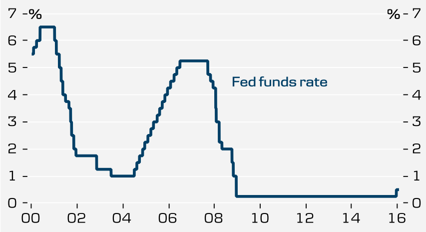
27 January 2016

FOMC review

Less 'confident' Fed likely to stay on hold in March as well

- **As expected, the Fed funds target rate was unchanged at 0.25%-0.50%. The vote was unanimous. The statement was dovish and more or less in line with our expectations.**
- **Overall, the statement supports our view that the Fed will also skip March, although Fed is keeping the doors open.**
- **The main change in the statement was that Fed is no longer *'reasonably confident'* that inflation will reach 2% in the medium term.**
- **As expected, the Fed reinstated that it is *'monitoring global economic and financial developments'*. It is also worried about the fall in market inflation expectations.**
- **We stick to our view that the Fed will increase the Fed funds target rate three times this year (April, September and December). However, we still believe there are downside risks to this call, as the Fed will not risk tightening too much, too quickly, in our view.**
- **Markets have still priced in one full hike this year and one next year.**

As expected, FOMC left the target rate unchanged



Source: Federal Reserve

Statement supports our view that Fed will stay on hold in March

As expected, the Fed kept the Fed funds rate target unchanged at 0.25-0.50%, which, however, was also widely expected already before the financial turmoil this month. The decision was unanimous. However, there were several important changes to the statement, which support our view that the Fed will also stay on hold in March.

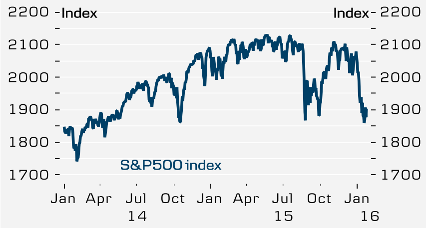
The most important change was that the Fed is no longer *'reasonably confident'* that inflation will reach 2% over the medium-term, although it is still the Fed's main scenario. While this is key, it is not a huge surprise since the initial lift-off was a 'close call' for 'some members' according to the minutes from the December meeting, see *FOMC Minutes: Not all members are as confident as Yellen despite the unanimous hike*, 6 January 2016. The subdued core inflation means that FOMC can stay patient raising rates.

As expected, FOMC reinstated the phrase that it is *'closely monitoring global economic and financial developments'*, which was otherwise removed from the statement in December. In other words, the Fed takes the financial market turmoil and the development in China and other emerging markets into account.

There were only a few Fed speeches between the December and January meeting. The most important speech was one by the Fed's Bullard (voter, hawk) in which he expressed his concerns about falling inflation expectations. This concern was reflected in the statement as it is stated that *'market-based measures of inflation compensation declined further'* (in December: 'remain low').

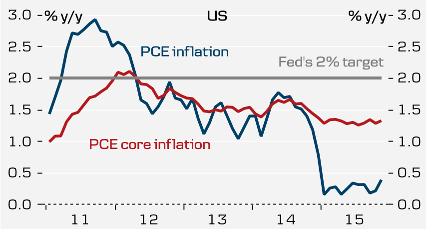
While *'labour market conditions improved further'*, the Fed recognised that *'growth slowed'* in Q4 15 (in December: 'expanding at a moderate pace'). However, this was partly due to slower *inventory investment* (new in the statement). Household spending and business fixed investment were still increasing at *'moderate'* pace (In December: 'solid').

Fed is 'monitoring global economic and financial developments'.



Source: Macrobond Financial

No longer 'reasonably confident' that inflation will reach 2% in the medium-term



Source: BEA

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The statement was overall to the dovish side. The Fed no longer *'reasonably confident'* that inflation will reach 2%, it is *'monitoring global economic and financial developments' and* worried about the low market-based inflation expectations. Although the Fed kept the doors open by not communicating anything explicitly at this meeting, we think the statement supports our view that the Fed will also stay on hold in March. We have for some time argued that the Fed is unlikely to risk tightening too much, too quickly, latest in our *FOMC Preview*, 25 January.

We still believe the Fed will hike three times this year

Based on the statement, we stick to our current view that the Fed will increase the target rate three times this year (April, September and December). However, we still believe there are downside risks to this call, as the Fed will not risk tightening too much, too quickly, in our view. Our expectation is based on our main scenario, which is that the financial stress will ease and data rebound. If so, April is still in play. To some extent, the current situation is equivalent to what we saw in August-September 2015. The combination of financial market stress and a weak jobs report in August-October pushed market expectations for the first Fed hike too far out as the labour market rebounded sharply in Q4. While two months seem too short, three months could, in our view, still prove sufficient for the Fed to raise rates again. Hence, markets may be too pessimistic on the US and still underestimate the number of hikes this year. However, as mentioned previously, the downside risks have increased and it could be that the next hike is indeed pushed further out in line with market expectations.

