CENTRAL BANKS

FOMC Preview: March 14th-15th Meeting

Boyd Nash-Stacey

Rate hike imminent as Fed uses intermeeting period to cajole markets back to life

Labor market fundamentals and inflation outlook support new baseline for 3 hikes in '17

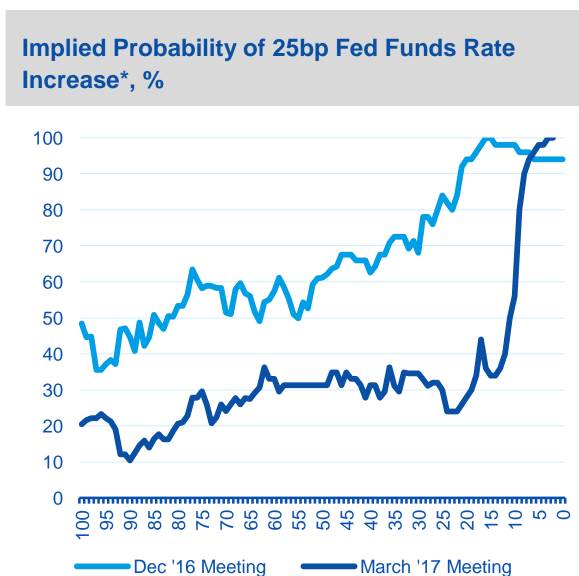
Commitment to a "gradual" pace dependent on FOCM view of neutral interest rates and risks

After a series of FOMC speeches that struck a noticeably more hawkish tone, markets shifted from anticipating a 6-month pause in 2017 to expecting a rate hike in the upcoming meeting. With implied market expectations for a rate increase at 100%, today's employment report held less significance in terms of the Fed's decision to raise interest rates in March. However, with payroll gains above 200K and the unemployment rate trending back to 4.7%, and with a sturdier inflation outlook, conditions are apt for the Fed to continue on its gradual path of rate hikes. This implies two additional rate hikes after March's meeting. Although the committee remains lukewarm on the prospects of deregulation and fiscal expansion, broader economic and financial conditions are consistent with a gradual, if not, faster removal of monetary policy accommodation. Assuming risks remain balanced, it seems that the committee will begin to discuss balance sheet normalization in lieu of this.

In terms of the labor market and its proximity to full employment, current unemployment data suggests that conditions are nearing levels consistent with maximum employment. While an argument can be made that the natural rate of unemployment has trended down due to structural and secular changes in the labor market, it is unlikely that it is more than 40bp lower than the current estimate of 4.7%. In addition, even the most dovish members will have a hard time defending significant labor underutilization, as labor force growth was the highest in 10 years in 2016, suggesting that only 1-1.5M workers remain out of the labor force and willing to work.

Figure 1

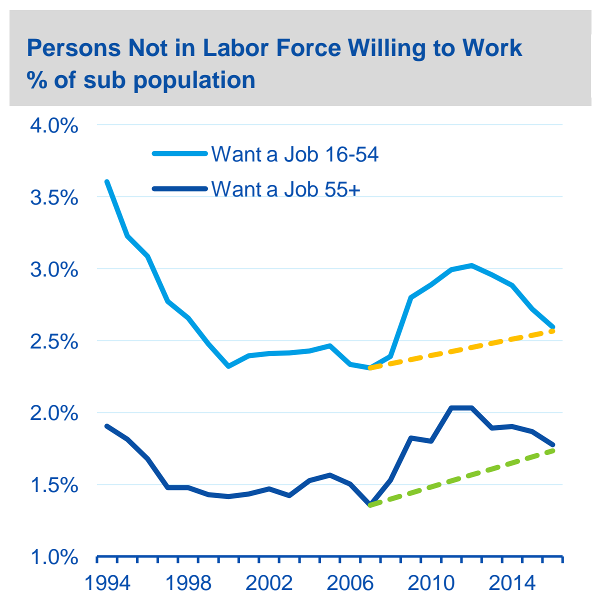
Implied Probability of 25bp Fed Funds Rate Increase*, %



