Central Banks

FOMC Preview: November 1st-2nd Meeting

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FOMC Statement to clarify intentions to raise rates in December

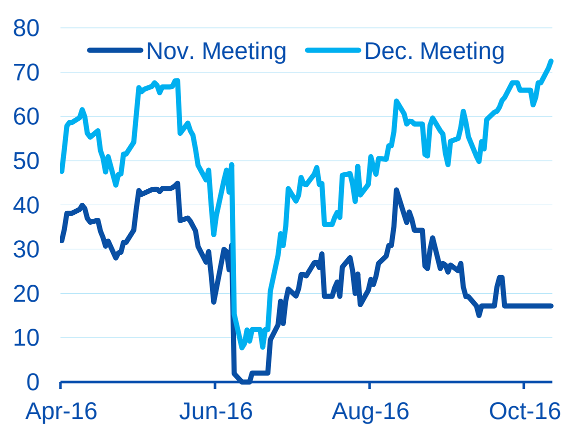
Committee's credibility on forward guidance at risk if statement fails to anchor long-run expectations

At its November 1st-2nd meeting, the FOMC will be faced with the challenge of preparing markets for policy renormalization in December and reconciling market expectations with a gradual —but still positive– tightening cycle. With markets looking to December for the next increase, and with the meeting falling only 6 days before the U.S. presidential elections, there is a low probability of a rate hike at the upcoming meeting. That being said, broader macro conditions are consistent with levels that would imply a rate hike, suggesting that December remains the most likely time for a rate hike.

However, the prolonged pause in rate hikes– now in its 11 month— has driven a wedge between the committee's implied tightening schedule (dot plot) and markets' long-run expectations of the path of nominal interest rates. In fact, markets are 100bp, or in other words, four 25bp rate increases, away from where the FOMC sees rates in 2018. This skepticism is not entirely misplaced. In spite of the unemployment rate trending near levels consistent with internal projections of the NAIRU and the pace of job creation growing at a level that is nearly twice as high as the pace needed to absorb new entrants into the labor market, the committee continues to delay rate increases. While low inflation caused by low energy prices and declining import prices has given the FOMC cover for delaying a rate increase, a broad set of inflation indicators are trending towards the Fed's target.

Figure 1

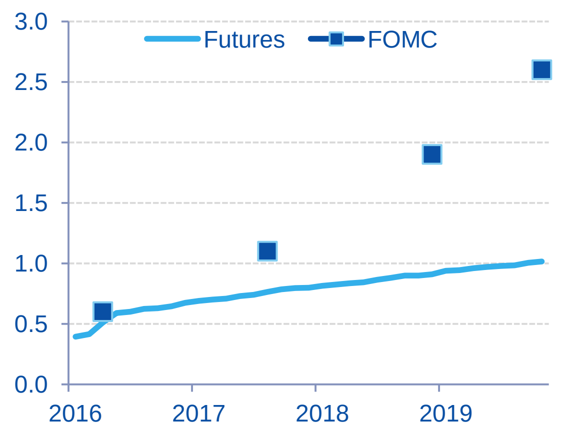
Rate Hike Probability



Source: BBVA Research

Figure 2

FOMC Median Implied Path vs. Futures Curve



Source: BBVA Research

With conditions improving broadly in developed and emerging markets and global financial tensions having receded after Brexit, the committee is likely to view global risks as balanced or slightly tilted to the upside. In addition, risks to further delaying rate hikes also seem tilted towards tightening despite some committee members' view that there is ample room to curtail risks from overly accommodative monetary policy. Assuming that the assessment of domestic financial conditions is positive and their concerns about adverse shocks from abroad are muted, the emphasis in the statement will be on forward guidance of the upcoming increase in December. As such, we maintain that the committee will increase the Fed Funds rate by 25bp in December and begin moving market expectations closer to our baseline of two rate increases in 2017.