Central Banks

FOMC Statement: October 27-28th

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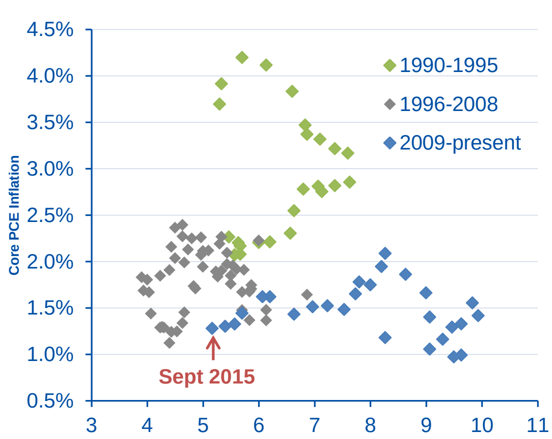
Fed Funds Rate Remains Unchanged as FOMC Hopes for December Liftoff

- **As expected, the FOMC did not increase rates in October but specifically alluded to the potential for action at the next meeting**
- **Statement removed reference to global risks and the impact on domestic growth, though the Fed will continue to monitor these developments**
- **December rate hike is still the target, but mixed messages from the statement and other Fed communication suggest that delays to 1Q16 are still possible**

October's FOMC announcement played right into expectations as the Fed decided yet again to hold off on the first federal funds rate hike. Prior to the meeting, the implied probability of an October liftoff had declined to just 4%, so it was in the Fed's best interest to keep rates unchanged and avoid any unwanted surprise to markets. However, the statement wasn't completely a dud, with new hawkish language hinting at preparation for a possible December liftoff as long as data evolve in line with the Fed's outlook.

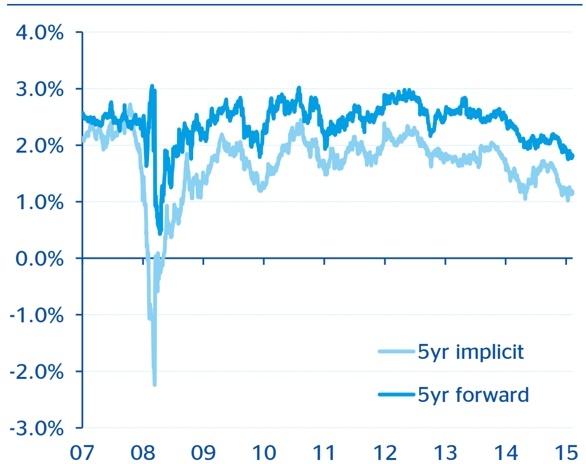
The Committee's review of economic activity was less dovish than anticipated. Participants agreed that consumer spending and business investment had increased "at solid rates" rather than just "moderately", highlighting more optimistic views compared to September. The statement acknowledged the slowdown in job growth in recent months but contributed no additional assessment of the labor market other than maintaining that underutilization "has diminished since early this year." Finally, the FOMC qualified views on market-based measures of inflation compensation as having shifted only "slightly lower", though it is likely that this underplays their true feelings on inflation.

Chart 1
Unemployment Rate & Core PCE Inflation (%, YoY % Change)



Source: BLS, BEA, & BBVA Research

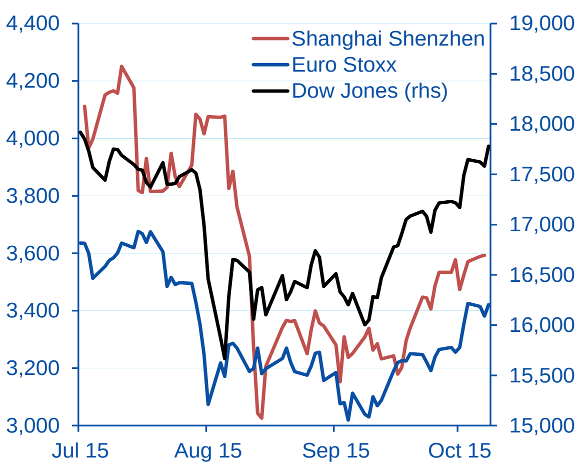
Chart 2
Inflation Expectations (%)



