Central Banks

FOMC Minutes: January 26th – 27th Meeting

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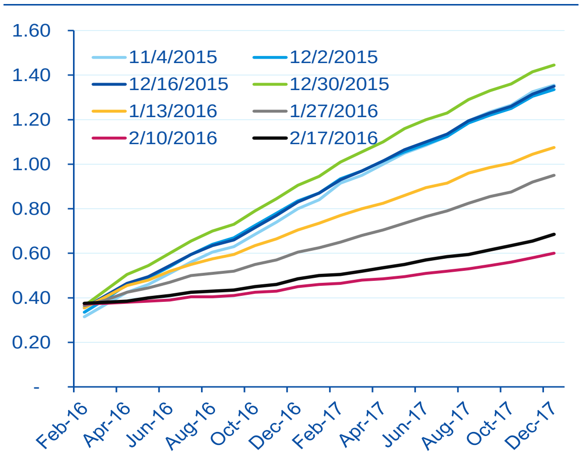
Details Reveal Increased Uncertainty Among FOMC Members

- **Committee acknowledged falling inflation expectations as an increasing concern**
- **FOMC members "unclear" in January on how deteriorating financial developments might impact their outlook**
- **No rate increase expected in March, with Fed likely to revise down projections**

FOMC meeting minutes can be tricky to interpret because of the timing of the discussion detailed in the release, and January's notes are no exception. Economic and financial conditions were looking gloomy at the time of the January meeting, but things seem to have deteriorated since then. Talk of an impending recession has intensified and market expectations have fallen considerably, from one rate increase in 2016 to no increases until 1Q17 or later. If anything, January's meeting minutes will further more skeptical views on the economy, emphasized by tighter financial conditions and increased uncertainty.

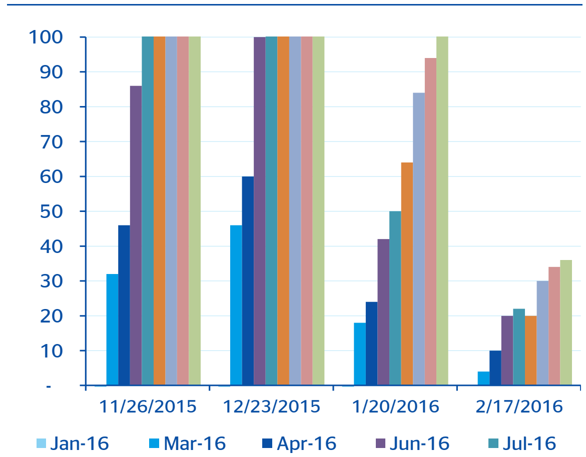
Dovish views were certainly dominant at the January FOMC meeting, with most participants acknowledging that economic activity had slowed throughout the past few months. Views of the labor market remained optimistic, although the meeting took place a few days before the release of January's employment report which noted a slowdown in job growth to start the year. Still, this is unlikely to have a big impact on the Fed's labor market outlook given that "several saw the prospect of some moderation in employment gains from the particularly large increases in the fourth quarter of 2015." The fact that the labor market has already made significant improvement toward the Fed's longer-run goals suggests that this is the least of their concerns at the moment.

Chart 1
Federal Funds Rate Futures (%)



Source: FRB & BBVA Research

Chart 2
Federal Funds Rate Futures Implied Probabilities (Second 25bp, %)

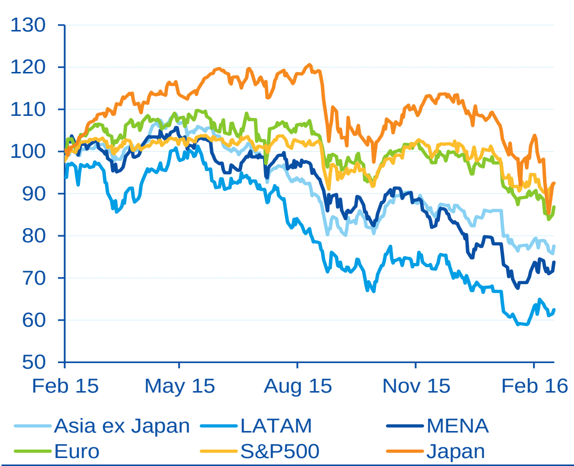


Source: Bloomberg & BBVA Research

Inflation is an ongoing issue, and finally we are seeing some acknowledgement from the FOMC that it "would take somewhat longer than previously anticipated to rise to the Committee's objective." There was also discussion of their ability as policymakers to appropriately respond to inflation shocks, with many members noting that "monetary policy was less well positioned to respond effectively to shocks that reduce inflation or real activity than to upside shocks," suggesting that waiting for additional information before taking the next step "would be prudent." This also depends on long-run inflation expectations remaining well-anchored, which hasn't been the case as of late. If inflation expectations do continue to move lower, the Fed would have a much harder time justifying any additional forward progress in their policy normalization strategy.