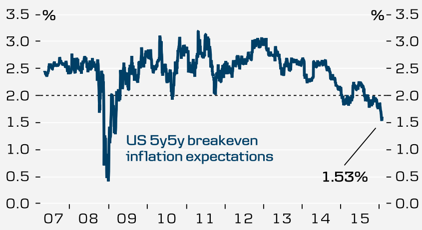
Market is now pricing 20% probability of a hike in March

The initial market interpretation was dovish with money market rates taking back the increases leading up the statement release. The largest declines happened in the 5y segment (5bp decline on the release), which is the area on the curve most sensitive to the aggregate hiking cycle rather than the immediate timing of a second hike. The general interpretation can thus be translated to 'dovish, but with options kept open' and that is reflected in the implied probability of a hike in March that now stands around 20% down 10%-points from before the meeting.

We would not be surprised to see some further USD strength

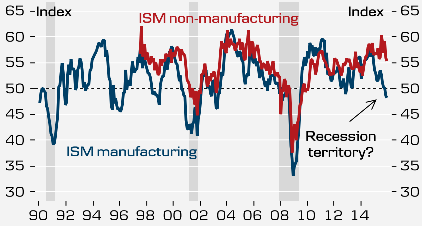
While the relatively soft Fed initially managed to send EUR/USD above 1.09, the spike proved somewhat short-lived. Notably, USD/JPY fell on impact - not quite your usual risk-on reaction - alongside falling equities and oil, suggesting the Fed did not manage to fuel a genuine risk rally. We note that while the (small) drop in US short rates is negative for EUR/USD here, souring risk appetite is a positive due to the status of the single currency as a safe haven. As we have stressed previously, with market pricing already soft ahead of the meeting it was indeed difficult for the Fed to send a message dovish enough without backtracking completely on it now having entered tightening mode, and we would not be surprised to see some further USD strength against both the majors and EM currencies materialise in the coming days. With USD/JPY close to 119 there is little pressure on the Bank of Japan to deliver more at this stage, confirming our view that it is too early for Kuroda and co to deliver this week, see *BoJ preview*, 27 January. Finally, with the Fed failing to prop up risk appetite to any great extent the Scandies could stay under pressure near term.

Even the hawks are worried about the very low inflation expectations



Source: Bloomberg

Very low ISM manufacturing a concern



Source: ISM

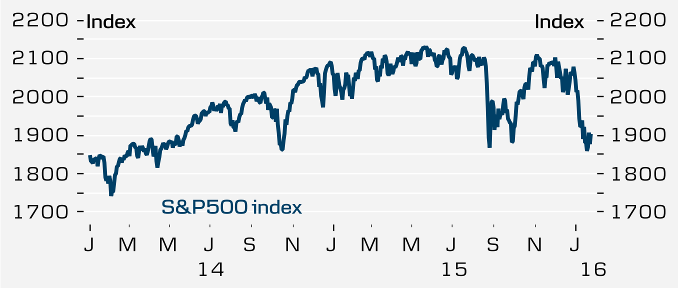
Important changes to the statement

Below we have included the most important changes. (our own highlights in bold. italic are quotes.)

- **Fed no longer 'reasonably confident' that inflation will reach 2%. Remember that initial lift-off in December was a *'close call'* for *'some members'* according to the minutes:** The phrase Fed *'is reasonably confident that inflation will rise, over the medium term, to its 2 percent objective'* was removed.
- **The Fed is worried about the financial turmoil and the slowdown in China and other emerging markets. The phrase was removed in December but has been reinstated: '***The Committee is closely monitoring global economic and financial developments'.*
- **As Bullard (voter, hawk) mentioned in a speech before the meeting, the Fed is worried about falling market inflation expectations:** *'Market-based measures of inflation compensation declined further'.*
- **Growth and data have been weak lately but the labour market continues to tighten. The Fed seems to think that the slower growth is mainly a temporary dip:** '*labor market conditions improved further even as economic growth slowed late last year. Household spending and business fixed investment have been increasing at moderate rates in recent months, and the housing sector has improved further; however, net exports have been soft and inventory investment slowed'.*

