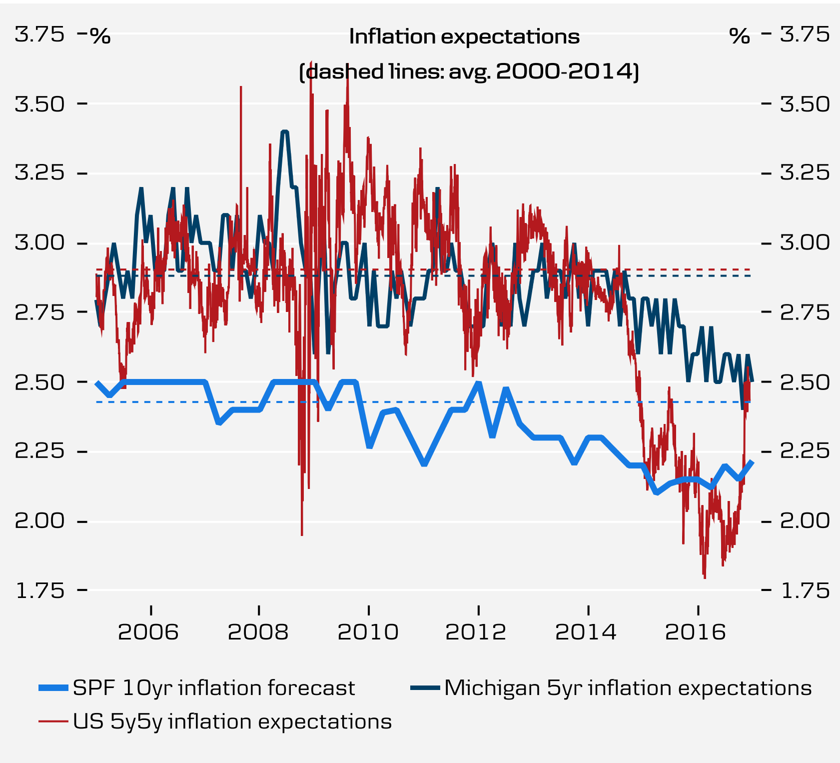
Goods deflation fading



Source: BEA

Inflation expectations have rebounded

Inflation expectations still below historical averages



Source: SPF, University of Michigan, Bloomberg

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