FOMC Meeting September 19th-20th

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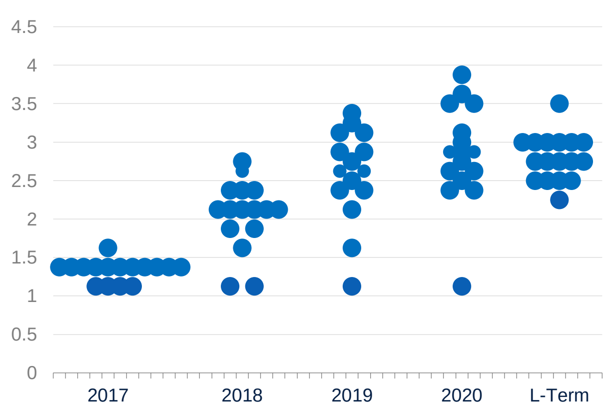
FOMC strategy afloat: stable outlook, balance sheet normalization, and realigned expectations

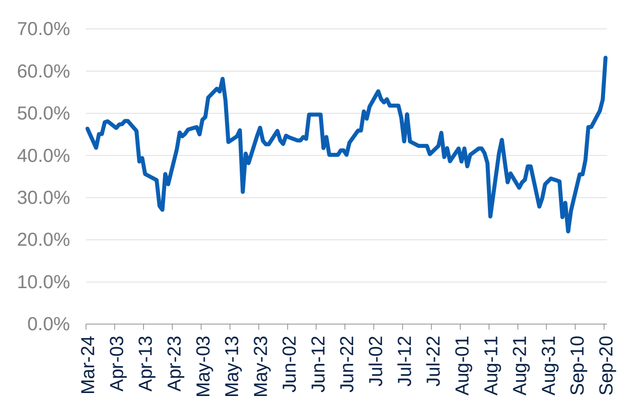
As we expected, the FOMC maintained the Fed funds rate at 1%-1.25% and announced the start of the balance sheet normalization process, which will begin in October. The statement also noted the negative effects from recent Hurricanes, but stated, "…past experience suggests that the storms are unlikely to materially alter the course of the national economy over the medium term." In terms of the outlook, the median forecasts on inflation edged down slightly, confirming our view that core prices will remain subdued throughout 2017 and 2018. The shift in the inflation forecasts has prompted one or two members to anticipate a more gradual pace of normalization than what was expected in 2Q17, suggesting how sensitive some members feel towards persistently low inflation and their readiness to alter their monetary policy stance if current trends of low inflation do not reverse in coming months. Forecasts for the unemployment rate were also slightly lower, highlighting the ongoing debate around the amount of slack remaining in the economy, the impact that demographics changes have on labor force participation and the debate behind the flattening of the Phillips curve. The Fed remains committed to its current playbook, but has implicitly acknowledged that conditions are not supportive of a faster pace of normalization given the uncertainty over trend inflation, as Yellen recognized in the Q&A saying that she "…can't point to a specific set of factors on inflation" to explain the low levels. Nevertheless, we maintain our expectation for a 25bp increase in December 2017, and 50bp more throughout 2018. However, the uncertainty around the medium-term has grown given the turnover expected at the FOMC in 2018. With potentially five new board members, on top of two freshman regional Fed presidents, there is greater likelihood for a nontrivial shift in the voting bias, ranging from rules-based to acquiescent.

Figure 1. FOMC Dot Plot: Fed Funds Rate, EOP, %



Source: BBVA Research & FRB

Figure 2. December 2017, Implied Probability, %



Source: BBVA Research & Bloomberg