Central Banks

FOMC Minutes: July 28th – 29th Meeting

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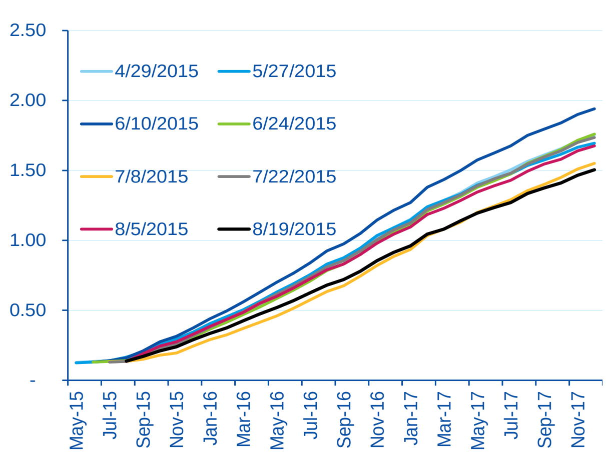
Committee in Preparation Talks for Impending First Rate Hike

- **Most FOMC members view downward pressures on inflation as transitory, but risks to the inflation outlook may outweigh labor market improvement for some doves**
- **Global risks have diminished for the short-term and are thus unlikely to delay the first rate hike, though they may impact the future pace of rate increases**
- **As long as economic data in August hold up, we continue to expect a September liftoff**

The minutes from the July FOMC meeting did not reveal any new details on the timing of the first federal funds rate hike, but the discussion hinted at a Committee that is almost ready for liftoff. Most members agreed that "conditions for policy firming had not yet been achieved, but they noted that conditions were approaching that point." Labor market conditions were mostly met, even though they acknowledged room for "some further improvement."

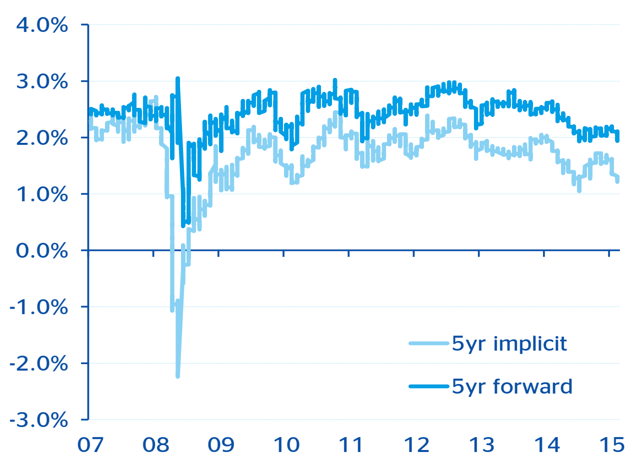
Inflation appeared to be more of a focus in July's meeting, and FOMC participants noted a variety of concerns. While many still view downward pressures on inflation as transitory (i.e. declines in energy prices as well as non-energy import prices), risks appeared tilted to the downside. FOMC members addressed concerns relating to the possibility of a further appreciation of the USD as well as a continued downward trend for oil and commodity prices. Furthermore, some participants noted "the absence of any noticeable response of inflation to the reduction in resource slack over the past several years." This year's underwhelming data on inflation has led some Committee members to lack "reasonable confidence" that inflation will reach the Fed's target over the medium term. On the other hand, a couple FOMC members argued that "appreciable delay" in the first rate hike may lead to "an undesirable increase in inflation."

Chart 1
Federal Funds Rate Futures (%)



Source: Bloomberg & BBVA Research

Chart 2
Market Inflation Expectations (%)



Source: FRB & BBVA Research

Overall, FOMC participants viewed risks to growth and the labor market outlook as mostly balanced. Still, there were a variety of risks that needed to be discussed, particularly on the international stage. Greece remained a topic of discussion despite the fact that it no longer posed an immediate threat. The Chinese stock market crumble had a surprisingly limited impact on FOMC views, although several members pointed out that a slowdown in China's economy could become a problem for the U.S. Also, the Committee discussed the risk that an increase in U.S. interest rates (while global rates remain low or continue to decline) may cause further appreciation of the USD, thereby putting additional downward pressure on commodity prices and net exports.

Markets interpreted the minutes as dovish, with the 10-Year Treasury yield down from 2.22% to 2.13% at close. Equity markets increased immediately following the release of the minutes but ended the day just slightly below opening levels. The biggest shift was in fed funds futures, with markets expecting a much flatter path compared to earlier this month.

It is worth noting some of the administrative items discussed in the meeting. First, it was agreed that future changes in the federal funds rate would be effective on the day after the FOMC policy announcement. Second, Committee members decided it would be useful to include the median values for all variables in the Summary of Economic Projections, beginning in September. Both of these items address the need for clear and consistent communication to the public in order to ensure a smooth policy normalization process.

Bottom Line: Some Uncertainty in the FOMC, but September Liftoff Still Likely

Economic data have continued to evolve in line with FOMC expectations. Although the Committee continues to justify the need for "some further improvement" in the labor market, it is unlikely that this will hold back the first rate hike. Inflation, on the other hand, will be the culprit if the FOMC decides to delay liftoff past September. As long as inflation data for the next month are mostly positive, we expect that the FOMC will be ready to raise rates at the September meeting. Recent communication from FOMC members, along with July's FOMC meeting minutes, emphasized the importance of the expected path of interest rates, rather than just the first rate hike. Even if liftoff comes in September, the FOMC has made it clear that monetary policy will remain highly accommodative for some time as the Committee sticks to their data dependent strategy.