Central Banks

FOMC Preview: March 15-16th Meeting

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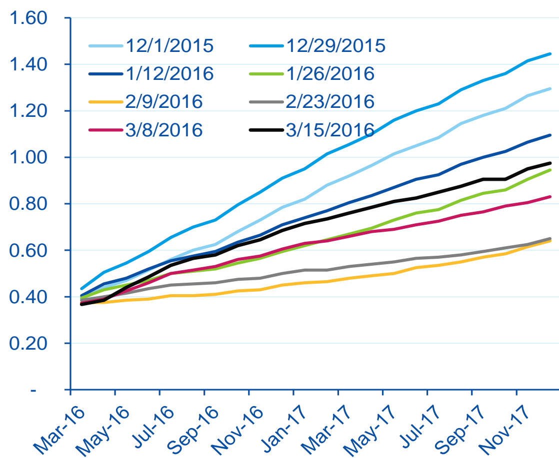
Communication is the Key to the Fed's Success

- **No rate increase expected in March, though we continue to project a move in June**
- **FOMC considering changes to economic projections to better align with markets**
- **Yellen's commentary on negative interest rates will be cautious so as not to spook markets**

The March FOMC meeting may be bringing along revised economic projections and a lively Chair press conference, but another federal funds rate increase is just not in the cards at this time. Low inflation, heightened financial market volatility, and continued headwinds in the global economy are holding back the Fed from shifting the target rate up by another 25 basis points, despite the fact that the U.S. economy is performing relatively well (all things considered). While we don't expect any major policy moves, the Committee is likely to revise their policy path projections from four to three expected rate increases this year. Furthermore, Chair Yellen's press conference will certainly touch on some market-moving topics, like negative interest rates.

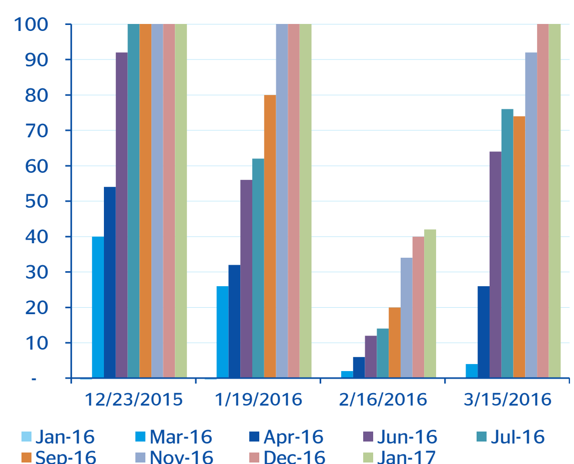
Many FOMC members have spoken out recently about the importance of the Summary of Economic Projections as well as possible changes in order to be more transparent and help better communicate policy plans to the public. James Bullard, President of the St. Louis Fed, has argued that the FOMC should consider adjustments "in a way that would cease giving such explicit guidance on the likely path of the policy rate going forward. Such a change might help better align the Committee with financial markets on the idea that policy is data dependent and does not follow a predetermined path." This would certainly help limit potential market overreactions on a meeting-to-meeting basis, and there will likely be some discussion on this during the meeting.

Chart 1
Federal Funds Rate Forecasts (%)



Source: FRB & BBVA Research

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



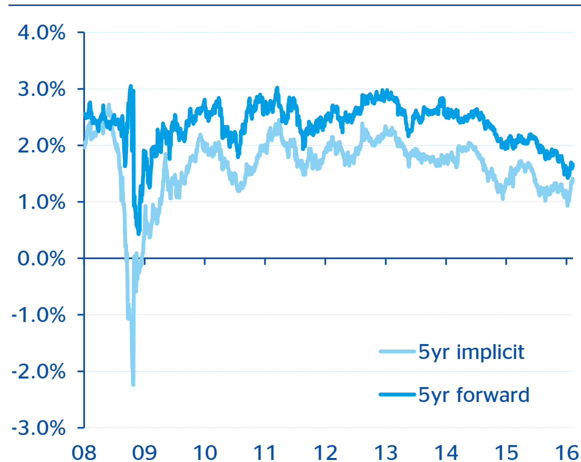
Source: Bloomberg & BBVA Research

The key here will be finding clarity in the Fed's communication, with is often very vague and easily misinterpreted by financial markets. Sometimes, it is not what the FOMC says but rather what they don't say that is more revealing of future Fed plans. With this in mind, it is important to take a step back and consider what we already know about the Fed's progress toward their data-dependent policy goals.

