

A Hawkish Hold

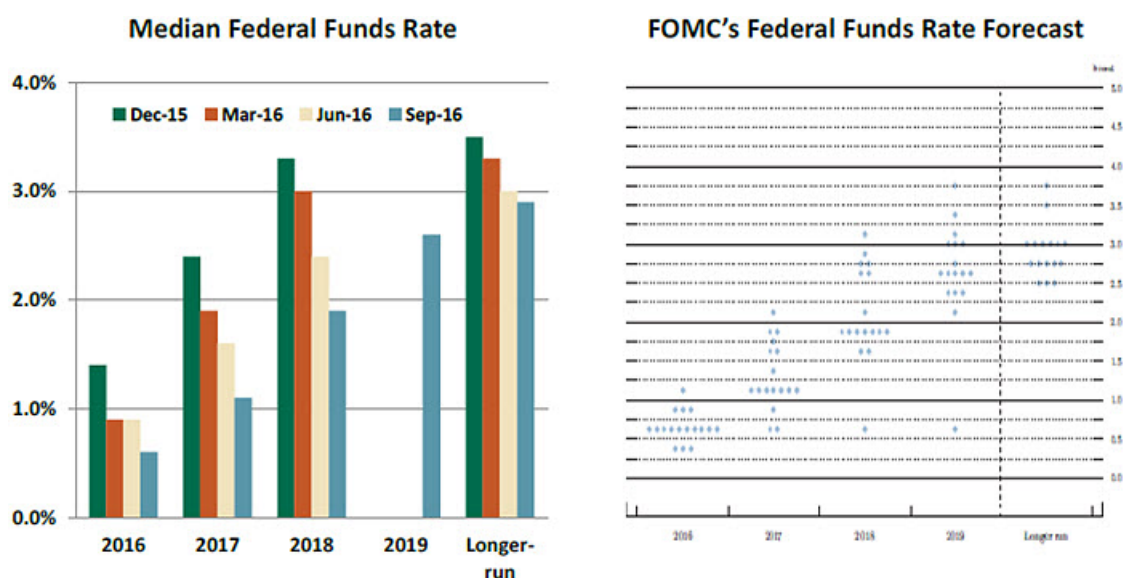
September 22, 2016

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The Federal Open Market Committee (FOMC) ended the meeting today without a change to the policy rate. But they sent clear signals that a rate increase in December is a strong possibility.

The statement following the meeting noted that the case for a higher rate has strengthened, but that the group preferred to wait to see further progress toward its goals of full employment and price stability. The FOMC indicated that risks to the outlook are roughly balanced.

The Fed's infamous dot plot, which maps expectations of how the funds rate might progress, shows that 14 of the 17 contributors expect interest rates to be higher at the end of this year.



Source: Federal Reserve Board

Three FOMC members (Fed presidents Esther George, Loretta Mester and Eric Rosengren) would have preferred to raise the federal funds rate at this meeting. Of these three members, President Rosengren's vote is a bit of a surprise as he usually favors a dovish stance. Rosengren's position likely stems from his suspicion that low interest rates are contributing to asset price excesses; he recently shared concern about increases in commercial property prices.

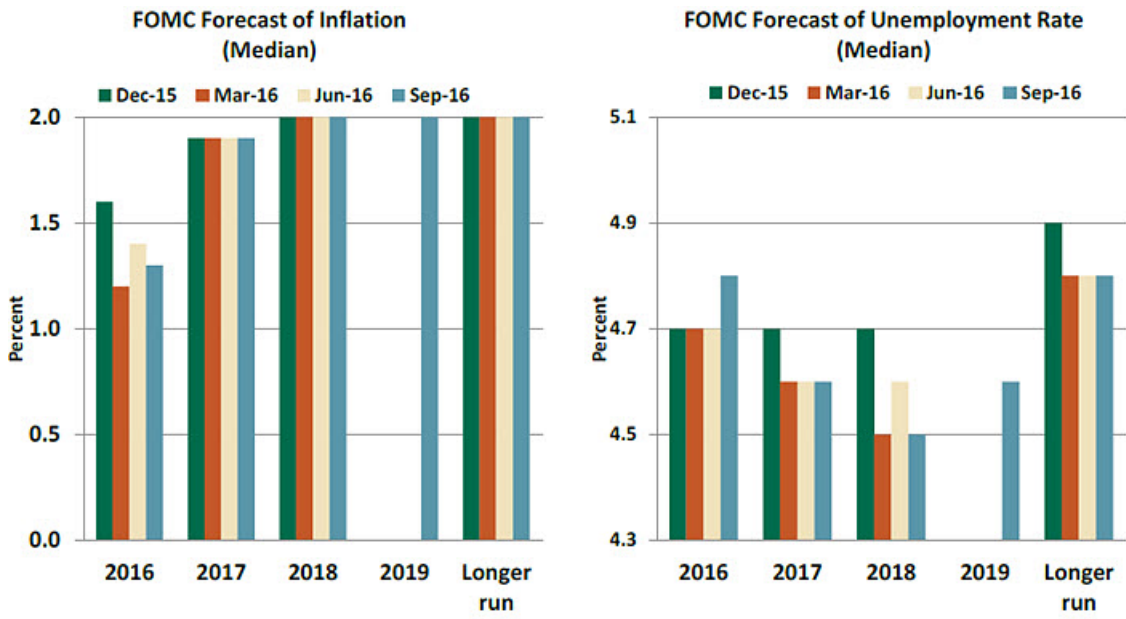
This is only the fourth time in the past 24 years we have seen three dissents, and it is the first since December 2014. Janet Yellen appears to be having difficulty maintaining consensus behind an unchanged policy. She stated in her press conference that the group "struggled mightily to understand each other's point of view."

The Fed's dot plot suggests that two rate hikes are likely in 2017, down from three hikes expected at the June meeting. The median rate for the federal funds rate has been revised down for 2018 and in the longer-run to 2.9%. The current federal funds rate is quite a distance from this target, especially when you consider the Fed would prefer not to make any sudden upward moves. That argues from getting started along that path sometime soon.

Markets seemed to take little inference from the Fed's accumulated communication. After the meeting, market expectations for higher rates at the December FOMC meeting rose only modestly, to 61% from 58% last evening. One can only surmise that investors are cynical about the Fed's intent; we've had hawkish statements and forecasts at several junctures in 2016, but policy rates haven't changed since last December.

The Summary of Economic Projections (SEP) indicates a reduction of real growth in 2016, reflecting, in part, the soft

growth seen in the first-half of the year. Growth expectations for 2017 and 2018 were unchanged at 2.0%. The Fed expects inflation to reach the 2.0% target gradually by 2018. The unemployment rate is estimated to hit a low of 4.5% in 2018, which is lower than the median forecasts seen at earlier meetings.



Source: Federal Reserve Board

In the months ahead, the Fed will be looking for additional progress toward full employment and some additional signs that inflation will, indeed, converge to its targeted level next year. Needless to say, international infarctions between now and mid-December may also warrant consideration.

Given the proximity of presidential elections to the November FOMC meeting, monetary policy changes are unlikely at that time. As for the December meeting, skeptics will certainly say that it hasn't taken much to frighten the Fed during the course of the past several years. Three months is a long time for something to go amiss.

But absent a backward step, we continue to expect a hike in December. More than likely, that step would be a "dovish tightening," paired with a pledge to continue to move slowly and deliberately.

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