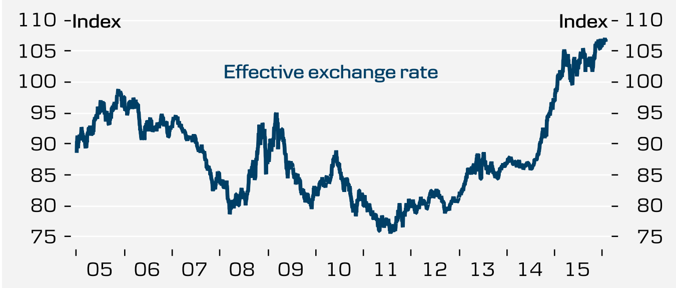
FOMC chart book

Fed is 'monitoring global economic and financial developments'



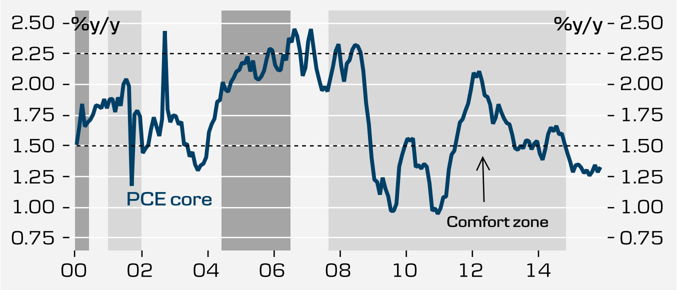
Source: Macrobond Financial

Strong USD puts a damper on growth



Source: Federal Reserve, Bloomberg and Danske Bank Markets

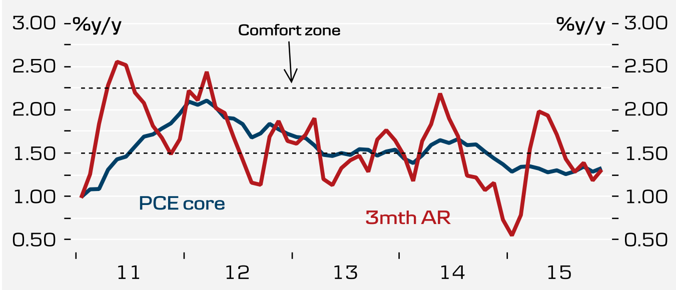
Fed no longer 'reasonably confident' that inflation will reach the 2% target in the medium-term



Source: BEA, Danske Bank Markets

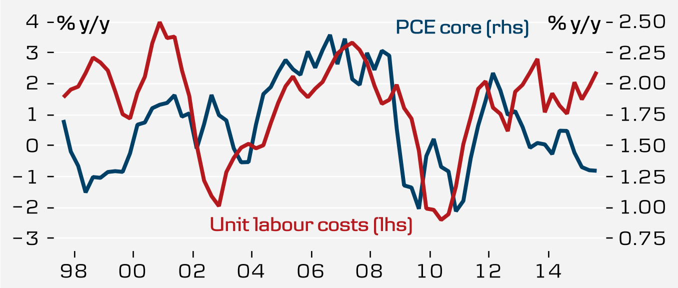
Note: Dark (light) shading indicates periods of tightening (easing)

Remember that hike was a 'close call' for 'some member' in December



Source: BEA, Danske Bank Markets

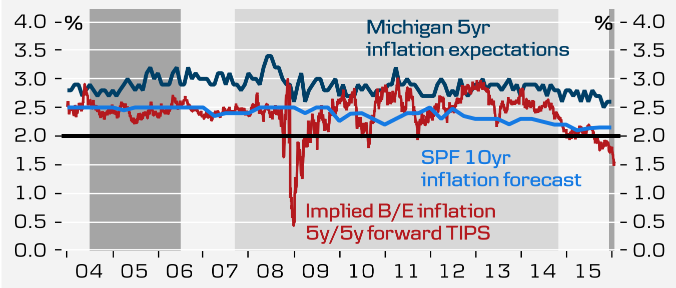
Unit labour costs indicate higher underlying inflation pressure



Source: Federal Reserve of Philadelphia, Macrobond Financial, University of Michigan and Danske Bank Markets

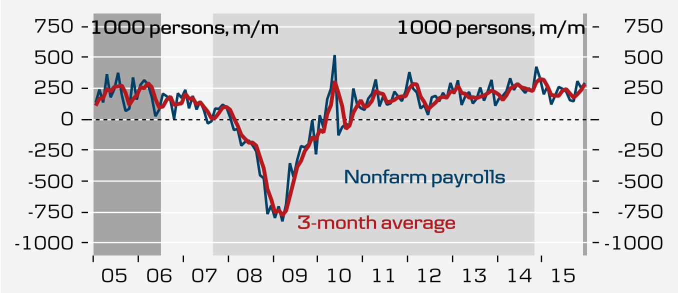
Note: Dark (light) shading indicates periods of tightening (easing)

