Central Banks

FOMC Minutes: March 17-18th Meeting

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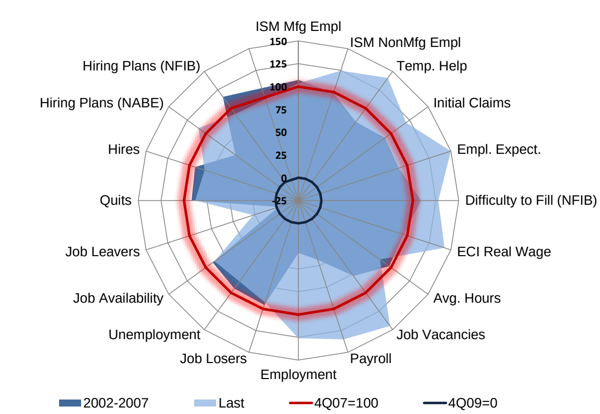
Meeting-by Meeting Approach to Normalization Officially Underway

- **Rate hike in April unlikely, but statement may reveal whether or not all bets are off for June**
- **FOMC strives for more flexibility in decision-making with meeting-by-meeting approach**
- **Expectations are set for a September hike as the probability for June has fallen drastically**

The minutes from the March FOMC meeting already feel somewhat outdated given the latest economic developments throughout the past few weeks. Most importantly, March's disappointing employment report seems to negate at least some of what was discussed in the meeting. At the time of the discussion in mid-March, many Committee members felt that "the economic data and outlook were likely to warrant beginning normalization at the June meeting." While some of these hawkish participants will keep their eyes set on June, it is likely that others will have since pushed back their views toward September (or even later). Unfortunately, we'll have to wait another month to find out for sure, as we will most likely get additional details in the minutes for the upcoming April 29th meeting (knowing that a rate hike at this time is "unlikely").

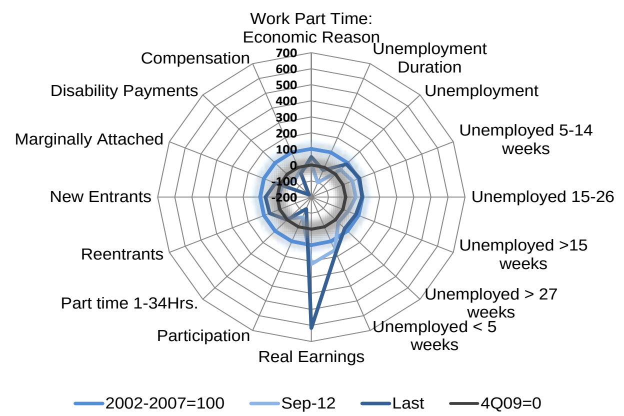
Clear communication has become a significant factor, and thus it was important for FOMC members to hash out all the details of their forward guidance statement. Most participants voted in favor of removing "patient" from the language but at the same time agreed that an increase in the rate hike would be unlikely at the April meeting. The idea was not to imply a more decisive stance on the timing of the rate hike but rather to allow for some additional flexibility in the "meeting-by-meeting" approach to monetary policy. This goes hand-in-hand with their longstanding data-dependent strategy but at the same time can become challenging if they do not properly prepare markets ahead of time for future changes to accommodation. Only one FOMC member was against the change to forward guidance, arguing that "the announcement of a meeting-by-meeting approach to policy could lead to a tightening of financial conditions that would slow progress toward the Committee's objectives."

Chart 1
Labor Market Outlook (%)



Source: BLS, DoL, NABE, NFIB, ISM, & BBVA Research

Chart 2
Labor Market Utilization (%)

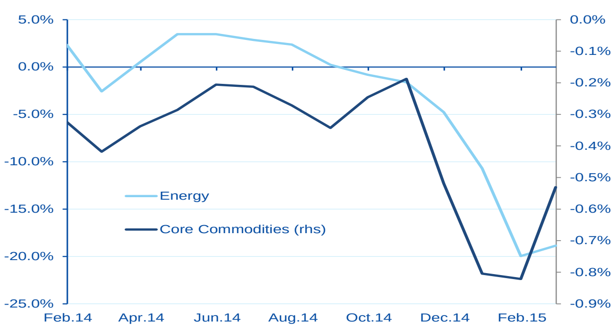


Source: BLS, DoL, NABE, NFIB, ISM & BBVA Research

When it comes to the Fed's dual mandate, FOMC communication continues to emphasize low inflation and simultaneously downplay the labor market strength we have seen up until March. In hindsight, this was a smart move because it allows for members (particularly the dovish ones) to react more cautiously to the weaker job growth as of late. Unfortunately, the minutes did not reveal specific details on what would constitute "further improvement in the labor market", but the Committee did note important indicators of remaining slack including the low participation rate, elevated involuntary part-time employment, and subdued wage growth. Some members did cite the weak outlook for wage growth as a key determinant in bringing down their projection for the long-run normal unemployment rate. Others noted diverging unemployment rates by age and that those with lower unemployment rates have accounted for an increasing share of the total labor force.

