MARKET ANALYSIS

Ad-hoc research into market moving events from our in-house analysts



PREVIEW: FOMC Meeting December 2017

- **The FOMC will release its rate decision and economic forecasts at 1900 GMT (1400 ET/1300 CT) on Wednesday 13 December 2017; Chair Janet Yellen will begin her press conference at 1930 GMT (1430 ET/1330 CT)**
- **The central bank is expected to lift the Federal Funds Rate target by 25bps to 1.25-1.50%**
- **Little change is seen in the 'dots'; there is potential for upward revisions to growth in 2018 and beyond, factoring in US fiscal reform; however, analysts still forecast that inflation will undershoot the Fed's forecasts**

EXPECTATIONS:

Money markets have been pricing in a 25bps FOMC hike at the 13 December meeting for some time, which would take the Federal Funds Rate target range to 1.25%-1.50%, and represent the third hike this year (and fifth of this hiking cycle).

Minneapolis Fed's Neel Kashkari is likely to continue his dissent over the lifting of the Federal Funds Rate target, while there will also be attention on Chicago Fed's Charles Evans, who has also recently cautioned on hikes.

INFLATION CONCERNS MAY EASE:

Concerns regarding the inflation outlook were noted in the minutes of the FOMC's October/November meeting minutes. But the recent run of data will likely provide support to the hawks. The October CPI data ticked up slightly, with the core Y/Y rate now at 1.8%, and the headline rate at 2.0%.

November's inflation data will also be released on Wednesday 13 December - which the FOMC will likely have sight of during its two-day meeting – and the consensus expects the headline to tick up further, while the core rate is seen steady. The Fed will have been encouraged by the better-than-expected November PPI data, which suggests that pipeline inflation pressures may be emerging.

ECONOMIC PROJECTIONS:

Change in real GDP	**2017**	**2018**	**2019**	**2020**	**Long-run**
FOMC Forecast (Sep 2017)	2.40%	2.10%	2.00%	1.80%	1.80%
Analyst Median Forecast	2.20%	2.40%	2.10%	--	--
Unemployment Rate	**2017**	**2018**	**2019**	**2020**	**Long-run**
FOMC Forecast (Sep 2017)	4.30%	4.10%	4.10%	4.20%	4.60%
Analyst Median Forecast	4.40%	4.10%	4.10%	--	--
PCE Inflation	**2017**	**2018**	**2019**	**2020**	**Long-run**
FOMC Forecast (Sep 2017)	1.60%	1.90%	2.00%	2.00%	2.00%
Analyst Median Forecast	1.65%	1.80%	2.00%	--	--
Core PCE Inflation	**2017**	**2018**	**2019**	**2020**	**Long-run**
FOMC Forecast (Sep 2017)	1.50%	1.90%	2.00%	2.00%	--
Analyst Median Forecast	1.50%	1.70%	2.00%	--	--

Source: FOMC, Reuters

The FOMC is due to update its economic projections, and there may be scope for upward revisions to the growth estimates made in September - analysts are certainly more optimistic than the Fed's current projections.

The forecasts made in September did not include any of the proposed fiscal stimulus into its projections; while there remains uncertainty about the exact impact the recent tax cuts are likely to have on the US economy, some Fed policymakers have argued that there will be only limited upside potential at the very minimum.

However, the consensus view for PCE and core PCE is below the Fed's September forecasts, and meanwhile, the market and the Fed are more-or-less in-line on the rate of joblessness from 2018 onwards.

It is worth noting that, as at the previous five Fed meetings, there will only be nine voters at the December meeting, rather than the full contingent of 12. IFR points out that, this means there will only be 16 (of a possible 19) dots on the dot plot.

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There will be speculation around the forecasts of newly instated Governor Randall Quarles. “Although Fed Governor Quarles voted in the last meeting, this will be the first time we see his dot,” IFR writes, “we suppose, for now, his dots will fall next to the median projections for end-2018, end-2019 and end-2020.”