The Fed is "closely monitoring" financial developments in regards to any potential changes to their outlook, but so far nothing has come of this. We expect to see some adjustment to the statement language reflecting the fact that negative global factors have pushed down the Committee's outlook slightly. This tightening of financial conditions has not been completely driven by U.S. economic data, which is the primary focus of the Fed's monetary policy planning process. Therefore, despite the scare that increased financial market volatility can cause, we must be careful not to get distracted by the buzz and instead remain focused on the Fed's dual mandate. John Williams, President of the San Francisco Fed, recently touched on this, noting that "From a policymaker's perspective, my concern isn't as simple as whether markets are up or down. Watching a stock ticker isn't the way to gauge America's economic health…What's important is how it impacts jobs and inflation in the U.S." William Dudley, the dovish President of the New York Fed, also confirmed this sentiment, acknowledging that tighter financial conditions do "not mean that we will let market volatility dictate our policy stance."

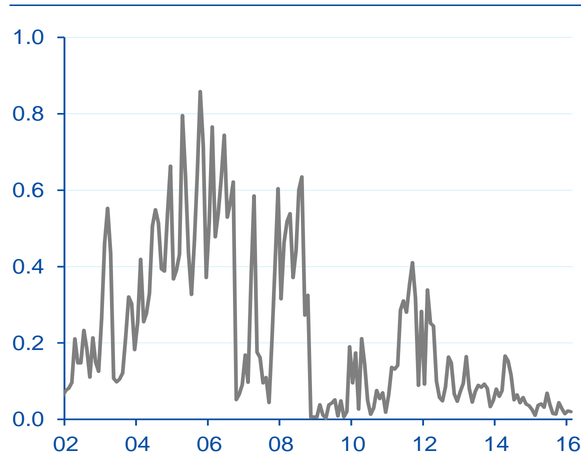
For one thing, employment will not be standing in the way of future rate increases – while there is still some room for improvement (i.e. lagging wage growth, elevated involuntary part-time employment, low labor force participation, etc), the Committee seems comfortable with the progress that has already been made to date. February's jobs report was enough to ease worries of a potential slowdown in job growth that was ignited with January's slower-than-expected sub 200K figure. Only about 100K payrolls per month are needed to keep the unemployment rate steady (assuming no change in labor force participation), so it would take a report below that threshold to really cause the Fed to worry about the labor market. Loretta Mester, Cleveland Fed President, noted that she "wouldn't be surprised if the pace of job gains slowed somewhat, based on demographics and the stage of the business cycle, but the gains should be strong enough to put additional downward pressure on the unemployment rate and support broader acceleration in wages."

Chart 3
Inflation Expectations (%)



Source: FRB & BBVA Research

Chart 4
St. Louis Fed Price Pressures Measure (Probability of PCE inflation >2.5% in 12m, %)

