Fed Interest Rate Projections Increased

- As expected the FOMC continued to taper its monthly asset purchases. The final step down is anticipated in October.
- The FOMC's guidance that rates will remain on hold for a "*considerable time*" after asset purchases end was maintained.
- The median projections for the Fed funds rate were lifted. The median for 2015 is now 1.375% and for 2016 is 2.875%.

Tapering to end soon. Minor tweaks to the economic assessment.

As widely expected the US FOMC tapered the pace of its monthly asset purchases by US$10bn to US$15bn per month. According to the FOMC, should the economic outlook hold the current asset purchase program will end at the "*next meeting*" in late October.

In terms of the economic assessment, there were modest changes made by the FOMC. The US economy was described as "*expanding at a moderate pace*", while labour market conditions were viewed as having "*improved somewhat further*". That said, the Fed reiterated that "*there remains significant underutilization of labour resources*". Post the softer August US CPI data, which showed annual inflation now running at 1.7%pa, it was unsurprising that the FOMC tempered its language on inflation (chart 1). The FOMC now views consumer price inflation as "*running below the committee's longer-run objective*". This compares to "*moved somewhat closer*" at the July meeting.

Forward guidance maintained. But dissenting voice rising.

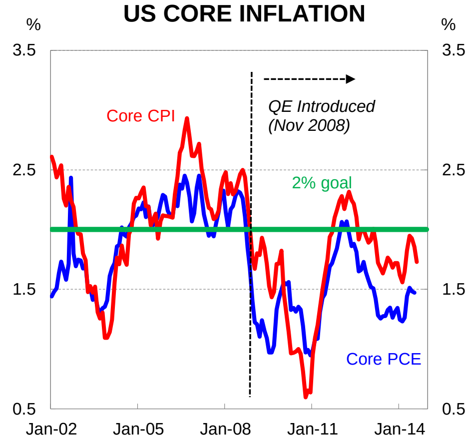
Market interest leading into the FOMC meeting was squarely focused on whether the FOMC would alter its forward guidance on interest rates. In the end the FOMC held firm and reiterated that it will "*likely be appropriate to maintain*" the current fed funds target rate for a "*considerable time after the asset purchase program ends*". In the follow up press conference Fed Chair Yellen stressed that "*considerable time*" wasn't a form of calendar-based guidance and there was no mechanical interpretation, but rather it is "*highly conditional and it is linked to the committee's assessment of the economy*".

Notably, the dissenting voice on the FOMC increased slightly in September. Richard Fisher and Charles Plosser voted against the September monetary policy action. In July, only Plosser had dissented. According to Fisher, the outlook for the US economy, and "*continued signs of financial market excess*" warranted an earlier reduction in monetary accommodation than suggested by the forward guidance. Plosser retained his view that the current forward guidance on interest rates was effectively time dependent and did not reflect the economic progress made in the US.

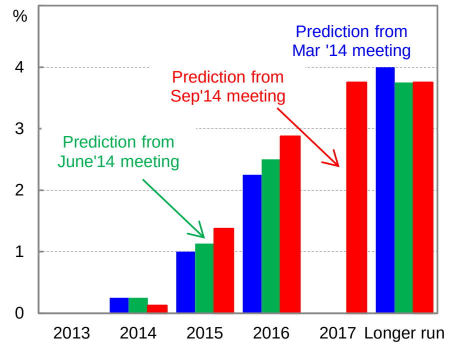
Joining the dots

The US FOMC updated its economic projections at the September meeting. Interest remains on the "dot chart" of the FOMC's projections for the fed funds rate. In line with the trend over recent forecasting rounds, the median projections of the FOMC for the fed funds rate in 2015 and 2016 were lifted (chart 2). The median projection for 2015 is now 1.375% (previous 1.13%), for 2016 it is now 2.875% (previous 2.5%) and for 2017 it is 3.75%. The 2017 median forecast is in line with the

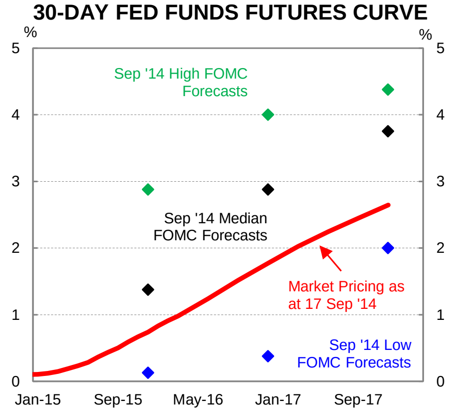
US CORE INFLATION



FOMC'S FUNDS RATE PREDICTION
(prediction of the median FOMC, yr end)



30-DAY FED FUNDS FUTURES CURVE



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FOMC's long run estimate. Significantly, the FOMC's median projections continue to run substantially above market expectations implied by the futures curve (charts 3 and 4).