Source: FRB & BBVA Research

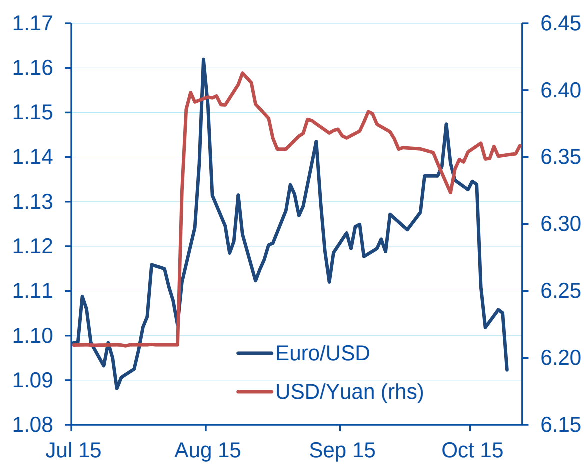
A major change in the October language stemmed from the reference to global growth. The FOMC removed the comment that global developments “may restrain economic activity somewhat and are likely to put further downward pressure on inflation.” Instead, they simply emphasized that they would continue to monitor “global economic and financial developments.” It can be argued that conditions do appear to have improved since the China-influenced global financial market downturn prior to the September meeting or that the Fed is confident that the spillover effects are limited. However, it seems overly optimistic for FOMC members to imply that these global developments are no longer a threat to domestic growth or inflation, even in the near term. The USD has been strengthening again throughout the past few weeks after a brief reprieve in early October, reflecting continued weakness abroad and adding to concerns on importing low inflation. Similarly, it seems like a stretch to imply that one month of data was enough to assess the true impact of the global slowdown. The fact that this was such a quick turnaround in sentiment for the FOMC, having just added the statement in September and already removing it just a month later, suggests that the Fed is doing everything they can to prepare markets for the potential hike in December. While the Fed did not fully commit to December, the big swing in the statement helps to reel in expectations closer in line with the FOMC view. This, in fact, may have been the Fed strategy for today’s statement if the majority felt that markets overreacted to the September’s statement, pushing consensus for liftoff further into 2016.

Chart 3
Global Stock Market Indices



Source: Bloomberg & BBVA Research

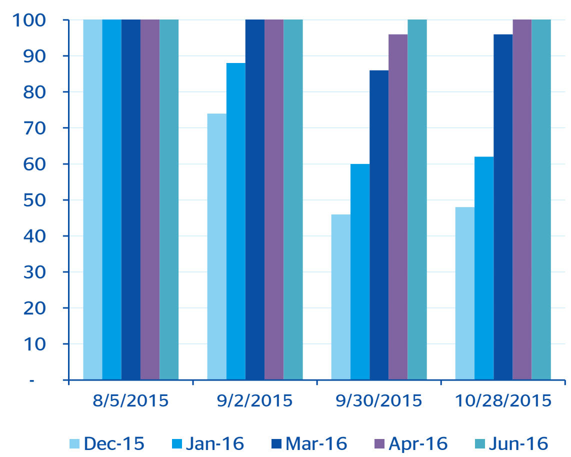
Chart 4
USD vs Euro and Chinese Yuan



Source: FRB & BBVA Research

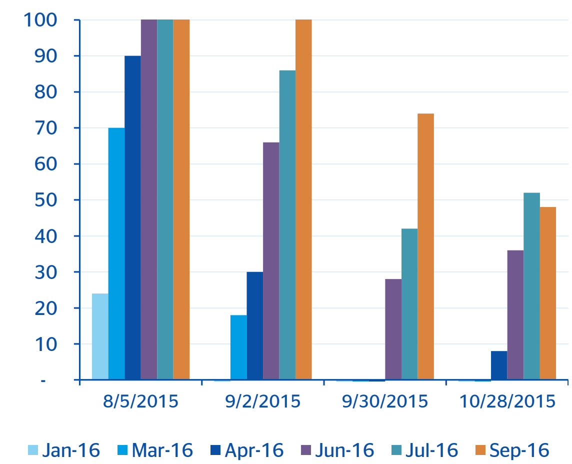
Another significant addition to the statement was the specific mention of the next FOMC meeting, something that hasn’t been done since March, when the Fed noted that a rate hike was “unlikely” to occur at the April meeting. This time around they were a little less direct but clarified “how long to maintain this target range” with “whether it will be appropriate to raise the target range at its next meeting.” Clearly, the FOMC wants to communicate that they are seriously considering a December liftoff, even though there are many signs pointing to a delay into 1Q16. Still, the Fed’s requirements for such a move remain unchanged, making it harder to believe that they’ll be able to justify a rate hike in just over a month. In any case, the implied probability of a December rate hike according to fed funds futures has increased from 36% prior to the October meeting to 48%.

Chart 5
Federal Funds Rate Futures Implied Probabilities (First 25bp, %)



Source: FRB & BBVA Research

Chart 6
Federal Funds Rate Futures Implied Probabilities (Second 25bp, %)



Source: FRB & BBVA Research

These changes contradict recent comments from various FOMC members. Fed Governor Lael Brainard reasoned that "the downside risks make a strong case for continuing to carefully nurture the U.S. recovery – and argue against prematurely taking away the support that has been so critical to its vitality." Chicago Fed President Charles Evans, a voting member this year, also seems skeptical of a December rate hike, noting that he is "far less confident about reaching our inflation goal within a reasonable time frame." Atlanta Fed President Dennis Lockhart remains in favor of a December rate hike but did comment in early October that there was "a touch more downside risk" compared to a few weeks ago. Again, this is inconsistent with the general message set forth by the October FOMC statement and suggests that there is still a wide range of views hiding behind the face of the Committee.