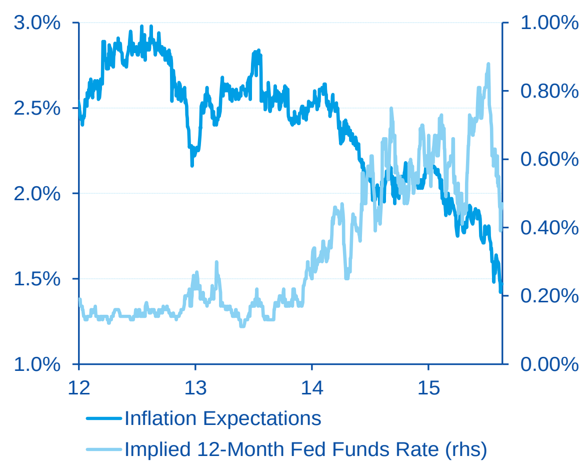
More notable was the Committee's focus on financial market conditions and their increased uncertainty on how the situation will evolve. As we have seen so far, conditions have not improved since then. Some FOMC members argued that the volatility in domestic financial markets was "difficult to reconcile with incoming information on U.S. economic developments." This reflects their views that markets often overreact to short-term news or events. In January, FOMC members were "unclear" on how these developments might impact their outlook, and "therefore judged that it was premature to alter appreciably their assessment." This is similar to the sentiment expressed at Yellen's testimony to Congress – clearly the Fed is beginning to worry that the economy is not evolving in line with their expectations, but they are not quite ready to directly admit it to the public just yet. Interestingly, the meeting minutes did suggest that "the effects of these financial developments, if they were to persist, may be roughly equivalent to those from further firming in monetary policy," implying that the Fed would not be inclined to increase rates under such circumstances.

Chart 3
Global Equities (Index)



Source: Bloomberg & BBVA Research

Chart 4
12M Implied Fed Funds & Inflation Expectations (%)



Source: FRB, CME, & BBVA Research

Communication will be a key factor moving forward, with FOMC members trying to be transparent in their monetary policy strategy while at the same time maintaining control of financial market reactions to their commentary. The Committee did discuss the idea of adding fan charts to the Summary of Economic Projections in order to better convey to the public their uncertainty surrounding the economic outlook. However, members discussed the fact that when it comes to the federal funds rate, a fan chart could get tricky if the lower band extends into negative territory, which could ultimately send an unnecessary signal to the public about the possibility of negative interest rates. No firm decision was reached, but it is likely that we will see some enhancements to the FOMC's communication throughout the coming year.

Regardless, we do expect that the FOMC will revise down their policy path projections at the March meeting, even if it's just from four to three rate increases for the time being. The Fed acts very cautiously and would be unlikely to make a more drastic change to their projections, especially since we are only in February and there is still plenty of time for conditions to turn around in a more positive light. Markets may not be pricing in any rate increases for this year, but we continue to expect two hikes under the assumption that economic activity will improve in 2Q16 and beyond.

Bottom Line: Concerned Fed Unsure of How to Proceed with Next Moves

There is no denying that the FOMC is worried about current economic and financial conditions, and the heightened uncertainty reflected in January's meeting minutes is just adding fuel to the dovish fire. At the time of the meeting, Committee members were beginning to show signs of concern – concern that must seem a bit more justified now that conditions have deteriorated further. At this point, there is very little chance that they will increase rates at the March meeting, but the path thereafter appears completely unknown. The FOMC's data-dependent strategy lends itself to a more short-term plan for the time being, with members seemingly unsure where things will stand even a few months from now. Still, we have to remember that it is only February, and a lot can change in the remaining ten months of the year that may influence the Fed's monetary policy plans. Ultimately, we stick to our expectations for two federal funds rate increases in 2016, depending of course on whether or not current conditions reverse course for the better.