Central Banks

# FOMC Preview: September 16-17th Meeting

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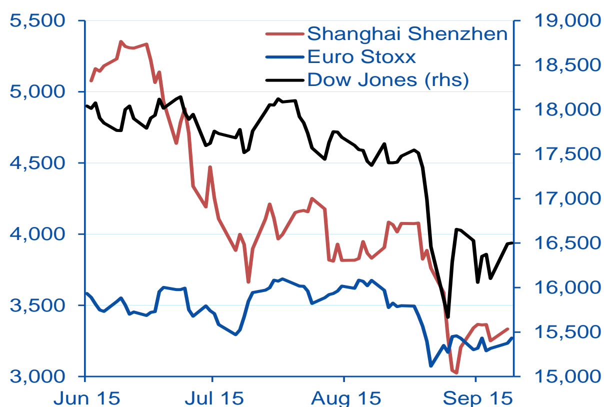
## Why the Fed Should Raise Rates in September and What May Hold Them Back

- **FOMC members waiting until the last minute to digest all incoming information and make a decision on whether liftoff is appropriate this month**
- **"Some further improvement" in the labor market has been achieved, but persistently low inflation and global financial market volatility call for more dovish views to dominate**
- **Increasing rates in September would send a positive signal on the economic outlook, whereas delaying would prolong this period of economic uncertainty**

Seven days: that's how long Janet Yellen and her FOMC colleagues have to make up their minds on the biggest monetary policy move since the crisis. Each member is coming into the meeting with a different opinion, and it is unlikely that we will see a unanimous decision either way. Up until about a month ago, most FOMC members were on board with a September rate hike. Now, as we stand only a few days away from the meeting, the slate has been wiped clean by recent financial market volatility, leaving a more confusing economic environment for the Fed (and markets) to interpret.

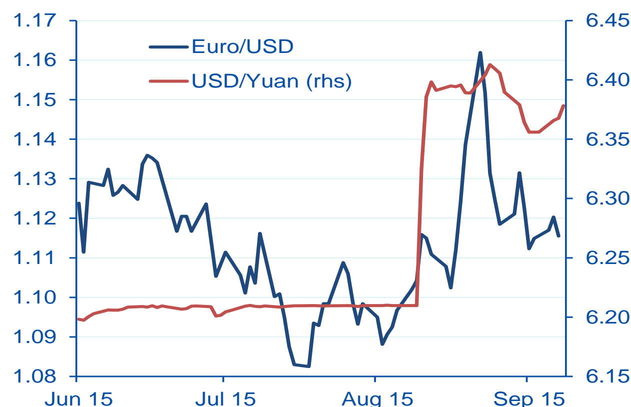
So what has changed? Most notably, the threat of a slowdown in the Chinese economy is materializing. China's stock market crumble and the subsequent reactions throughout the rest of the world have confirmed that the U.S. remains susceptible to external shocks. Although U.S. markets have been on the mend, this increased vulnerability makes it less appealing for the Fed to introduce another potential shock to the system. Furthermore, the depreciation of the Chinese yuan (and other currencies) adds another challenge for the Fed as a rate hike would only exacerbate the ongoing strength of the USD, as this weighs on U.S. competitiveness and foreign profits, and increases downward pressure on inflation.

Chart 1
**Global Stock Market Indices**




Source: Bloomberg & BBVA Research

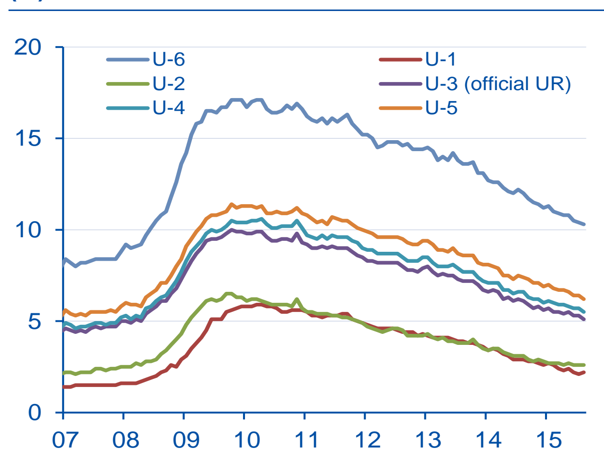
Chart 2
**USD vs Euro and Chinese Yuan**




