BBVA RESEARCH

# U.S. Fed Watch
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Central Banks

# FOMC Statement: March 15-16th Meeting

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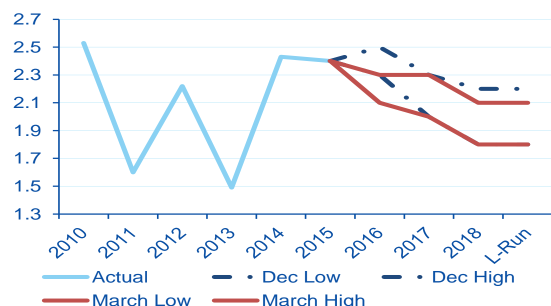
## Committee Revises Down Expected Policy Path to Two Rate Hikes in 2016

- **Rates unchanged and some downward revisions to projections, but strong employment**
- **FOMC will "monitor inflation developments closely" as transitory factors fade**
- **All meetings are "live" but June and December seem most appropriate for rate increases**

The FOMC played cautiously into expectations with the March announcement, dodging another rate increase for now but not completely ruling out potential policy action in the near future. Statement language was less dovish than in January but at the same time did not give off an overwhelmingly positive view on the economy. This was confirmed in the revised Summary of Economic Projections, which revealed softer GDP and inflation expectations as well as a slower pace of interest rate hikes in 2016. The action was almost unanimous, with the hawkish Esther George (FRB Kansas City) the only dissenter, arguing that the timing was appropriate for another 25bp increase.

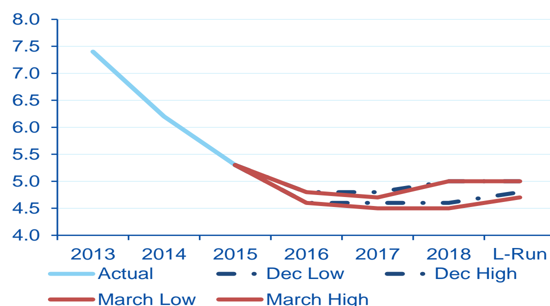
In general, the Committee agreed that "economic activity has been expanding at a moderate pace", with strength in household spending and the labor market. Some softness remains in business investment and net exports, though this is mostly due to energy sector weakness and the strength of the USD – both of which are transitory factors that the Fed expects will dissipate eventually. Since January, it seems that the FOMC has switched gears in the statement, finally focusing more on inflation than on global financial market volatility. While they have acknowledged that "global economic and financial developments continue to pose risks," the Committee removed the statement language about continuing to monitor this situation and instead emphasized that they will "monitor inflation developments closely." This helps draw attention back toward the importance of domestic data in monetary policy decision-making, which the Fed has struggled to effectively communicate given the heightened tensions in global financial markets. In this regard, the fact that inflation has moved up in 2016 thus far bodes well for a rate increase in the coming months. Still, Yellen noted that the "stability of longer-run inflation expectations cannot be taken for granted."

Chart 1
**Change in Real GDP**
**(4Q % Change, Central Tendency)**




Source: FRB & BBVA Research

Chart 2
**Unemployment Rate**
**(4Q %, Central Tendency)**

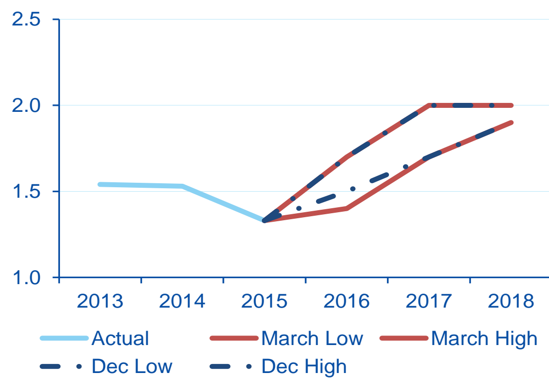



Source: FRB & BBVA Research

Not surprisingly, the FOMC adjusted their economic projections to reflect lower headline inflation and softer real GDP growth for 2016, as well as slightly faster declines in the unemployment rate in 2017 and beyond. The drop in GDP expectations is most likely reflecting expectations for a weak first quarter when it comes to business investment and net exports. Yellen and her colleagues remain confident that labor markers will continue to improve despite the fact that wage growth has been slower than expected.

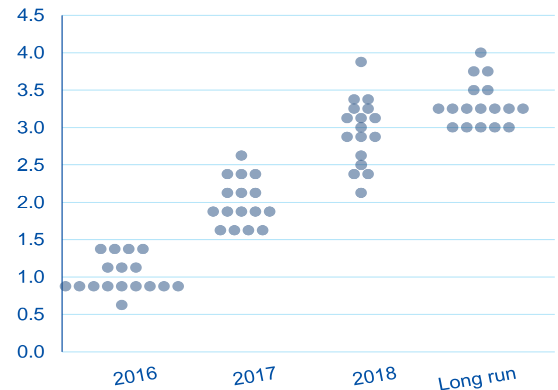
Most notably, the Committee revised down their median projections for the expected path of policy firming, from four to two rate increases for this year. This was an aggressive shift in expectations, as we would have expected they transition to three rate increases given that we are only in the first quarter and there is still plenty of time left in the year for economic conditions to strengthen further. However, it is not unlike the Fed to err on the side of caution, and moving to only two rate hikes helps align their projections better with financial market expectations. This is also in line with our baseline scenario, with two 25 basis point increases expected in both June and December to close out the year at the target range of 0.75%-1.0%.