HIKE TRAJECTORY:

Federal Funds futures are currently pricing in just over three hikes (including one at this meeting) through to the end of 2020, undershooting the Fed’s view of another seven hikes over that horizon. Analysts at ING suggest that there will be two factors to consider on this front:

1) Persistently low US inflation dynamics: “such signs remain few and far between – and trackers of long-run US inflation expectations (like the 5Y5Y break-evens) are right to be pricing in structurally lower price dynamics,” ING writes, ”it’s a tall order for the median Fed dots to shift lower, but we may see a slight downshift in the distribution.”

2) The impact of fiscal stimulus on the Fed’s outlook: “Odds of the Trump Tax Bill being passed have increased since the Sep FOMC projections and it will be interesting to see whether officials will incorporate any fiscal stimulus into their forecasts,” ING writes. “We think it is too early for this, while some Fed officials have also downplayed the reflationary effects of proposed policies.”

POST-MEETING PRESS CONFERENCE:

The post-meeting press conference with Chair Janet Yellen will be her last, and she is expected to strike a balanced tone regarding future policy, HSBC says, reiterating her view that the FOMC will tighten policy gradually (as the incoming Fed Chair Powell recently endorsed in his confirmation hearing).

WHAT BANKS DESKS ARE SAYING:

ABN AMRO: We expect the FOMC to raise its target range for the Fed funds rate by 25bp to 1.25-1.5% at its meeting on Wednesday, with the policy rate (the IOER) also moving up by the same amount to 1.5%. This is widely expected by economists and is virtually fully priced in by financial markets (98.3% according to the Bloomberg probability calculator based on futures pricing). So investors will be largely focused on the Fed’s guidance for 2018, which will be shaped by the dot plot and communication in the press conference. Our sense is that the FOMC must be torn by conflicting signals on the economy and inflation. Its confidence in a continued positive outlook for economic growth and the labour market must have strengthened in recent months. On the other hand, its confidence in its view that inflation will return to target over the medium term must have softened somewhat given continued subdued readings for wage growth, unit labour cost growth and core inflation numbers (even though the latter appear to have stabilised recently after falling for much of the year). Against these conflicting signals, we think the FOMC may continue to project 3 rate hikes in 2018. Given that financial markets are pricing in less than two hikes, this might be negative for Treasury markets in the near term (in particular the short-end), but positive for the US dollar. Our own view is that the Fed will eventually deliver less rate increases than it is signalling (two rather than three) given that underlying inflationary pressures are likely to remain subdued.

BARCLAYS: We expect a 25bp increase in the federal funds rate in December. We expect a modest upgrade to the description of labour markets following the landfall of the major hurricanes which disrupted labor markets temporarily. In the updated SEPs, we expect a modest upgrade to growth in 2017 and 2018 alongside a lower unemployment rate path along the forecast horizon. This should lead to increased confidence about the outlook for inflation and, in our view, will result in a 12.5bp firming in the average funds rate over the next two years. We no longer expect a delay in the rate hike cycle early next year and restore our outlook for three further rate increases in 2018 in March, June, and December.

BAML: The final FOMC meeting of the year will give us a sense of how FOMC officials see the economy evolving as we head into 2018. A key question is whether FOMC officials include the potential impact of tax reform. Moreover, Randy Quarles will be submitting his forecasts for this meeting, replacing Stanley Fischer's submissions. In our view, the forecasts are likely to be quite similar, but there is a risk Quarles has a more positive outlook for the longer term, buying into the argument fiscal stimulus and de-regulation could boost longer-term growth prospects. On balance we think the risk is that the dots shift slightly higher in 2019 and beyond, sending the forecast for long-run rates back to 3.0%, therefore reversing the move in September. This would send a more hawkish signal. However, we believe the risks are that Chair Yellen strikes a more cautious tone in the press conference as she expresses the need for caution as the hiking cycle progresses. She will also likely have to answer questions on the recent flattening of the curve.

