Central Banks

FOMC Statement: July 26-27th Meeting

Boyd Nash-Stacey

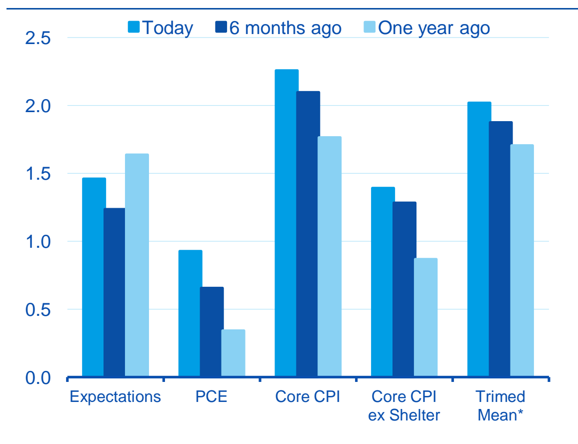
Fed uses July statement to re-prime the policy normalization pump

- **Unprecedented for a tightening cycle, Fed delays rate increase for 5th consecutive meeting**
- **Improvements in domestic conditions move committee closer to resuming normalization**
- **Uncertainty and U.S. elections will complicate possibility of rate increases in September**

In line with expectations—12% implied probability of a July rate increase—the FOMC delayed rate increases for the fifth consecutive meeting, an unprecedented move in a tightening cycle. In choosing not to raise rates, the committee maintained its target range for the federal funds rate at 0.25-0.50%. After a series of non-trivial downward revisions to the committee's outlook for employment, inflation, growth and long-term real interest rates, it is no surprise that the committee used the July meeting to prime the pump for possible rate increases in 2H16. However, language in the statement continues to underlie a feeling of unease about how further tightening could impact global financial conditions and how these conditions could spill over to the domestic economy, which remains in low gear.

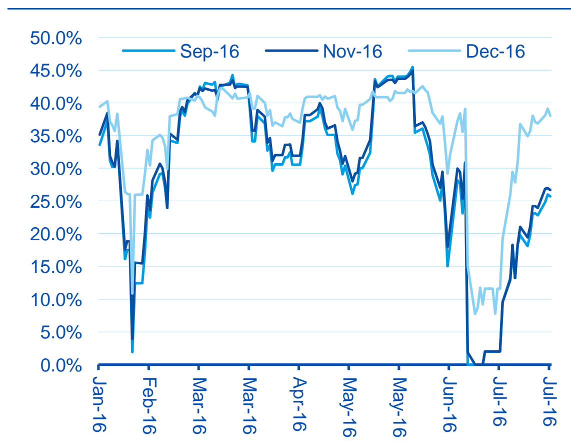
That being said, hawkish undertones regained some prominence, as Esther George, the lone dissenter, resumed her campaign to raise rates. In fact, the committee judged that the "labor market had strengthened" and that "on balance, payrolls and other labor market indicators point to some increase in household labor utilization in recent months." This is a shift away from the previous statement, which emphasized the weakness and slow growth in the labor market. In addition, the committee deemed household spending to be strong and expressed that "near term risks to the economic outlook have diminished." Although additional forward guidance would be needed to move markets, the decision to emphasize more positive aspects of the economy suggests that they may be primed and ready for a September rate increase, assuming that inflation edges up.

Chart 1
Inflation Expectations, %



Source: BBVA Research
*Cleveland Federal Reserve

Chart 2
Federal Funds Implied Probability of Rate Increases, %



Source: BBVA Research & Bloomberg

However, some dovish undertones remained, as concerns over “soft” business fixed investment and inflation running “below the committee’s 2 percent longer-run objective” were unchanged from June’s statement. In fact, despite noticeable improvements in core CPI and increases in market-based measures of inflation compensation from six months ago, the committee’s inflation assessment was little changed, citing ongoing labor market slack and previous energy price declines as reasons for prices remaining low.

Easing global financial tensions, stable growth in the EU and China and lower stress in emerging markets should give the FOMC enough breathing room to refocus their attention on domestic conditions, but not without caveats. The industrial sector, while on better footing than in June, remains vulnerable to external shocks—oil prices and global financial and economic conditions. In addition, any further oil price decline could stall momentum in the upstream oil and gas industry. Similarly, further gains in the dollar could counteract improvements in the manufacturing sector, generating more austere conditions in regions home to these industries.

That being said, the hawks’ ammunition is building with headwinds abating outside of those regions. Momentum built up over 1H16 in the housing sector is likely to carry over into the second half of the year as consumers enjoy greater purchasing power from better wages, lower gasoline prices and greater confidence. Markets are also realigning to a more hawkish policy normalization path with the implied federal funds rate suggesting a 26% probability of a rate increase in September—up from 0% in June.

However, ongoing global uncertainty and the proximity to the U.S. presidential election cycle will increasingly complicate the committee’s meeting-by-meeting, data-dependent approach. In fact, the FOMC has only raised rates once in an environment of elevated policy uncertainty and once in the two months prior to an election (September 1987). As such, it is reasonable to expect the committee to delay any increase until after the November election, making 4Q16 the most likely possibility for a rate increase in 2016. However, it is unclear how two strong labor market reports could tip the balance in favor of resuming policy normalization, suggesting that all meetings will remain live for remainder of 2016.

Bottom Line: FOMC reopens the door for rate increases in 2016

In an unprecedented move during a tightening cycle, the FOMC delayed rate increases for the fifth consecutive meeting, maintaining the target range at 0.25%-0.5%. The statement confirms the pivot away from indefinite pause to possible rate increases in 2H16. However, language in the statement continues to underlie a feeling of unease about how further tightening could affect global financial conditions and their impact on the domestic economy which remains in low gear. Despite a more optimistic and clear outlook for the economy, the overriding tone remained dovish. Improvements in the labor market will challenge the doves’ wait-and-see approach, as the expansion cycle ages. While we continue to expect all remaining meetings to be live, the unshakable uncertainty of 2016, the complicated and delicate task of realigning expectation to policy normalization and the proximity to the November election suggest that any further rate increase will be delayed until the fourth quarter.

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