Chart 3
**Core PCE Inflation**
**(4Q % Change, Central Tendency)**



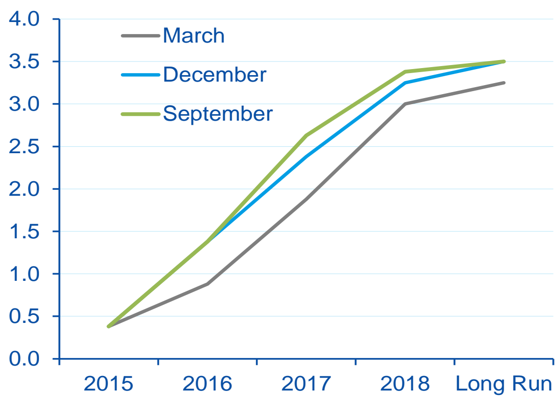

Source: FRB & BBVA Research

Chart 4
**Target Federal Funds Rate Forecast, March**
**(Year-end, %)**



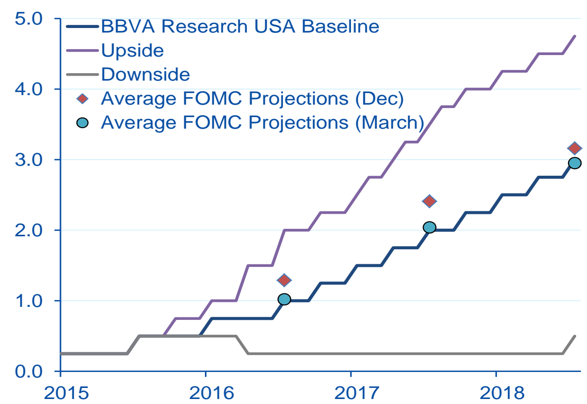

Source: FRB & BBVA Research

Chart 5
**Median Target Federal Funds Rate**
**(Year-end, %)**




Source: FRB & BBVA Research

Chart 6
**Federal Funds Rate Projections**
**(%)**




Source: FRB & BBVA Research

In her press conference, Chair Yellen tackled some interesting questions on the impact of global economic developments and policy timing, among others. On the global front, Yellen acknowledged that risks abroad made it “prudent to maintain the current monetary policy stance” but that all in all, the U.S. economy had remained “resilient” in the face of negative shocks. Also, she addressed the fact that there was no “collective judgment” within the Committee to describe the risks to the outlook as either balanced or weighted to the downside, which is why there was no explicit mention of it in the statement. This suggests some difficulty among FOMC members to come to a clear consensus, and Yellen acknowledged that individual views are uncertain and tend to change frequently as economic conditions develop over time.

The Fed has been facing international pressure when it comes to monetary policy tightening, given that most other central banks are moving in the opposite direction. Yellen took this chance to assert the Fed’s independence from other central banks, suggesting that actions abroad are not going to be the primary drivers behind any policy-related decisions for the FOMC. Surprisingly, there was only one question on negative interest rates, which has become a more popular policy tool for other central banks. Yellen very adamantly argued that the FOMC is not spending anytime discussing or considering negative interest rates at this time. This was an important message to communicate, and she seemed to be effective in clearly addressing the fact that the Fed is planning for only positive increases in interest rates at this time.

Although Yellen insisted that “April remains a live meeting”, the chances are slim to none that any economic reports in the next 6 weeks would be strong enough to sway the FOMC towards a rate increase. However, we continue to expect that June is a strong possibility, as long as the labor market remains healthy and inflation continues to move gradually toward the Fed’s target. At this point, it seems that the Fed is willing to overlook the ongoing tensions in financial markets and lingering weakness in the global economy so long as it doesn’t significantly impact domestic activity.

Equity markets reacted positively to the FOMC statement, up about 0.5% on the day, while the dollar index dropped 0.95% to the lowest level since mid-February. Federal funds futures increased only slightly since before the meeting, with markets pricing in a 38% probability of a June rate increase and only one hike total in 2016.

## Bottom Line: All Eyes on June for the Next Rate Hike Announcement

The FOMC may not have announced a rate increase with the March statement, but they certainly took a step forward in signaling their policy plans. Downward revisions to GDP and inflation expectations as well as a move from four to two rate increases in 2016 brings June back into focus for the next big announcement. Although these may appear to be dovish moves, the underlying messages from the statement and Yellen’s press conference suggest that the Fed is willing and ready to move forward in increasing rates as soon as they deem appropriate. The April meeting is unlikely given that it is only six weeks away. Therefore, we continue to expect additional rate increases in June and December, with the Fed leaving time in between to thoroughly assess the impact of higher rates on the domestic economy.

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