The Macro Research Desk

Herman van Papendorp
(Head of Investment Research and Asset Allocation)

Sanisha Packirisamy
(Economist)

Making sense of the March 2017 US Federal Reserve rate-setting meeting

Federal funds rate hiked, but interest rate projections largely unchanged

The United States (US) Federal Reserve (Fed) raised the target range for the Fed funds rate for the third time since the global financial crisis. The increase left the target range higher at between 0.75% and 1%, from between 0.5% and 0.75% previously. With only two more hikes signalled for the remainder of the year and one member dissenting from the vote for a rise in interest rates, it is likely that the market perceived the March 2017 interest rate hike by the Federal Open Market Committee (FOMC) as dovish in nature. This was reinforced by the move in market expectations for at least four interest rate increases in 2017, which dropped to a 19% probability of occurring from 25% earlier in the week.

Economy evolving in line with earlier Fed forecasts

The Fed left its real GDP growth forecast of 2.1% for 2017 unchanged from estimates tabled in December 2016. Growth expectations were revised marginally higher to 2.1% for 2018, but remained at 1.9% in 2019 and 1.8% for the longer term. During the question and answer session following the statement, Fed Chair Janet Yellen remarked that the Fed would not rush its judgement on the effect of potential changes to tax and spending policies, despite market expectations that looser fiscal policy could boost growth prospects, in 2018 in particular.

Unemployment forecasts remained at 4.5% for the next three years, but the Fed acknowledged a further strengthening in labour market conditions by lowering their long-run estimate of unemployment from 4.8% in December 2016 to 4.7% in the latest March 2017 summary of economic projections.

The Fed reminded the market of its symmetric inflation goal

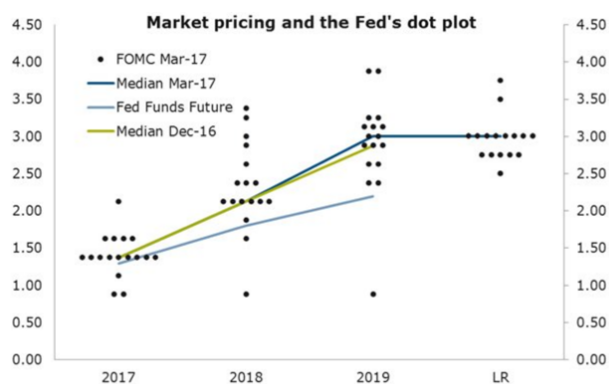
The FOMC expressed balanced views around the recent increase in inflation. It noted that although headline inflation increased in recent quarters towards its 2% inflation goal, inflation excluding food and fuel (core) remains little changed at lower levels. Moreover, market-based measures of inflation compensation were viewed as being low, while survey-based measures of longer-term inflation expectations remained largely stable during the past few months. Some market participants had adopted the view that the Fed would err on the side of caution, by allowing inflation to run higher to prevent the economy from sliding back into recession. However, the Committee noted that it would carefully monitor inflation developments relative to its symmetric inflation goal, suggesting that this is less likely to be the case.

The FOMC's projections for the headline measure of inflation (personal consumption expenditure deflator) remained unchanged at 1.9% in 2017 and 2.0% in 2018 and 2019. Core inflation expectations were nudged 0.1% higher to 1.9% in 2017, but remained stable at 2% in 2018 and 2019.

Marginal shift in median interest rate projections amongst FOMC members

The median FOMC projections for the Fed funds rate still suggest three interest rate increases in 2017 and 2018 (see chart 1). The FOMC's projections for the policy rate were left unchanged at 1.375% for the end of 2017 and at 2.125% for the end of 2018. There was a minor upward revision to 2019 forecasts. The median 2019 Fed funds rate edged up to 3.0% from 2.9% previously. Meanwhile, the average (mean) dot increased 9 basis points for 2018 and 9 basis points for 2019.

Chart 1: Fed dot-plot broadly unchanged



Source: Nordea Markets, US Fed

Despite fiscal stimulus proposals by the new administration supporting a more upbeat growth and inflation outlook, the policy environment remains uncertain. As such, Momentum Investments believes the risk to the above dot plot is for fewer rate increases this year. The company pitches potential output growth (based on estimates for factors including productivity and population growth) at around 2.25%, which leaves its neutral interest rate expectation at 2%, a full percentage point lower than the Fed longer-run (steady-state) expectation of 3%.

In addition, Momentum Investments does not anticipate the unwinding of the Fed balance sheet to disrupt markets. The FOMC reiterated its intention to maintain its existing policy of reinvesting principal payments from its holdings of agency debt and agency mortgage-backed securities and to roll over maturing Treasury securities at auction. It went on to say that it intends doing so until "normalisation of the federal funds rate is well under way".

Language shift in the statements between the February and March 2017 meetings

- Inflation still below Committee's 2% longer-run objective → moving close to Committee's 2% longer-run objective
- The stance of monetary policy remains accommodative, thereby supporting some further strengthening in labour market conditions and a return to 2% inflation → sustained return
- The Committee will carefully monitor actual and expected progress towards its inflation goal → symmetric inflation goal
- Voting against the action was Neel Kashkari, who preferred at this meeting to maintain the existing target range for the federal **funds rate.**

(Green = dovish for interest rates, red = hawkish)

Reasonable steps have been taken to ensure the validity and accuracy of the information in this document. However, Momentum Investments (Pty) Ltd does not accept any responsibility for any claim, damages, loss or expense, howsoever arising out of or in connection with the information in this document, whether by a client, investor or intermediary. The content used in this document is sourced from various media publications, the Internet and Momentum Investments (Pty) Ltd. For further information, please visit us at www.momentuminv.co.za.