FOMC June 13-14 Meeting: Wonder Woman Brings Hope to Markets

Nathaniel Karp / Boyd Nash-Stacey

In a widely anticipated move, for a third consecutive quarter, the FOMC raised its benchmark interest rate 25bp to 1.25%, as the labor market continued to tighten in the Committee's eyes despite some slowing job gains over the past months. The more pressing question heading into today's meeting was how the FOMC was going to justify increasing rates in spite of weakening in a handful of inflation indicators. In the end, as we expected, the statement, projections and press conference contained little hand wringing over the persistently low inflation, suggesting that most officials view the deflationary headwinds as transitory; Yellen, in her statement and press conference alluded to one-off pressures from prescription drugs and mobile phone contract prices as being responsible for the slowdown.

As we anticipated, the balance sheet normalization supplement solidified the Fed's plans to use a system of gradually increasing caps over a 12-month period, likely beginning at the end of this year. The caps initial values will be set at $6 billion for Treasury securities and $4 billion for agency and mortgage-backed securities. Every three months, the caps will be increased by $6 billion and $4 billion, respectively, until they reach $30 billion and $20 billion. With this, the Fed aims to ensure a predictable and passive exit that would imply reducing the balance sheet by around $300bn in the first 12 months and $2 trillion over four years.

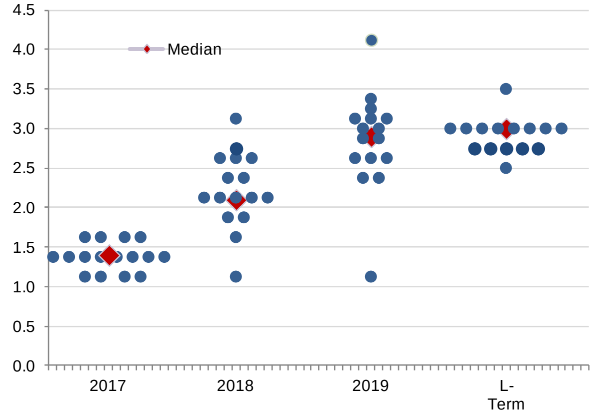
Although the Fed expects reserves balances to be "appreciably" lower than current levels but higher than pre-crisis, the FOMC was not ready to commit to any particular target. The FOMC will allow reserves to adjust to a level that allows the Fed funds to become once again the primary monetary policy tool.

Post-press conference market sentiment was mixed with equity prices edging down 0.3%, the EUR-USD appreciating and the 10-yr Treasury yields regaining losses from earlier in the day following weak CPI and retail sales reports. Yellen's press conference and slightly hawkish undertones of the supporting materials helped the 10-yr Treasury recover to 2.14%.

Going forward, we expect officials to focus on their communication strategy to realign market expectations with their outlook. This means lifting the expectations of the September rate increase, which has an implied probability of 20%, to achieve a smooth increase to 1.25-1.50%.

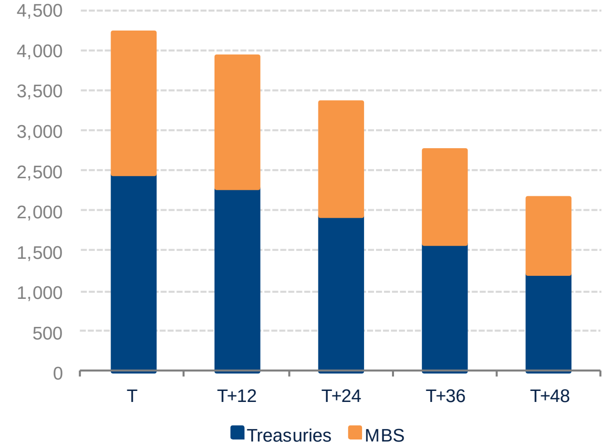
This can be done quickly through Fed communication as was the case leading up to the March increase. Particularly if we consider that real GDP growth will rebound in 2Q17, labor markets are converging with full employment and global risks have diminished. However, this will only happen if downward price pressures actually fade away, and inflation expectations realign with the Fed's 2% target over the medium term.

Figure 1. FOMC Fed Funds Expectations
%, EOP



Source: BBVA Research & FRB

Figure 2. Factors Supplying Funds
$bn



Source: BBVA Research & FRB

In any case, even if the Fed made a downward revision to their forecasts and inflation data generates some doubts, the FOMC seems convinced that the course of monetary policy normalization is appropriate in this environment. The economy is at full employment, benchmark interest rates need to move away from the zero-lower bound and stand ready for the next cycle, Fed's intervention in financial markets need to return to more normal conditions, higher interest rates help prevent the likelihood of asset prices misalignment and last but not least policy normalization protects Fed's credibility. In addition, officials also have to contemplate the potential effects of fiscal stimulus and financial deregulation, which increase risks of overheating the economy, and the impact of significant rotation inside the Board.

Another 25bp increase in September will allow the Fed to focus on balance sheet normalization in the fourth quarter. If market reaction is orderly, the Fed will resume interest rate increases in 1Q18.

Disclaimer