Source: FRB & BBVA Research

When it comes to the Fed's focus on incoming economic figures for the U.S., not much has changed. On the employment side, data are mostly supportive of a September liftoff, but that has been the case for a while now. Despite the sub-200K job growth in August (a month often subjected to significant upward revision after the initial release), the unemployment rate now officially stands within the FOMC's long-run target (5.0-5.2%). Furthermore, wage growth in August increased at the fastest pace since January. Also, the latest JOLTS numbers for July indicated a significant jump in job openings for the month – a hint that businesses are confident and ready to boost their workforce. The question remains how much weight the Fed will place on positive labor market information and whether or not this will outweigh their more skeptical views on inflation and global market instability. If the Fed is truly confident regarding the latest news on the labor market, they should not hesitate to begin the normalization process as soon as possible. Still, there are no guarantees. August's unemployment rate may be additional support for those FOMC members who were already in favor of a September liftoff, but the most dovish members may still need more convincing.

Chart 3
**Alternative Measures of Unemployment (%)**



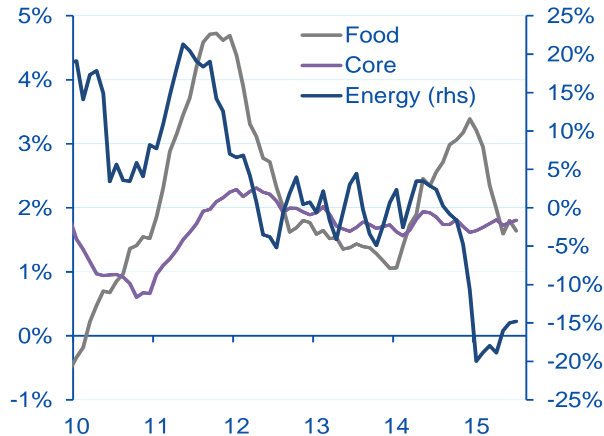

Source: BLS & BBVA Research

Chart 4
**Average Workweek and Hourly Earnings (YoY % Change)**

Source: BLS & BBVA Research

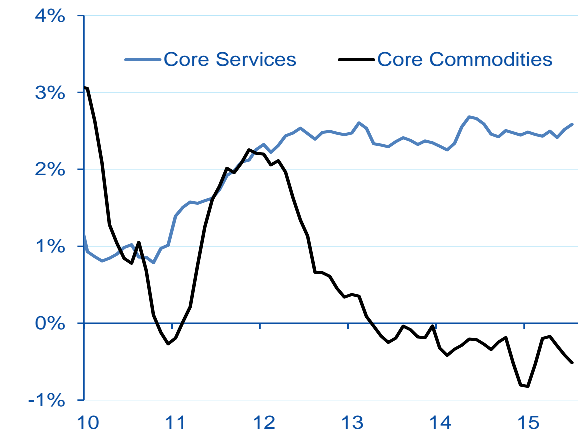
These doves will certainly point to low inflation as a reason to hold off increasing rates in September. In their support, inflation remains far from the Fed's target. However, core inflation continues to move upward, albeit slowly. It has become clear that many FOMC members see a significant risk to delaying liftoff based solely on inflation, as it is a lagging indicator. Back in June, San Francisco Fed President John Williams warned that "waiting until we're close enough to dance with 2% [inflation] means the very real risk of having to dramatically raise rates to reverse course, which could destabilize markets and potentially derail the recovery. I see a safer course in starting sooner and proceeding more gradually." Fed Vice-Chair Stanley Fischer and Richmond President Jeffrey Lacker have confirmed this risk more recently due to the fact that "the forces that lead to rising inflation can build up before they are apparent in the data." Janet Yellen has also emphasized her desire to start the process sooner rather than later in order to allow for a more gradual pace of rate hikes thereafter.

