Central Banks

FOMC Minutes: October 27 – 28th Meeting

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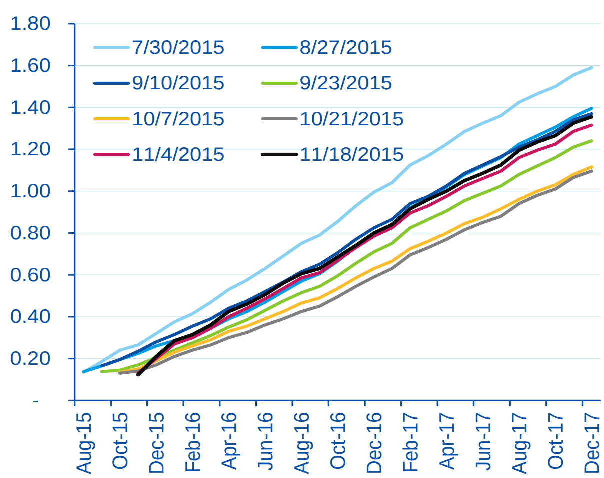
Despite Hawkish Language, Dovish Views Still Prevalent in FOMC

- **Divided views on whether conditions for policy normalization had been met, though most felt that it could happen by the next meeting**
- **Hawkish change to statement language was intended to leave "options open for the next meeting", but the signal may have been too strong**
- **Committee continues to emphasize the future path of interest rates as more important than the initial hike**

October's FOMC meeting statement was surprisingly hawkish, with the Fed successfully reeling in expectations for a potential rate hike by the end of this year. However, the meeting minutes reveal more dovish undertones and an intense ongoing debate within the Committee. Members were divided on many issues ranging from the current stance of economic activity to the interpretation of changes to the statement's language. If anything, the wide range of views on both ends of the spectrum suggest that there is still no guarantee for a December liftoff.

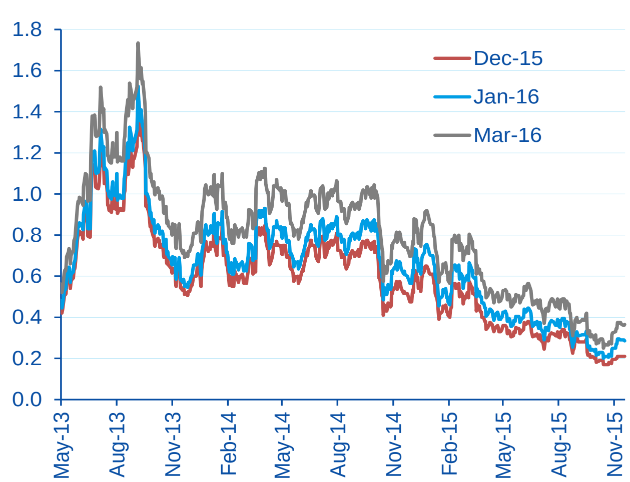
Economic data in the period between the September and October FOMC meetings warranted more in-depth discussion, especially related to the labor market. FOMC participants thoroughly discussed the slowdown in job growth at the end of the third quarter, and some were concerned that it marked the end of overall labor market improvement. However, October's strong employment report negates some of that conversation, swinging the pendulum back toward the hawks for support at the December meeting. Regardless, there was general agreement that resource utilization had diminished throughout the year.

Chart 1
Federal Funds Rate Futures (%)



Source: Bloomberg & BBVA Research

Chart 2
Federal Funds Rate Futures (%)



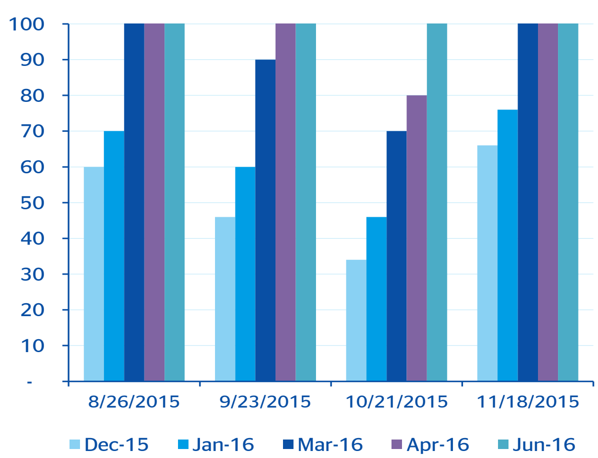
Source: Bloomberg & BBVA Research

Financial markets were also a hot topic of discussion given the Committee's reaction to increased volatility prior to the September meeting. Markets have since recovered, and participants agreed that "the U.S. financial system appeared to have weathered the turbulence in global financial markets without any sign of systemic stress." Still, this is a reminder that monetary policy remains vulnerable to any financial market volatility that might arise prior to the December meeting.

