Central Banks

FOMC Statement: January 26th – 27th Meeting

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Dovish Twist Setting the Stage for Potential Downshift in Fed's Policy Plans

- **Statement highlights economic vulnerability but FOMC still downplaying inflation concerns**
- **Members likely to reduce policy path expectations in revised projections to come in March**
- **We continue to expect only two additional increases in 2016, closing out the year at 1.0%**

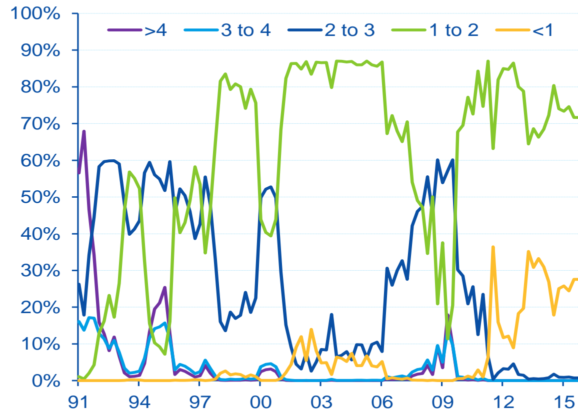
The January FOMC meeting statement comes as little surprise, with the decision to maintain the federal funds rate range at 0.25-0.50% and some dovish commentary to set the mood for 1Q16. Recent economic and financial market developments made it clear that the Fed would not be ready to increase rates again just a short month after liftoff. Still, their projections from December (which are not to be revised again until March) suggest plans for nearly four additional rate increases in 2016 – much more optimistic than what current conditions would imply. Today's statement opens the door for a potential downward revision to the FOMC's projected policy path at the next meeting in March.

Data since the last meeting have been underwhelming, to say the least, with the one exception being continued strength in job growth – which tends to lag overall economic trends. The FOMC acknowledged these labor market improvements in the January statement "even as growth slowed late last year." Other language softens the strength of business fixed investment and household spending, helping the Fed set themselves up for what could be a weak start to 2016.

The Committee also adjusted some language on inflation, though still not as much as we would have expected. Despite the fact that "market-based measures of inflation compensation have declined further", FOMC members expressed their views that long-term inflation expectations "are little changed, on balance, in recent months." The statement did qualify that inflation would "remain low in the near term", but they remain steadfast in their assessment that it will rise to 2% over the medium term. Furthermore, the FOMC continues to downplay the ongoing declines in energy and import prices, as well as omitting views on other aspects of core inflation, maintaining that these are "transitory effects" rather than a more permanent and/or prolonged shift in the economy. This hesitance to significantly alter their communication on inflation is almost surely their way of preventing a downward spiral in inflation expectations, which have already reached a seven-year low. They did, however, delete the comment about being "reasonably confident" in their inflation projections, though this was more of a condition for the initial rate hike in December that can now be interpreted elsewhere in the statement.

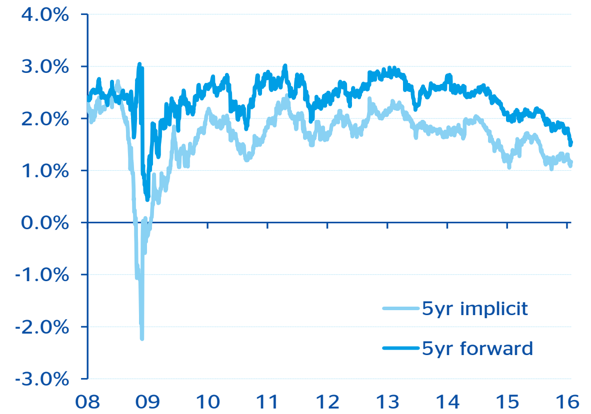
In a dovish move, the FOMC deleted commentary on risks to the outlook "as balanced" and instead noted that "the Committee is closely monitoring global economic and financial developments and is assessing their implications for the labor market and inflation, and for the balance of risks to the outlook." This covers their backs in the case of further deterioration in the coming months and helps ease the transition to potential downward revisions in the March Summary of Economic Projections, which we expect will be necessary.