Source: BBVA Research & Bloomberg
*Days until meeting

Figure 2

Persons Not in Labor Force Willing to Work % of sub population



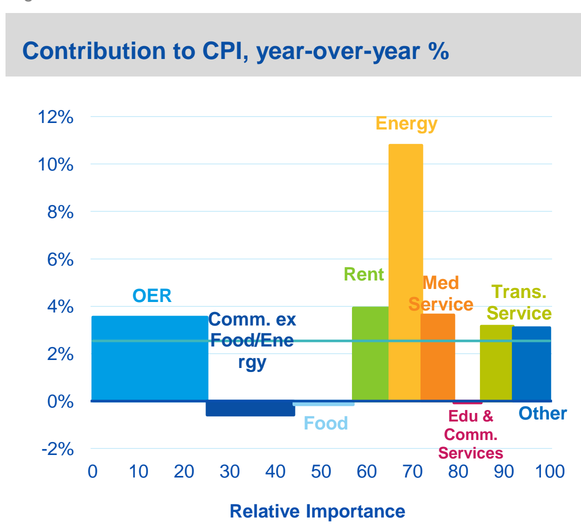
Source: BBVA Research & BLS

Moreover, the broadest measure of labor underutilization— U-6— is below average even considering pre-1990s underutilization measures. In fact, if employment growth continues at its current pace of 175-200K, the "missing worker" could be fully absorbed by yearend 2018. Labor force participation also continues to edge up, reaching 63% in February, suggesting that despite tepid real wage gains, the labor market is becoming increasingly attractive for idle workers.

On inflation, while labor markets have tightened and core and headline measures are moving up, the risk of a major overshooting of the 2% target is low. The fact remains that the bulk of the recent pressures on headline consumer prices stems from the rise in oil prices in 2016. In fact, the energy component in the consumer price index explained one-third of the year-over-year increase in consumer prices after increasing 4.0% month-over-month in January. Another one-third was explained by rising home prices, which continue to increase at higher than average pace. Going forward, however, energy prices are forecasted to grow at a slower pace or even remain flat thus eliminating the large contributions from energy while home prices are forecasted to decelerate which should alleviate some of current inflationary pressures.

Figure 3

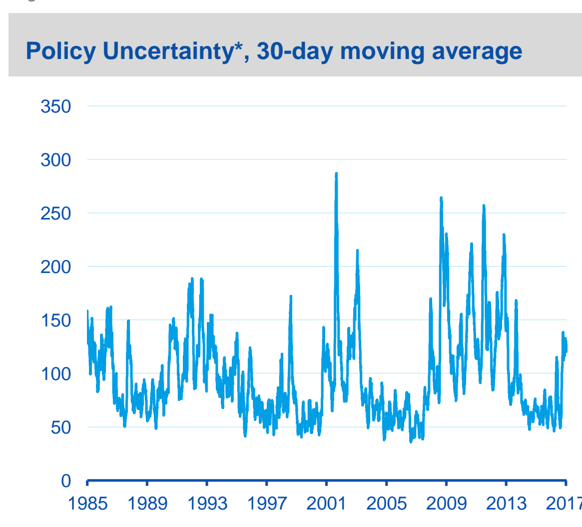
Contribution to CPI, year-over-year %



Source: BBVA Research & BLS
*Days until meeting

Figure 4

Policy Uncertainty*, 30-day moving average



Source: BBVA Research & Bloom et al
100=average

Moreover, from a cost-push perspective wage pressures remain modest in a handful of sectors such as retail and transportation and nonexistent in others, suggesting that any further undershooting of the unemployment rate will not risk pushing inflation well above the 2 percent target. These factors underlie the FOMC's projections for the inflation rate to be marginally below the 2% target in 2019 in spite of the gradual pace of normalization.