Talk on inflation was less divided, with participants acknowledging only modest improvements in inflation but that longer-run inflation expectations had remained stable. While most agreed that inflation would eventually move toward their target, some Committee members addressed lingering downside risks stemming from recent declines in market-based measures on inflation compensation as well as downward pressures related to the strength of the USD. Most members were "not yet sufficiently confident of that outlook to begin the normalization process." It is hard to believe that incoming inflation data will change their minds in just a few short weeks.

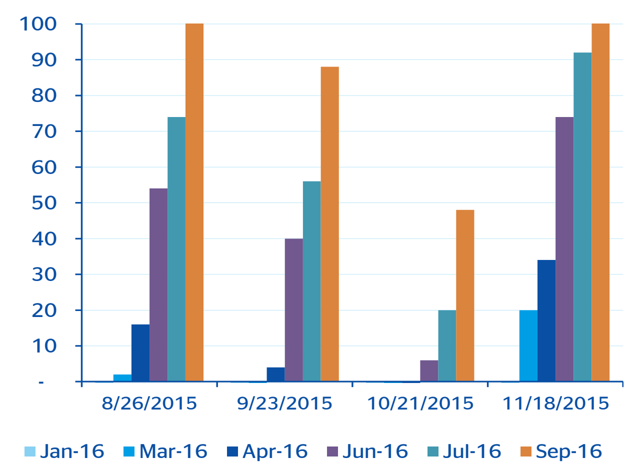
Given both economic and financial developments, some FOMC members argued that conditions for policy normalization had already been achieved. Although most participants felt that "these conditions could well be met by the time of the next meeting," some were still not convinced that the incoming information would warrant a rate hike in December. The hawkish change to the statement's language was meant to leave "policy options open for the next meeting," yet some members were concerned that this would send too strong of a signal for a December liftoff. Markets certainly reacted this way, with the implied probability from federal funds rate futures jumping from 36% before the October meeting to 50% immediately after the announcement. The strong jobs report for October boosted market expectations to near 70% probability for a December rate hike. The probability has settled near 66% since the release of the meeting minutes.

Chart 3
Fed Funds Futures Implied Probabilities (First 25bp, %)



Source: Bloomberg & BBVA Research

Chart 4
Fed Funds Futures Implied Probabilities (Second 25bp, %)



Source: Bloomberg & BBVA Research

The FOMC remains divided on whether or not to continue delaying liftoff, with members pointing out risks on both sides of the spectrum. One the one hand, the more hawkish participants argued that continued delays could increase financial market uncertainty and "unduly magnify the perceived importance of the beginning of the policy normalization process." Holding back the rate hike could also increase the risk of growing financial imbalances as well as send a negative signal regarding the overall economic outlook. On the other hand, some noted that "appreciable downside risks to the outlook remained," with the dovish members citing concerns over the ability of the economy to withstand potential adverse shocks.

Despite these differences in opinion, FOMC members were in agreement that the future pace of interest rate hikes will be gradual. Furthermore, participants continue to emphasize the importance of the overall path of interest rates in an attempt to control reaction to the first hike. The data-dependent strategy will live on indefinitely, and the FOMC will continue to monitor a variety of economic and financial reports. Moreover, the Committee will assess "both realized and expected progress towards its objectives", keeping in mind some suggestions to make decisions based on "cumulative gains made to date without placing excessive weight on month-to-month changes in incoming data."

Bottom Line: Don't Forget about the FOMC Doves

Markets may be pricing in a December rate hike following October's hawkish FOMC statement and strong jobs report, but these meeting minutes remind us not to forget about the doves still playing the cautious card. The FOMC wanted to reel in expectations for the possibility of a December rate hike, but now it seems that they have gotten more than what they asked for. Although this helps the Fed feel more confident that a rate hike at the end of the year won't completely surprise markets, we still cannot completely rule out a delay to 1Q16. FOMC members remain sensitive to unexpected changes in incoming economic data, and any negative report could again push expectations past December.