Chart 1
Core PCE Inflation Probability Ranges (%)



Source: BEA & BBVA Research

Chart 2
Inflation Expectations (%)

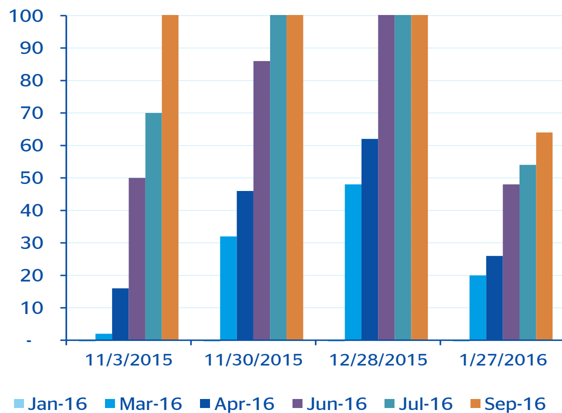


Source: FRB & BBVA Research

Voting on the action was unanimous, with a few new members in the loop. Joining the voting ranks this year are James Bullard (FRB St. Louis), Esther George (FRB Kansas City), Loretta Mester (FRB Cleveland), and Eric Rosengren (FRB Boston) replacing Charles Evans (FRB Chicago), Jeffrey Lacker (FRB Richmond), Dennis Lockhart (FRB Atlanta), and John Williams (FRB San Francisco). On balance, the FOMC remains slightly biased to the dovish side.

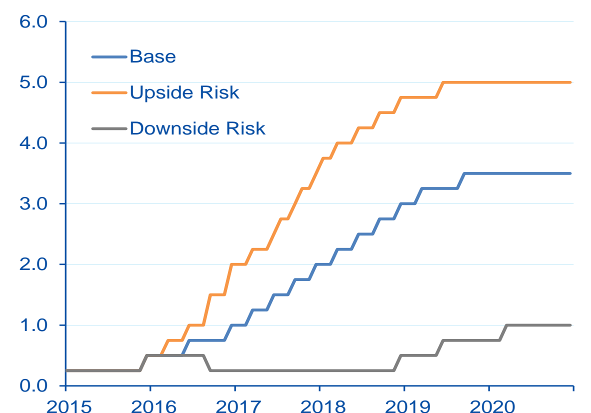
With today's statement, the FOMC also released an update to their Longer-Run Goals and Monetary Policy Strategy, though there were no major changes from the January 2015 publication. Most notably, the FOMC decided to maintain its 2% inflation goal as it "is most consistent over the longer-run with the Federal Reserve's statutory mandate." They did add that "the Committee would be concerned if inflation were running persistently above or below this objective," which appears to be just another means to publicly convey their "confidence" in inflation projections.

Chart 3
Federal Funds Rate Futures Implied Probabilities (Second 25bp, %)



Source: Bloomberg & BBVA Research

Chart 4
Federal Funds Rate Forecasts (%)



Source: FRB & BBVA Research

Bottom Line: Changes to FOMC's Projected Policy Path Likely to Come in March

January's FOMC announcement played right into our expectations for a dovish switch after December's big policy move. Considering the fact that we are just over a month past the first rate hike, there has been little opportunity to assess the impact in the real economy. Data releases in the coming months will be more telling, though from what we have seen so far, upcoming reports are unlikely to be overwhelmingly positive. The problem is that the latest FOMC projections from December suggest four rate increases in 2016, meaning we may see one in March if the Fed sticks to this plan. However, our expectations are for only two increases this year, considering the time needed to assess the impact from each rate move as well as the slow and uncertain start to 2016. Market expectations have also declined sharply in the past month, implying just one additional increase in 2016. With today's statement, the Fed has paved the way for a potential downgrade to its outlook and policy path when the time comes in March.

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