CAPITAL ECONOMICS: A 25bp rate hike at next week’s FOMC meeting is all-but guaranteed. Of more interest will be whether the increased prospect of a near-term fiscal stimulus prompts officials to revise up their projections for GDP growth, inflation and interest rates. Regardless, we still expect a rebound in inflation to convince the Fed to raise rates an above consensus four times in 2018.

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GOLDMAN SACHS: FOMC to hike by 25bps as widely expected (95%+ priced). The pressing question is how much tax reform makes its way into the FOMC forecasts; we think for now more into the "balance of risks" around the forecasts than the forecasts themselves. Otherwise more of the same: strong labor market, solid activity data, easing financial conditions and somewhat sluggish inflation. We expect lower Unemployment Rate forecasts (including Nairu) and slightly higher real GDP forecasts with upside risks. We expect an unchanged three hike median for 2018 but see hawkish risks to September's 2.25 median pace of hikes for 2019. We don't expect explicit mention of tax reform progress in the policy statement but near-term upside risks to be acknowledged by finally moving from "roughly balanced" to "balanced". Without material surprises, Wednesday morning's CPI might matter more than the FOMC release. A stronger print might also lead to an upgrade of the inflation language in the policy statement. Our baseline below is likely slightly dovish to market expectations but as flagged we see risks almost entirely to the hawkish side.

HSBC: We expect the FOMC to raise the federal funds rate by 25bp, lifting the target range to 1.25%- 1.50% from 1.00-1.25%. This would be the third hike this year and the fifth increase since the FOMC first began to raise policy interest rates at the end of 2015. Minneapolis Fed President Neel Kashkari is likely to dissent in favour of leaving rates unchanged, as he did in March and June. It is possible that Chicago Fed President Charles Evans could also vote against the rate hike; this would be his first dissent this year. We do not expect any major surprises from the policy statement. The statement will probably repeat that economic activity has been rising at a solid rate, while dropping earlier references to hurricane-related disruptions. The FOMC will likely repeat that near-term risks appear roughly balanced and that inflation developments will be monitored closely. Finally, the statement will likely reiterate the guidance that the Committee anticipates gradual increases in the federal funds rate. We expect the FOMC's median projection for GDP growth to be lifted slightly for the next several years. The projection for 2017 could be increased to 2.5%, up from 2.4% in September. The 2018 projection could be raised to 2.3% from 2.1%, and the 2019 projection could be raised to 2.1% from 2.0%. We expect the FOMC's median projection for unemployment at the end of 2018 to be lowered slightly to 4.0% from 4.1%. The FOMC's median estimates for core PCE inflation in 2018 and 2019 could be left unchanged, at 1.9% and 2.0%, respectively. We expect the FOMC's median projection for policy rates at the end of 2018 to remain at 2.1%, implying three 25bp rate hikes over the course of next year. Some of the policymakers may shift their rate projections for 2019 and 2020, but on balance we expect the median projections for those years will stay at 2.7% and 2.9%, respectively. This will be Ms Yellen's final post-meeting press conference as Fed Chair. She is likely to strike a balanced tone with respect to the future course of policy, continuing to endorse the FOMC's message that gradual rate hikes are likely to be warranted in the coming year. The Chair may be asked about the potential macroeconomic effects of the tax reform efforts currently under consideration in Congress.

LLOYDS: We expect the US Federal Reserve to raise interest rates by 0.25% at its December policy meeting As markets already attach a very high probability to a hike there should be little reaction to the announcement Also of interest will be what the Fed signals of its policy intentions for next year We forecast that the 'dot plot' will continue to show that the majority expect to increase rates three times in 2018 The gap between market pricing and the Fed's interest rate forecasts has shrunk sharply in recent weeks Nevertheless there remains room for markets to be surprised by the extent of the Fed's actions

MORGAN STANLEY: We expect the Fed to hike its target range by 25bp at its December meeting with little change in its economic or rate projections. We expect the Fed to remain on a gradual path through September 2018, then pause in December. Our strategists suggest a neutral stance on the yield curve into year-end.