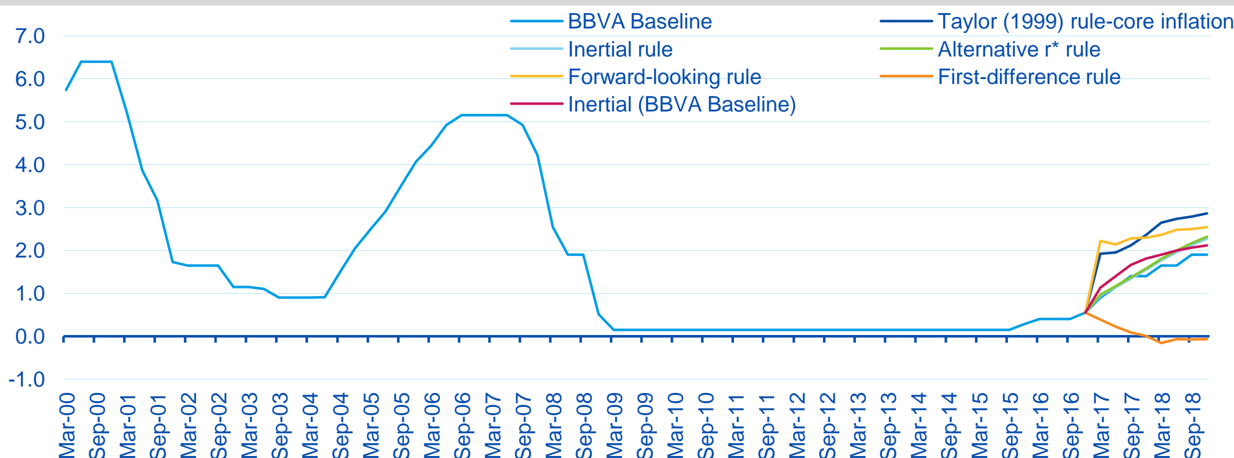
With the economy operating near full employment and inflation only slightly below the target, current debate has shifted to some degree from labor market underutilization to current and long-run neutral real interest rates. This outlook will be fundamental in the committee's determination of how far and fast to move, assuming that output and inflation trends remain stable. Current research widely cited by Fed board members (Laubach and Williams, 2016) suggests that current neutral real rates range from 0 and 1 percent with their current estimate around 0.25 percent. This is a significant departure from historical rates that trended closer to 2-3%, but also higher than consensus estimates in recent years

In equilibrium, the policy rate approximates the sum of the neutral real interest rate plus the inflation target. If neutral real interest rates today were closer to say 2-3%, which they have been historically, then current policy

could be viewed as overly accommodative. However, since the current rate is for all intents and purposes close to zero, the current implied real interest rate of around -1.15% percent is only 140bp from this target as opposed to 365bp if the neutral real rate was closer to 2.5%. With this in mind, the Fed could easily reach this level with two 25bp interest rate increases per year in 2017 and 2018, and one in 2019.

Figure 5

Fed Funds Rules-Based Rate Projections, %



Source: BBVA Research & Cleveland Fed

While different assumptions about the rules that guide the Fed can lead to very different conclusions about the tightening path and pace, the strength and commitment to forward guidance suggests that the probability of a more aggressive tightening cycle is low. Adhering to a strict Taylor-like rule would imply a more rapid and immediate tightening cycle whereas other rules, based on lower values of neutral real interest rates (r*), imply a more measured path. Although some of the speeches since February's meeting were slightly more optimistic with respect to r*, it still seems that most members agree that current policy course is not overly accommodative.

In addition, Fed officials may not only disagree on what is the long-term neutral real interest rate but also the explanations that would keep the rate low or bring it back up. And even for those that may agree that the rate is low, they may also disagree on what has been the caused for this. If the uncertainties remain high, it is less likely that the committee will reach consensus on the need to move quickly. Still, some officials may be paying less attention to these issues and may be looking at other concerns such as the ongoing increase in equity prices and still relatively low Treasuries. Particularly if they perceive that financial markets are beginning to overheat.