Chart 5
**Consumer Price Index (YoY % Change)**




Source: BLS & BBVA Research

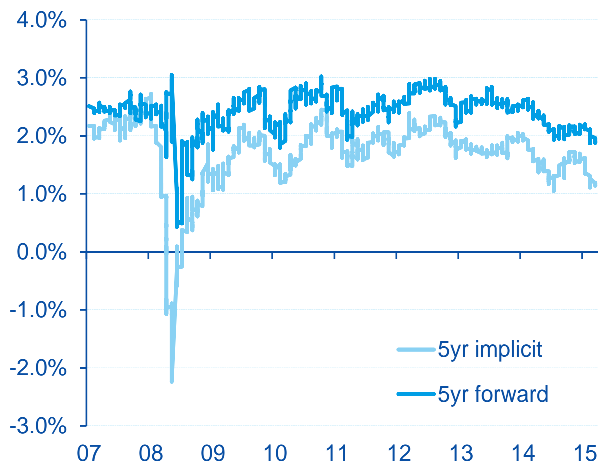
Chart 6
**Core Services vs Core Commodities (YoY % Change)**




Source: BLS & BBVA Research

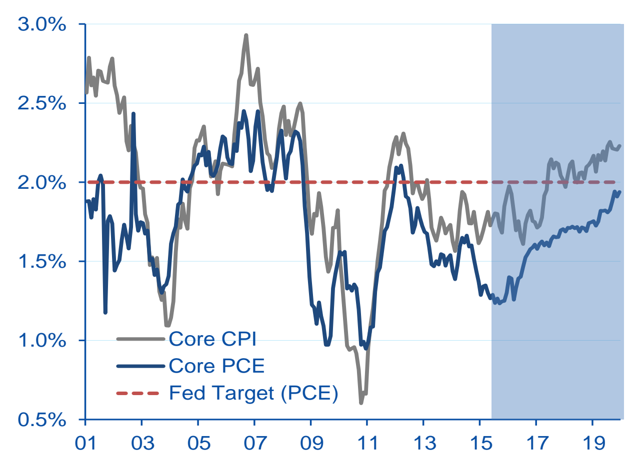
Still, it is hard to ignore the actual data on hand. Oil prices dropped well-below $50/barrel throughout August, with WTI prices even falling under the $40 mark for the first time since late 2008. Inflation expectations have also declined, though they are nowhere near dangerous levels. Core commodities inflation remains in negative territory and has held there since April 2013. The latest drag most likely reflects the weakness in the global economy and the strengthening of the USD throughout the past year. On the bright side, core services inflation has been above 2.0% since October 2011 and reached 2.6% this summer, suggesting that domestic demand remains healthy. August's CPI report will be released on September 16th, the first day of the FOMC meeting, and as long as core inflation does not shift downwards, we should see increasing support for a rate hike announcement on the 17th.

Chart 7
**Market Inflation Expectations (%)**




Source: FRB & BBVA Research

Chart 8
**Core Inflation Forecasts (YoY % Change)**



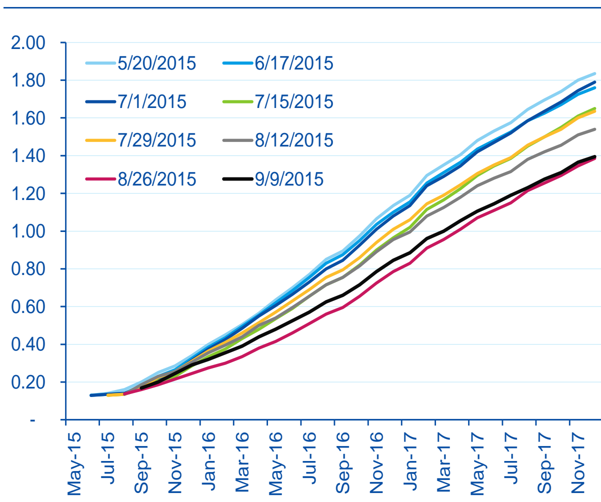

Source: BLS, BEA, & BBVA Research

An important fact to remember is that the latest turmoil stemmed from abroad, reflecting worries not on the stability of the U.S. recovery but on the health of emerging markets and policies outside the scope of the Fed. The Fed's primary focus is on the U.S., and if we ignore the external environment, current conditions seem to be supportive of a September rate hike. Some FOMC participants attach a heavy weight to the negative side effects of maintaining a zero policy rate for longer than needed. Chances are that if they delay liftoff, things won't be much different in October or December, so it might be hard to justify a rate hike at these subsequent meetings. Also, if the FOMC decides not to raise rates in September, it opens the door for the possibility that conditions could just get worse as we move through 4Q15 (i.e. China slows further, oil prices continue to fall, increased financial market volatility, outlook deteriorates, etc). This would make it even more difficult to hike rates by the end of this year, and may force the Fed to hold off until 2016, which most members would like to avoid.

