

U.S. PREVIEW: FOMC Beware -- Neutral Fed Funds, Dead Ahead (1)  
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(Bloomberg Economics) -- Federal Reserve policy makers face two important decisions at their September meeting: One, whether to retain optionality around a potential fourth interest-rate increase in December; and, two, the appropriate policy trajectory as rates approach neutral.

Bloomberg Economics believes that the decision regarding a fourth hike of 2018 will not need to be cast until much more is known about activity in the second half, including trade-tariff impacts, third-quarter GDP results and even midterm-election outcomes. As such, officials may wish to avoid painting themselves into a corner by nudging market expectations for a December hike even higher.

Furthermore, if the FOMC hopes to successfully execute a "soft landing" for the economy, policy makers will need to avoid materially overshooting a neutral policy stance during a period when economic signals are being distorted by fiscal stimulus and trade frictions.

With a September rate hike, Fed officials will begin encroaching on territory potentially consistent with a neutral policy stance -- at least according to their latest estimates published in June. Policy makers' forecast range for the neutral longer-run rate spans 2.25% to 3.50%, so at least one official should be satisfied that the September move achieves neutrality. The corresponding dot plot projections for the neutral level are mostly clustered at 2.75% and 3.00%, so while a post-September rate increase would cover the second-lowest estimate of 2.50%, the next hike would then pull at least seven officials into the fold -- assuming forecasts do not materially change.

#### Federal Reserve June Dot Plot

Given the lagged and variable impact of monetary policy on economic conditions -- further complicated in the current cycle by the Fed's balance-sheet unwind -- policy makers will need to navigate with caution when in the proximity of neutral. Fed Chairman Jerome Powell, in his Jackson Hole speech, sounded dual warnings about this: First, he stressed economists' inability to estimate the neutral level of interest rates in real-time and cautioned against the "mistake of overemphasizing imprecise estimates of the stars"; second, he invoked the Brainard principle, which advocates moving conservatively on policy when the effects of action are unknown.

If growth is moderating toward trend and inflation appears to be centering around policy makers' objective as the fed funds rate probes neutral territory, a significant portion of the FOMC should be willing to slow -- if not pause -- the pace of interest-rate increases in order to assess economic conditions. Policy makers may not be able to precisely identify the neutral policy rate in real time, but a continual decline in the terminal fed funds rate over the past several tightening cycles (shown below) serves as a cautionary reminder that, as Powell quipped at Jackson Hole, a "smaller dose" of normalization may prove adequate.

#### Lower Terminal Fed Funds Implies Lower Neutral

Here is what to expect from the meeting:

##### Interest-Rate Action

Market participants broadly anticipate a 25-basis-point rate increase in the fed funds rate to a new target range of 2.00-2.25%. According to the fed funds futures market, the probability of a hike is effectively 100%. The next move is priced in with a roughly 75% likelihood at the Dec. 18-19 meeting.

##### Rate Forecast

While Bloomberg Economics has been forecasting only three rate increases in 2018, the potential for a fourth hike has increased of late. The Fed has essentially met its employment and inflation targets, so the more likely catalyst of a year-end pause would be a financial signal, such as a flat or inverted yield curve or an equity sell-off.

##### Balance Sheet

Any discussion about the ongoing balance-sheet unwind will warrant heightened attention. The reduction reaches maximum speed next month and could exert greater pressure on financial conditions later in the year, particularly with the ECB reducing its pace of purchases, as well. While the statement is unlikely to reveal the details of the ongoing debate, Chairman Powell may provide an update on the Fed's thinking about the ultimate size of the balance sheet.

##### Economic Assessment

The statement's summary of economic activity is unlikely to

show major changes relative to the July 31-Aug. 1 meeting. If anything, the Fed might choose to indicate that last quarter's pace was inflated to some degree by transitory factors. Labor market characterizations are likely to remain intact.

### Inflation Assessment

Core PCE reached the 2% target in the July PCE report; however, the August income and spending data (due Friday) could see the core PCE deflator falling back to 1.9% year on year. The Fed could forgo acknowledging that inflation hit its goal in the statement and instead choose to leave the current characterization that it "remain[s] near 2 percent." The preliminary September University of Michigan report indicated that longer-term inflation expectations dropped to 2.4%, approaching the lowest readings of the cycle (in December 2016 they fell to 2.3%). As such, there are reasons to expect tame inflation in the latter half of the year. Bloomberg Economics' analysis of labor-cost trends suggests that wage pressures are not yet running at a pace consistent with sustained 2% inflation.

### Dot Plot

The dot plot is not likely to shift in a major way from the trajectory reflected in the June SEP. Previously, the median dot signaled four rate increases in 2018, followed by three in 2019 and one in 2020, thereby pushing rates to a 3.25-3.50% target range, moderately above estimates of neutral (2.75%-3.00%). The potential fourth rate hike this year can remain an open question until closer to the December meeting. Policy makers may wish to avoid locking themselves into a December rate hike amid political uncertainty and recent downside surprises on a number of inflation metrics.

The tone of the recent Fedspeak suggests policy makers could continue hiking rates through the neutral level, based on the notion that the short-term equilibrium rates are currently exceeding the long-term estimates. Thus, the outer-year rate forecasts will likely continue to exceed those of the longer-run levels. The newly sworn-in vice chairman of the Board of Governors, Richard Clarida, will submit his dots for the first time. The San Francisco Fed dot will likely reflect the views of incoming President Mary Daly, even though she will not be formally participating in the meeting as an FOMC member.

### Dissents

There have been no dissents since Jerome Powell became Fed

chairman, due to the slightly more hawkish composition of FOMC voters in 2018 -- and this should continue through September. The December rate decision could prove to be more controversial. The most likely dovish dissent is Atlanta Fed President Raphael Bostic. The majority of committee members appear to be supportive of the Fed continuing to trudge along toward a more neutral policy stance.

#### Summary of Economic Projections (SEP)

The Fed will extend its economic and financial forecasts through 2021. Based on the recent history, when the outer-year forecasts are introduced, they are usually not that different from the longer-run values. Bloomberg Economics anticipates only minimal modifications to the SEP, likely including a moderate upgrade to the 2018 growth forecast. Changes to the longer-run forecasts would be of greater consequence, but will likely be limited to a minor drop in the unemployment rate further below 4.5%.

#### Federal Reserve Scorecard

Financial data between the August and September FOMC meetings reflect a net loosening in financial conditions. Stocks rose modestly, longer-maturity yields increased slightly and the dollar was little changed. Credit spreads narrowed, while the yield curve flattened. Economic data have been solid, but moderated from unsustainable strength in the second quarter.

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