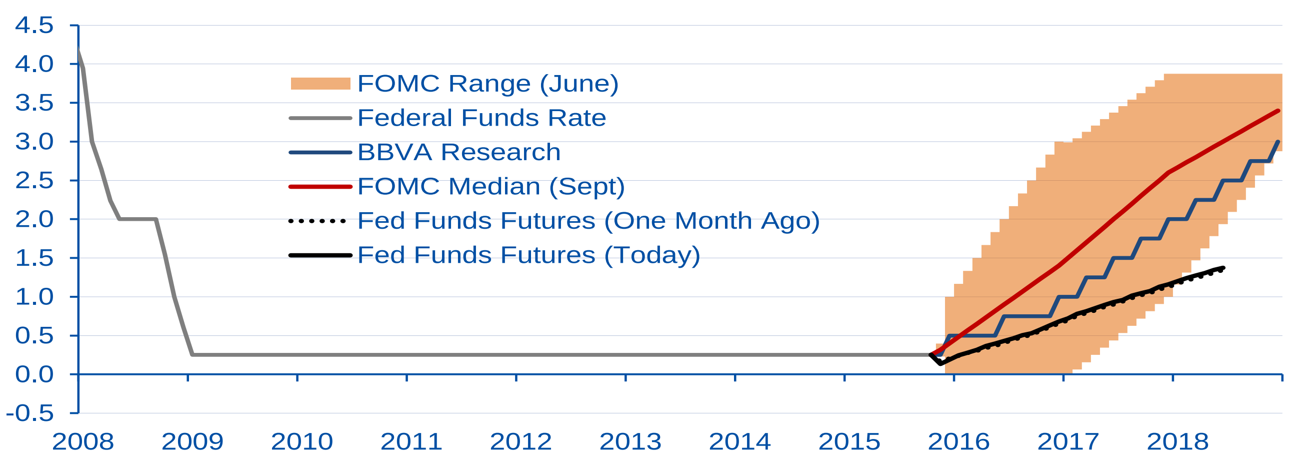
Other factors to consider for a December rate hike include fiscal uncertainty and global monetary policy easing. Fiscal uncertainty had been on the rise as Congress deals with another debt-ceiling debate and we approach another potential government shutdown. However, it appears that we are on the brink of a 2-year budget agreement that would resolve most of these pressures until early 2017. This is a positive for the Fed as it means one less problem to stand in the way of a rate increase in the near future. However, other major central banks have recently announced plans for additional monetary policy easing, continuing to move in the opposite direction as the Fed. The ECB has hinted that it will increase quantitative easing in the short term, and China just recently cut interest rates in order to ease financial conditions. Recent history suggests that Yellen and her colleagues remain sensitive to pressures from abroad, and despite changes to today's statement on global developments, these pressures still have the potential to delay and/or limit the pace of rate hikes in 2016.

The S&P 500 and Down Jones equity indices dropped sharply at the time of the announcement, most likely reacting to the Fed's readiness to move this December, but then recovered completely thereafter, closing the day back near annual highs seen in July and August (prior to the China-induced decline). This rebound reflected the positive message implied by today's statement that the Fed is less worried on global developments than a month ago. The 10-year Treasury yield increased throughout the day in anticipation of the meeting and remained up on the day, closing near 2.10% following yesterday's close of 2.04%. The USD spot index also increased, up a sharp 1.0% following the announcement.

Bottom Line: Fed Sending Mixed Signals on December Rate Hike

The Fed's announcement to keep rates unchanged aided in avoiding an unwanted negative reaction in financial markets. However, the shift to more hawkish language in the statement sends a mixed message on how seriously the Fed is considering a December liftoff, particularly when assessing the latest bout of weak data as well as very dovish comments from some FOMC members pushing for a delay to 2016. The Fed was quick to remove comments in the statement that related to global risks and the potential impact on domestic growth, and in general their review of economic activity was more positive compared to September. This noncommittal vote of confidence for a December rate hike can't be ignored, but neither can the incoming data that continue to point to weak momentum moving into 4Q15. Clearly, December remains the Fed's target for liftoff, but delays to 1Q16 are possible, and the meeting-by-meeting approach will continue into next year, where we expect to see a very gradual pace of rate increases.

Chart 7
Federal Funds Rate Futures and Projections (%)



Source: FRB & BBVA Research