Nevertheless, as is normally the case Fed Chair Yellen looked to downplay the significance of the projections in the press conference by stating that the adjustments were "quite modest". And that the "dots" don't show members "uncertainty on forecasts".

In terms of the macroeconomic projections, there were no significant adjustments. The central forecast for US GDP growth in 2014 and 2015 is now 2.1 and 2.8% respectively. This is down from 2.2% and 3.1%. Longer-term growth projections were left relatively unchanged, with the US economy expected to grow by 2.75% in 2016 and 2.4% in 2017. The 2017 forecast is slightly above the FOMC's longer run estimate of 2.15%.

The US unemployment rate projections were revised slightly lower. The US unemployment rate, currently sitting at 6.1%, is forecast to ease down to 5.5% in 2015, and then onto 5.1% by 2017. If realised, this would see the US unemployment rate dip below the FOMC's longer run goal for the unemployment rate (5.2-5.5%) (chart 5).

The normalisation road map

With asset purchase tapering close to completion and the turning point in the Fed's monetary policy cycle approaching, focus on the Fed's monetary policy normalisation process is growing. On this front, the FOMC released a supplementary document that outlined its "*policy normalisation principles and plans*".

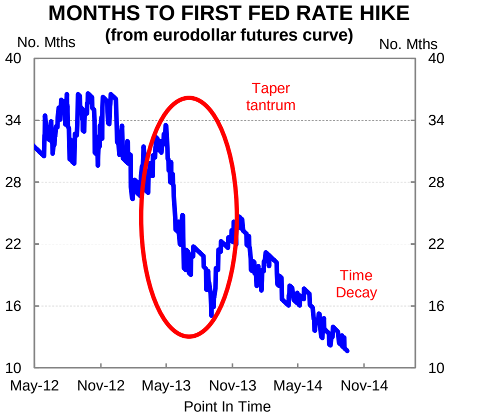
The FOMC stipulated that the recent discussion on the topic of normalisation is part of its "*prudent planning*" and did not imply it "*will necessarily begin soon*". According to the FOMC, many of the normalisation principles adopted in mid-2011 remain applicable. However, in light of changes to the System Open Market Account (SOMC) portfolio in recent years and other enhancements in the tools available to the FOMC, some adjustment to the previous guide may be necessary.

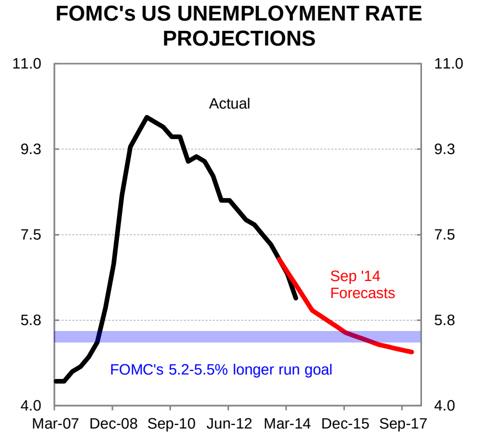
All but one member of the FOMC agreed on the following key elements of the approach intended to be taken when monetary policy normalisation was deemed appropriate:

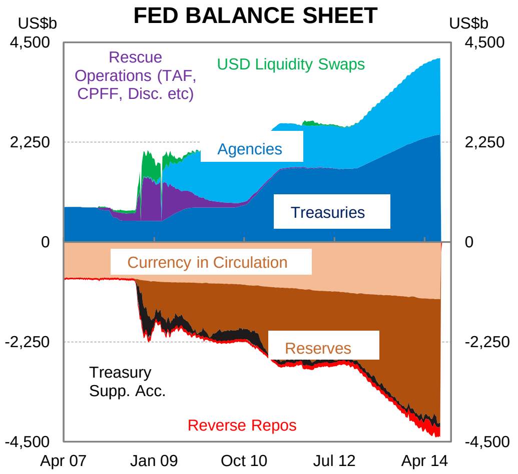
(a) When less policy accommodation is warranted, the FOMC will raise the "*target range*" for the funds rate. During normalisation, the Fed intends to move the funds rate into the target range "*primarily by adjusting the interest rate it pays on excess reserve balances*" (IOER).

(b) The Fed also intends to use an overnight reverse repurchase agreement facility and other supplementary tools to help control the federal funds rate. In our view, this is designed to keep the effective fed funds rate from falling too far below the IOER rate.

(c) The size of the Fed's balance sheet will be reduced in a "*gradual and predictable*" manner, primarily by ceasing to reinvest repayments of principal on securities. The FOMC expects to "*cease or commence phasing out reinvestments*" after it beings to raise the target range for the federal funds rate. Selling of Mortgage Back-Securities is not anticipated to be part of the normalisation process. But should limited sales be warranted in the longer run, such sales would be communicated in advance.







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