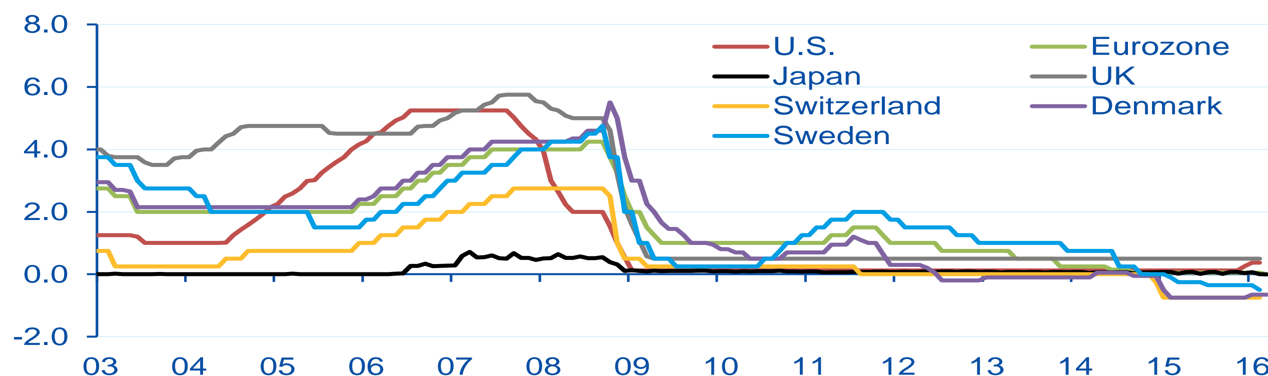


Source: FRB & BBVA Research

Inflation remains a bigger issue, and in terms of the Fed's data-dependent strategy this is the one to watch. More FOMC members have expressed their concern in recent months that inflation is going to take a bit longer to get back to their target than they have previously thought. Unfortunately, this may also mean a slower pace of interest rate increases compared to what the Fed had previously hoped for. According to Eric Rosengren (Boston FRB), "if inflation is slower to return to target, monetary policy normalization should be unhurried." On the bright side, we are starting to see that transitory downward pressures are fading (i.e. oil prices slowly moving back upward) – although for now we must take this with a grain of salt because if the past few months have taught us anything, it's that trends can change pretty quickly overnight.

More specifically, though, is the concern on falling inflation expectations. Here is where Fed communication is critical – significant negative commentary on low inflation could spur further declines in inflation expectations, making it even more difficult for inflation to get back to the Fed's target anytime soon. So far, it seems that market-based inflation expectations have increased slightly after reaching seven-year lows in February. However, this will continue to require close monitoring and careful interpretation over the coming months.

Chart 5
Central Bank Official Interest Rates (%)



Source: Haver Analytics & BBVA Research

When it comes to the post-statement press conference, Yellen will likely need to tackle some questions on negative interest rates given the increased utilization of such a policy tool by central banks in other developed economies. Sweden was the first to move to negative interest rates back in 2009, followed later by Denmark and Switzerland. However, concerns really heated up earlier this year when Japan took the dive into negative rate territory, igniting fears that maybe the U.S. would be next. Yellen has already touched on this topic in prior speeches, most notably her testimony to Congress in which she confirmed that the Fed is investigating the possibility of utilizing negative interest rates even though she felt they were not necessary at that time. It is likely that her feelings on the subject have not changed, yet she will need to be extremely careful in her responses so as not to inadvertently spook markets. The latest move by the ECB to cut rates further and increase quantitative easing measures has made markets even more sensitive to any potential surprises in the upcoming FOMC announcement. Yellen and her colleagues are fully aware of the consequences of simple miscommunications and will likely be overly cautious in both the statement language and press conference messages.

Speaking of communication, a brief of analysis of Fed speeches throughout the Yellen and Bernanke terms reveals an interesting difference between the two Chairs. Inflation and monetary policy were commonly used words among both, but Bernanke tended to put more emphasis on financial markets whereas Yellen has

focused more on labor markets. This suggests that Yellen may still push for a rate hike in the coming months even if we don't see a major improvement in financial markets, so long as the labor market remains healthy. If Bernanke were still running the show, he might be less inclined to increase rates under the current circumstances.

Chart 6
Ben Bernanke's Most Commonly Used Words

Source: BBVA Research

Chart 7
Janet Yellen's Most Commonly Used Words

Source: BBVA Research

Bottom Line: Focus on FOMC Communication for Future Policy Planning

The FOMC is facing increasing challenges when it comes to clearly communicating policy plans to the public. Too many times markets have overreacted or misinterpreted the Fed's commentary, causing unwanted disruption in the economy. Although we do not expect another rate increase at the March FOMC meeting, the Fed will need to be extremely careful in signaling its next move, whenever that may be. In the words of John Williams (San Francisco FRB), "like a sledgehammer, strongly worded forward guidance can be a powerful tool when it's needed. But, like a sledgehammer, care needs to be taken when and where it is used."

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