Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
Thomas Demas, Managing Director
Michael Warren, Energy Strategist

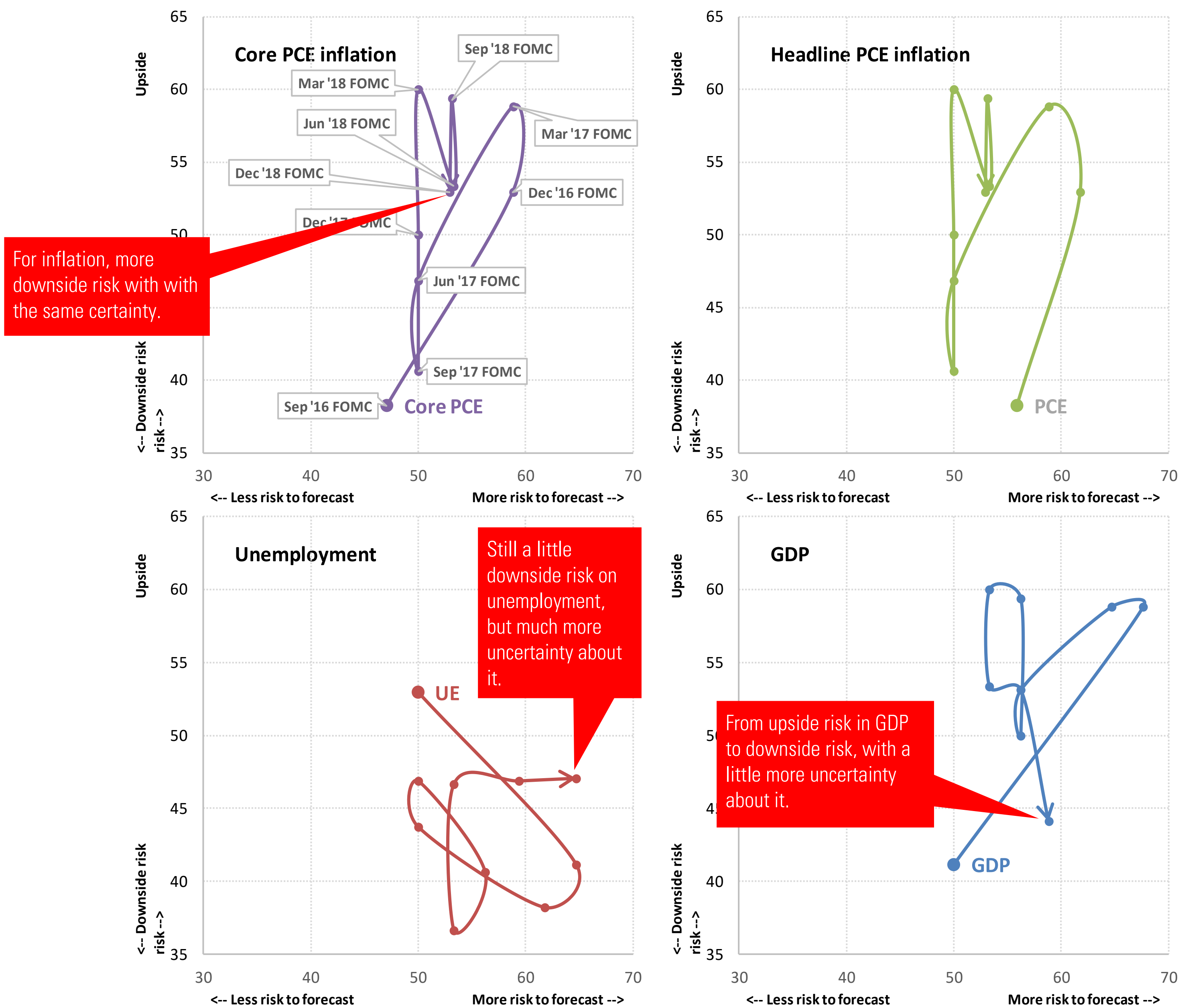
Data Insights: FOMC Minutes

Wednesday, January 9, 2019

Evolving "uncertainty"

Diffusion indices of forecast risks in Summary of Economic Projections

From ● September 2016 FOMC to → December 2018 FOMC



Source: FOMC, TrendMacro calculations

December minutes: key signaling language

Committee participants resumed their discussion from the November 2018 FOMC meeting of potential long-run frameworks for monetary policy implementation…

… the staff noted that the federal funds rate and other money market rates could possibly become somewhat volatile at times as banks and financial markets adjusted to lower levels of reserve balances. Were upward pressures on the federal funds rate to emerge, it could be challenging to distinguish between pressures that were transitory and likely to abate as financial institutions adjust and those that were more persistent and associated with aggregate reserve scarcity. The staff reported on the monitoring of conditions in money markets as well as various survey and market outreach activities that could assist in detecting reserve scarcity. The staff reviewed a number of steps that the Federal Reserve could take to ensure effective monetary policy implementation were upward pressures on the federal funds rate and other money market rates to emerge. These steps included lowering the IOER rate further within the target range, using the discount window to support the efficient distribution of reserves, and slowing or smoothing the pace of reserve decline through open market operations or through slowing portfolio redemptions…

In discussing the transition to a long-run operating regime, participants commented on the advantages and disadvantages of allowing reserves to decline to a level that could put noticeable upward pressure on the federal funds rate, at least for a time. Reducing reserves close to the lowest level that still corresponded to the flat portion of the reserve demand curve would be one approach consistent with the Committee's previously stated intention, in the Policy Normalization Principles and Plans that it issued in 2014, to "hold no more securities than necessary to implement monetary policy efficiently and effectively." However, reducing reserves to a point very close to the level at which the reserve demand curve begins to slope upward could lead to a significant increase in the volatility in short-term interest rates and require frequent sizable open market operations or new ceiling facilities to maintain effective interest rate control. These considerations suggested that it might be appropriate to instead provide a buffer of reserves sufficient to ensure that the Federal Reserve operates consistently on the flat portion of the reserve demand curve so as to promote the efficient and effective implementation of monetary policy.