Although the committee's current stance on policy uncertainty appears sanguine, there is a chance that the optimism may be short-lived presenting risks to the Fed's timing in 2017. In fact, the committee's bias seems to be tilted towards the wait-and-see strategy given how polarized politics remain in spite of having a unified White House and Congress. Furthermore, there has been a dearth of details on fiscal policy and the administrations timetable for tax reform. As such, it seems that any major fiscal legislation will not be passed until late in the year or 2018 if the GOP continues to focus on repealing and replacing the Affordable Care Act through reconciliation which would limit the party's ability to pass legislation without Democrats support. This scenario would likely imply a pullback in expectations and optimism and a more cautious Fed. Furthermore, elections in Europe and a retreat from integrated global markets present risks to the outlook.

Conversely, some Fed officials are beginning to incorporate some fiscal measures into their forecasts which would imply higher inflation and growth. If the measures are successful in boosting productivity, potential GDP and inflation, it could imply a more rapid tightening and a higher neutral long-term rate. However, these hawkish members will be reminded by their colleagues that equally important, downside risks from trade protectionism should not be ignored.

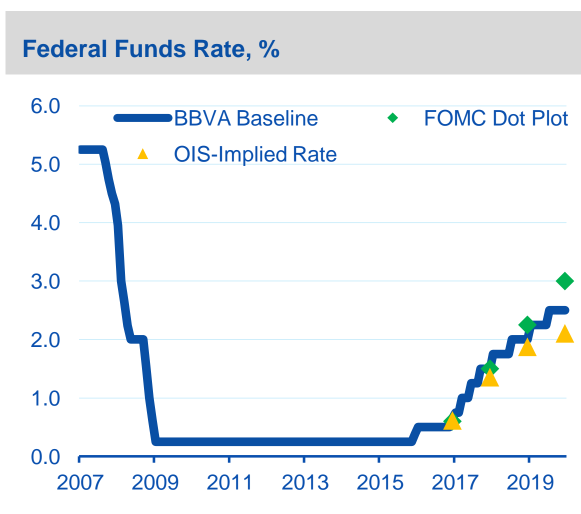
Bottom line

With February's employment report meeting expectations, and after a series of hawkish speeches by key voting members, we now expect the Fed to raise interest rates by 25bp at its March meeting. While the current strength of the labor market and rising inflation expectations underlie the decision, a favorable risk environment likely helped push the committee towards next week's move. A handful of rules-based approaches based on lower long-term interest rates also support a slightly faster tightening cycle.

With this in mind, assuming risks remain balanced, financial vulnerabilities and geopolitical risks are contained, we expect two additional rate increases in 2017. If deregulation is successful and fiscal policy is timely and large enough to boost growth there is a small probability that the Fed could embark on a steeper tightening cycle to a higher long-term rate. Yellen's press conference should shed light on the committee's view of what gradual will mean in the coming year and if the FOMC is likely to commit to a more aggressive tightening cycle or balance sheet withdrawal in the near future.

Figure 6

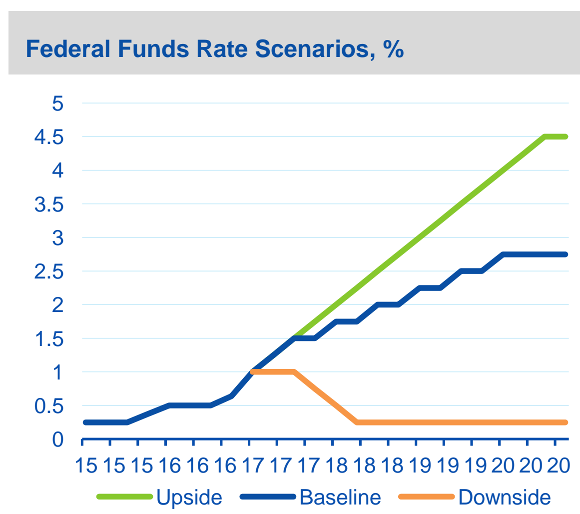
Federal Funds Rate, %



Source: BBVA Research & Bloomberg
*Days until meeting

Figure 7

Federal Funds Rate Scenarios, %



Source: BBVA Research

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