OXFORD ECONOMICS: We expect the FOMC to take another step in the slow climb back to normalizing monetary policy with a hike in the fed funds rate target range of 25 basis points to 1.25% - 1.50%. The majority of FOMC participants will continue to forecast that inflation will reach its 2% target in the medium-term. The recent uptick in core inflation readings, albeit modest, provides support to their forecasts. it looks very likely that the $1.5 trillion fiscal stimulus bill will soon be passed into law. Since most Fed officials had not factored fiscal stimulus into their forecasts. Doing so would support further rate hikes next year with monetary policy still deemed accommodative. There is the possibility that higher economic and inflation growth estimates will boost the interest rate dot plot estimates for 2018 and 2019.

RABOBANK: Although puzzled by this year's decline in inflation when unemployment has dropped below its own estimate of the NAIRU, the FOMC seems determined to deliver its third rate hike of the year on December 13. However, by trying to squeeze in a third hike before the end of the year they may also reduce the probability of delivering three hikes next year.

RBC: The FOMC meeting is the highlight of the week but it is likely to come and go with very little fanfare. An increase in rates is baked in the cake with the market pricing in 98% odds of a 25bps hike, according to Bloomberg. Likewise, Chair Yellen's press conference should prove to be a non-event. She just testified before the Joint Economic Committee (Nov 29th) and thus her most recent views are out there and well-known. She is also leaving once Powell is confirmed (really a formality now as his nomination cleared the Senate Banking Committee with a bipartisan 22-1 vote) so expect the news conference to look more like a deferential send-off than a grilling. The bigger question is whether the Fed will significantly alter their economic and rates projections. We think not and believe it is more likely the committee will seek flexibility on this front and wait until March to make significant upgrades. For starters, the Fed will want to wait until they can model the impact



of the looming tax plan. Even if it is signed into law by the time the committee meets, there will not be enough time to do a proper vetting of what the plan means for economic growth/inflation/rates. Moreover, by waiting until March to release new estimates, the Fed can still maintain flexibility to raise rates 4 times next year or not. Contingent on tax policy being signed into law, we think members will be out in force on the speaking circuit promoting their upgraded views on the economic backdrop, thus moving the probability of a March hike up sharply through early 1Q (it's around 60% at present). Then they couple a hike in March with a boost in growth/inflation and their dots profile (moving to 4 hikes in 2018).

UBS: The 25bp FOMC rate hike that we've long forecast is now almost fully priced into markets—and therefore unremarkable. More interesting will be how the FOMC incorporates tax reform into their projections. Most FOMC members had not built tax reform into their September projections, and progress has been much more rapid than they (or we) expected. With the FOMC putting the tax cuts into their baseline forecasts, the Summary of Economic Projections is likely to show faster growth, a lower unemployment rate, and a faster pace of rate hikes, but no revision to inflation. They'll also likely build in an additional rate hike in 2018 and 2019, with the fed funds rate above its long-run neutral level by the end of 2019.For our part, we have said that the single largest upside risk to our baseline forecast is that the Congress passes a large tax cut, which now looks much more likely. The details and timing of the tax cuts matter and are still being negotiated. Without any specifics, we have estimated that a tax cut on the order of what is being debated could result in a boost to real GDP growth on the order of ¼ to ½ percent per year in 2018-19.

WESTPAC: A rate hike at this meeting is the expectation of all in the market, having been well telegraphed by the FOMC since the decision to begin balance sheet normalisation back in September. Justification for the decision can be found in continued above trend GDP growth, led by the consumer, as well as a labour market that has well and truly achieved full employment. Wages growth continues to lag, but the FOMC remain expectant. Confidence and financial conditions are also very supportive for the economy, hence the downside risks of a rate hike are negligible. – Inflation on a PCE basis is expected to firm slowly to target over the coming two to three years. If this occurs and we see two additional hikes in 2018, then the Fed Funds rate will remain neutral to the economy, sustaining growth.