Low market inflation expectations a concern



Source: Federal Reserve of Philadelphia, Macrobond Financial, University of Michigan and Danske Bank Markets

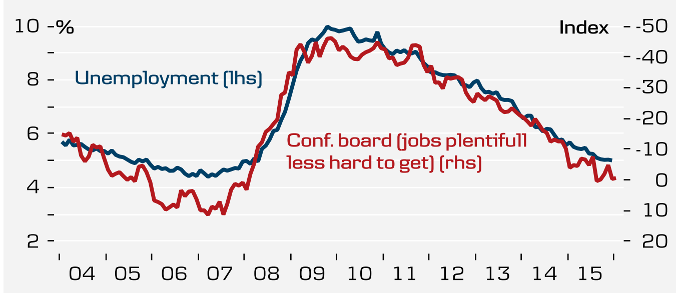
Very strong employment growth



Source: BLS, Danske Bank Markets

Note: Dark (light) shading indicates periods of tightening (easing)

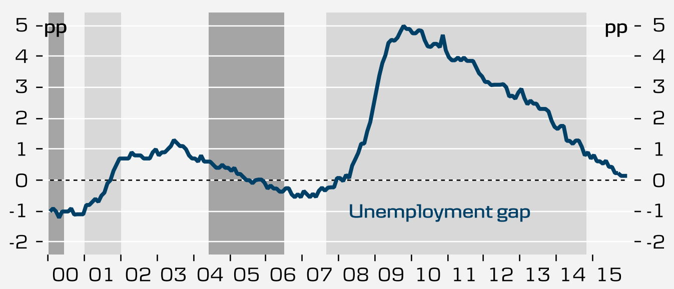
Unemployment rate continues to drift lower



Source: BLS, Danske Bank Markets

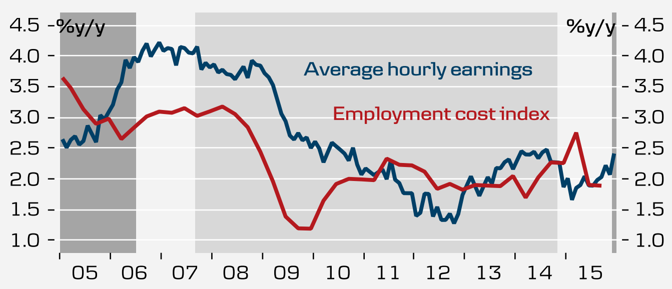
Note: Dark (light) shading indicates periods of tightening (easing)

Unemployment gap (actual – NAIRU) has more or less closed



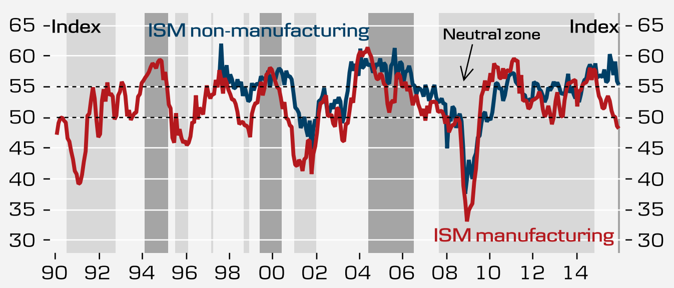
Source: BLS, CBO and Danske Bank Markets
Note: Dark (light) shading indicates periods of tightening (easing)

Wage inflation has been trending up but is still subdued



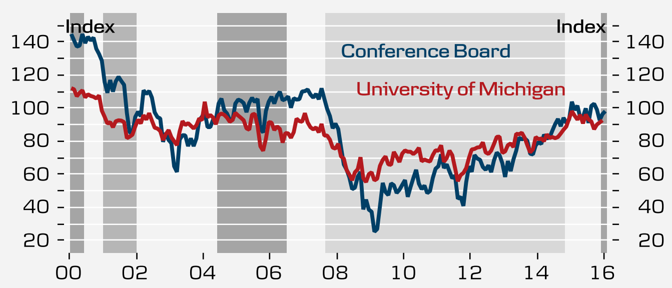
Source: BLS, Danske Bank Markets
Note: Dark (light) shading indicates periods of tightening (easing)

Weak manufacturing data one reason why Fed unlikely to risk tightening too much, too quickly



Source: ISM, Danske Bank Markets
Note: Dark (light) shading indicates periods of tightening (easing)

Good news that consumers are still quite optimistic



Source: University of Michigan, Conference Board, Danske Bank Markets
Note: Dark (light) shading indicates periods of tightening (easing)

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