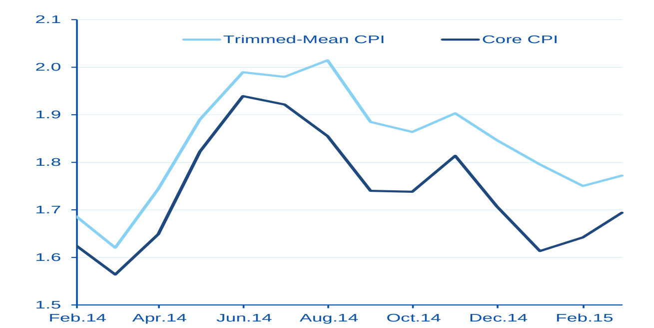
The discussion on inflation was more informative. Although "no simple criteria" was established for when the Committee might be comfortable with the inflation outlook, the minutes noted that "the normalization process could be initiated prior to seeing increases in core price inflation or wage inflation." This is consistent with our theory that the updated reference to inflation in the forward guidance allows for the flexibility to increase rates so long as core inflation does not decline from its current pace. Factors that may influence a more confident inflation outlook include further improvement in the labor market, stabilizing energy prices, and a slowdown in the USD appreciation.

Chart 3
Energy and Core Commodity Prices (YoY % Change)



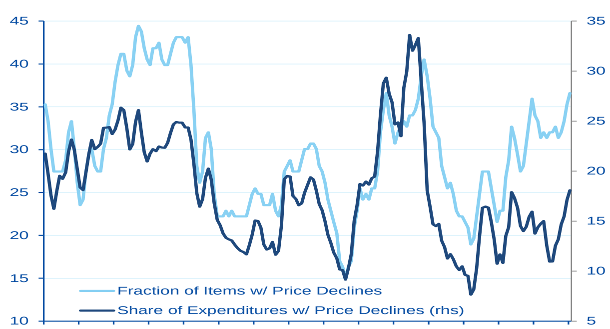
Source: BLS & BBVA Research

Chart 4
Trimmed-Mean and Core CPI (YoY % Change)



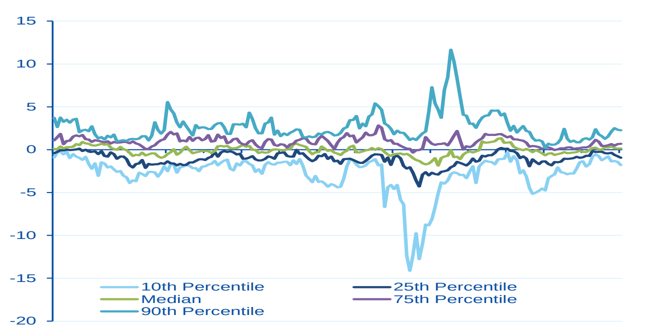
Source: BLS, Cleveland Fed, & BBVA Research

Chart 5
Dispersion of PCE Inflation (3MMA, %)



Source: FRBSF & BBVA Research

Chart 6
Change in PCE Inflation (12M Change of 12M Inflation Rate, %)



Source: FRBSF & BBVA Research

Normalization tools were discussed in depth at the March FOMC meeting (overnight reverse repurchase operations [ON RRP] and interest on excess reserves [IOER]) and the Committee members agreed to changes in the Policy Normalization Principles and Plans. Most notably, they decided it would be appropriate to "continue to target a range for the federal funds rate that is 25 basis points wide" when they begin the normalization process. In their discussion, the FOMC also "indicated that they expected that it would be appropriate to reduce ON RRP capacity fairly soon after the Committee begins firming the stance of policy." With communication to the public such an important factor, members discussed how and when they should reveal further specifics on the normalization but wanted to maintain some flexibility with regard to the timing of such strategies and avoid disclosing too much too soon.

Market reaction was minimal. Equity markets dropped immediately following the release by closed slightly higher than the previous day (Dow Jones and S&P500 up 0.15% and 0.27%, respectively), holding just below historical highs. The 10-year Treasury yield ended the day up slightly to 1.9%.

Bottom Line: Expectations Set for September Rate Hike

As we get closer and closer to the first federal funds rate hike, the FOMC is trying to effectively prepare themselves and the markets in order to avoid a major meltdown. In adapting a meeting-by-meeting approach, the FOMC hopes to allow for enough flexibility to react to incoming data as they see fit. There are a lot of pieces to the puzzle that still need to come together before the Committee is truly comfortable with raising rates, and each statement will become more and more important as we move forward. In the April statement, we may get another clarification that a rate increase is "unlikely" in June, especially when we consider that participants will have to decide whether one weak month of job growth is just an outlier or the start to a slower trend. While we do not foresee a slowdown in employment growth, the latest data since the March meeting have significantly reduced the probability of a June rate hike. We continue to expect a September hike and a very gradual pace of rate increases thereafter.

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