Another interesting event in the past month was the Fed's Jackson Hole Symposium. Janet Yellen had previously announced her planned absence from the event, so it was assumed that nothing major would happen. Overall, information from the meeting left a mixed message regarding whether or not the Fed will increase rates in September. Comments from FOMC members suggest that a hike this month is still on the table, but there is too much uncertainty to know for sure. William Dudley, New York President, sent a very dovish message to markets when he noted that "the decision to begin the normalization process at the September FOMC meeting seems *less compelling* to me than it was a few weeks ago." However, he did clarify that "it's important not to overreact to short-term market developments" – a sentiment expressed by many other FOMC participants.

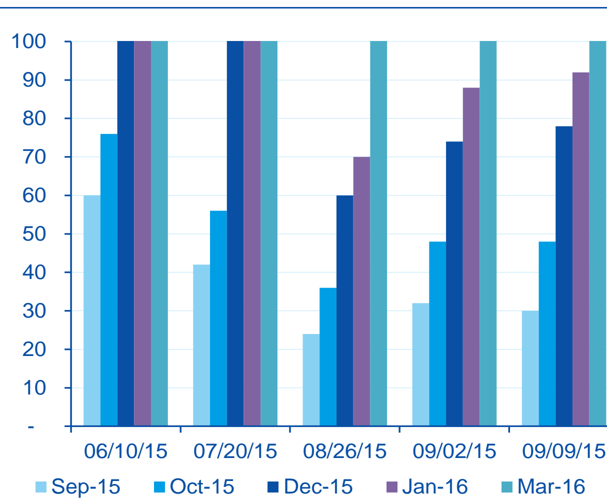
The fact is that no one on the Committee has made up their mind one way or another, and they seem willing to wait until the last minute to do so. Once they have the inflation report for August, they can make a more informed decision, keeping in line with the meeting-by-meeting approach that was emphasized earlier this year. Also, they will likely want to see reduced volatility in global financial markets at the time of the meeting. The important thing to remember is that they are trying to emphasize the path of future rate hikes, not just the initial increase, and they prefer liftoff to occur sooner so they can take a more gradual pace in the coming year.

Chart 9
**Federal Funds Rate Futures (%)**




Source: Bloomberg & BBVA Research

Chart 10
**Federal Funds Rate Futures Implied Probabilities, First 25bp (%)**




Source: FRB & BBVA Research

## Bottom Line: Risks to Delaying Liftoff are Rising, but Dovish Undertones Rule

The latest economic developments are not pointing to a clear path for the FOMC. Despite the fact that inflation is low and global financial markets remain vulnerable, labor market conditions have shown "some further improvement" and the unemployment rate has dropped to the Fed's long-run goal. According to fed funds futures, the probability of an interest rate hike in September has increased from 24% on the first day of the Jackson Hole Symposium to 30% with just one week to go before the big event. We maintain our view that the Fed *should* increase rates next week, but there is a real possibility that some FOMC members may be spooked by the ongoing weakness in the global economy. Most participants seem comfortable as long as a rate hike occurs sometime this year, whether that is September or December. However, the risk of delaying (even to December) is that it allows for the possibility that economic data do not improve in the intermeeting period, and in keeping with their data-dependent strategy, the FOMC would be forced to delay liftoff until 2016. The benefit of increasing in September is that it sends a signal to the world that the Fed is confident in the direction the U.S. economy is heading – and this will likely fuel increased confidence in the real economy. In any case, one thing remains clear – there has been no decision yet, and the FOMC will wait until last minute to digest as much incoming information as possible.

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