Central Banks

FOMC Statement: April 26-27th Meeting

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Doves Hold off Hawks for Another Meeting, but How Long Can This Last?

- **Fed kept rates unchanged again, despite hawkish undertones**
- **As expected, support for hike is on the rise, with strength in the labor market, fading downward pressures on inflation, and reduced volatility in global financial markets**
- **June remains in focus for the next announcement, though market expectations remain low**

The FOMC held true to their dovish roots at April's meeting, avoiding another federal funds rate increase and keeping the target range at 0.25-0.50%. Changes to the statement language were relatively minor and by no means provided a clear signal for a rate hike at the next meeting. However, hawkish undertones continue to poke through the surface as the Committee eliminated specific mention of any risks to growth. The doves have been able to hold off the hawks for a while now, but this will become a more difficult task as economic conditions continue to improve. Esther George (FRB Kansas City), who remained the lone dissenter for the second consecutive meeting, will have additional support in favor of a rate increase at the June 14-15th meeting.

The statement opened with firm language that "labor market conditions have improved further," adding to the existing commentary on "strong job gains." Most labor market indicators on Yellen's radar have improved significantly over the past twelve months and are close to (if not better than) the pre-crisis average. FOMC members also added that "real income has risen at a solid rate and consumer sentiment remains high." Clearly, the Fed has chosen to emphasize the more positive aspects of the economy despite the fact that GDP growth appears to have weakened further in 1Q16. This, along with removing the statement that "global economic and financial developments continue to pose risks," puts the Fed in a more comfortable position when it comes to transparency and communication, allowing for the possibility of raising rates in June if they so choose. Strong support for June will become clear in upcoming speeches.

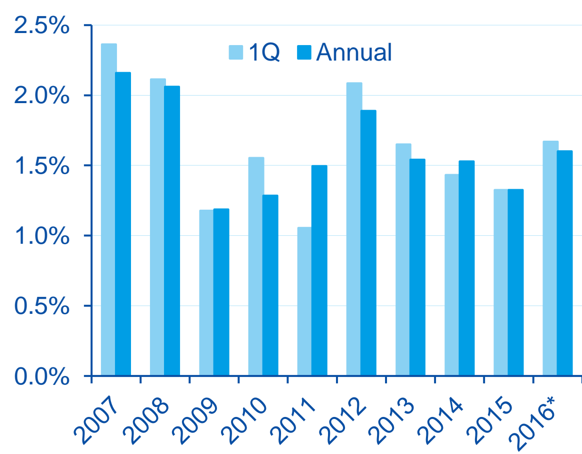
Chart 1
Labor Market Dashboard

	Last	1 month ago	3 months ago	6 months ago	12 months ago	2000-2007 average
Unemployment Rate	5.0	4.9	5.0	5.1	5.5	5.0
Nonfarm Payrolls	215	245	271	149	84	80
Participation Rate	63.0	62.9	62.6	62.4	62.7	66.4
Involuntary Part-Time	6,123	5,988	6,022	6,034	6,673	4,170
Long-Term Unemployment %	27.6	27.7	26.3	26.6	29.5	17.5
U-6 Unemployment Rate	9.8	9.7	9.9	10.0	10.9	8.7
Marginally Attached Workers	1,720	1,803	1,833	1,921	2,055	1,419
Average Hourly Earnings	2.3%	2.4%	2.6%	2.1%	2.0%	3.2%
Job Openings Rate	3.7	3.8	3.5	3.6	3.5	2.9
Hires Rate	3.8	3.6	3.7	3.6	3.6	3.8
Quits Rate	2.1	2.0	2.0	2.0	1.9	2.1
Layoffs and Discharges Rate	1.2	1.2	1.2	1.2	1.2	1.4

Source: BLS & BBVA Research

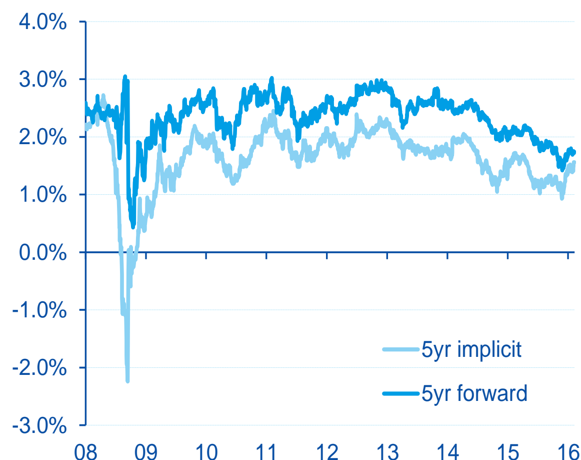
On the inflation front, the Fed appears less optimistic. While the data remain positive, March's CPI report noted a slight slowdown, forcing the Committee to remove language that inflation "picked up in recent months". There has been talk of seasonal volatility in inflation data and therefore it is important for FOMC members to remain cautious and not get too excited about gains in the first quarter, most of which continue to be driven by shelter and medical care. Still, it is hard to ignore the fact that core PCE inflation has gradually approached the Fed's 2% target—the highest in three years—and inflation expectations have started to climb back from hitting seven-year lows in February. Although inflation will continue to run below target for the foreseeable future, downward pressures are fading. This should provide some comfort to the most dovish FOMC members in moving forward with at least one additional 25 basis point rate hike in 2016.

Chart 2
Core PCE Inflation, 1Q vs Annual (YoY % Change)



*1Q16: only January and February data available; annual is projected
Source: BEA & BBVA Research

Chart 3
Inflation Expectations (%)



Source: FRB & BBVA Research

Recent improvements in global financial market performance have put many FOMC members at ease, with the Committee simply continuing to "closely monitor inflation indicators and global economic and financial developments." Rising oil prices have boosted market sentiment, and easing monetary policy actions from other central banks have helped maintain expectations for modest global growth in the coming year. Although the outlook remains uncertain, it seems that conditions are better primed for a rate hike in the next few months. Regardless, the Fed may be more inclined to react to financial markets than they are willing to admit (see "The financial stability mandate strikes back"). Federal funds rate futures suggest only a 15% probability of a rate increase at the June meeting, and if expectations do not improve, the FOMC may be hesitant to announce anything that would cause unwanted surprise in financial markets. However, expectations can change at the drop of a dime depending on how strongly upcoming communication signals such action. If FOMC members commit to communicating a June rate increase, market expectations should rebound and the Fed will feel more at ease in implementing the 25 basis point hike. Labor markets have clearly improved and inflation is moving toward the Fed's target, so financial markets are all that are left to satisfy appropriate rate hike conditions.

Bottom Line: Labor Market and Inflation Keep Rate Hike on the Horizon

April's FOMC meeting came as no surprise, with the Fed continuing to wait for the right moment to announce another rate increase. Some of the uncertainty stems from the growing disconnect between labor markets and GDP growth, with the former showing more significant strength than the latter. However, given that labor market indicators are currently providing a clearer picture of the economic cycle, the FOMC should feel more comfortable sticking to their guns in continuing this gradual normalization process. The timing may never be perfect, but conditions are certainly improving and it seems that any impact from the first rate hike has already been absorbed into the real economy. Still, some Fed officials may argue to continue delaying the second rate hike in order to wait for further improvement in financial stability even with stronger employment and higher inflation. While we continue to expect another increase in the near future, we cannot completely rule out the possibility that the FOMC could get cold feet and feel forced to rethink their strategy of higher rates in 2016, particularly if economic conditions do not evolve in line with their projections set forth at the time of liftoff.

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