… participants discussed options such as ending portfolio redemptions with a relatively high level of reserves still in the system and then either maintaining that level of reserves or allowing growth in nonreserve liabilities to very gradually reduce reserves further. These approaches could allow markets and banks more time to adjust to lower reserve levels while maintaining effective control of interest rates. Several participants, however, expressed concern that a slowing of redemptions could be misinterpreted as a signal about the stance of monetary policy…

…They also remarked that the size of the Federal Reserve's balance sheet was expected to increase over time as the growth of these liabilities roughly tracks the growth of nominal gross domestic product (GDP). Additionally, participants cited the social benefits provided by these liabilities to the economy. Participants considered it important to present information on the Federal Reserve's balance sheet to the public in ways that communicated these facts. In discussing the long-run level of reserve liabilities, participants noted that it might be useful to explore ways to encourage banks to reduce their demand for reserves and to provide information to banks and the public about the likely long-run level of reserves.

…Asset prices were volatile in recent weeks, reportedly reflecting a pullback from risk-taking by investors. In part, the deterioration in risk sentiment appeared to stem importantly from uncertainty about the state of trade negotiations between China and the United States. In addition, investors pointed to concerns about the global growth outlook, the unsettled state of Brexit negotiations, and uncertainties about the political situation in Europe.

Against this backdrop, U.S. stock prices were down nearly 8 percent on the period. Risk spreads on corporate bonds widened appreciably, with market participants reportedly focusing on the potential implications of downside risks to the U.S. economic outlook for the financial condition of companies, particularly for companies at the lower end of the investment-grade spectrum. Treasury yields declined significantly, especially at longer maturities, contributing to some flattening of the Treasury yield curve. Based on readings from Treasury Inflation-Protected Securities (TIPS), the decline in nominal Treasury yields was associated with a notable drop in inflation compensation. A sizable decline in oil prices was cited as an important factor contributing to the drop in measures of inflation compensation.

The deterioration in market sentiment was accompanied by a significant downward revision in the expected path of the federal funds rate based on federal funds futures quotes. In addition, futures-based measures of policy expectations moved lower in response to speeches by Federal Reserve officials.

…Real residential investment appeared to be declining further in the fourth quarter, likely reflecting in part the effects of the rise in mortgage interest rates over the past year on the affordability of housing. Starts of new single-family homes decreased in October and November, although starts of multifamily units rose sharply in November. Building permit issuance for new single-family homes, which tends to be a good indicator of the underlying trend in construction of such homes, moved down modestly over recent months. Sales of new homes declined markedly in October, although existing home sales increased modestly.

Growth in real private expenditures for business equipment and intellectual property looked to be picking up solidly in the fourth quarter after moderating in the previous quarter.

…Remarks by Federal Reserve officials over the intermeeting period were interpreted by market participants as signaling a shift in the stance of policy toward a more gradual path of federal funds rate increases. The market-implied path for the federal funds rate for 2019 and 2020 shifted down markedly, while the market-implied probability for a rate hike at the December FOMC meeting declined slightly though remained high.

…Concerns over escalating trade tensions, global growth prospects, and the sustainability of corporate earnings growth were among the factors that appeared to contribute to a significant drop in U.S. equity prices. The declines were largest in the technology and retail sectors.

…With some stronger-than-expected incoming data on economic activity and the recent tightening in financial conditions, particularly the decline in equity prices, the U.S. economic forecast prepared by the staff for the December FOMC meeting was little revised on balance.

…In assessing the economic outlook, participants noted the contrast between the strength of incoming data on economic activity and the concerns about downside risks evident in financial markets and in reports from business contacts. Recent readings on household and business spending, inflation, and labor market conditions were largely in line with participants' expectations and indicated continued strength of the economy. By contrast, financial markets were volatile and conditions had tightened over the intermeeting period, with sizable declines in equity prices and notably wider corporate credit spreads coinciding with a continued flattening of the Treasury yield curve; in part, these changes in financial conditions appeared to reflect greater concerns about the global economic outlook. Participants also reported hearing more frequent concerns about the global economic outlook from business contacts.

…Several participants noted that business fixed investment remained solid despite a slowdown in the third quarter, as more recent data pointed to a rebound in investment spending. Business contacts in several Districts reported robust activity through the end of 2018 and planned to follow through or expand on their current capital expenditure projects. However, contacts in a number of Districts appeared less upbeat than at the time of the November meeting, as concerns about a variety of factors--including trade policy, waning fiscal stimulus, slowing global economic growth, or financial market volatility--were reportedly beginning to weigh on business sentiment. A couple of participants commented that the recent decline in oil prices could be a sign of a weakening in global demand that could weigh on capital spending by oil production companies and affect companies providing services to the oil industry. However, a couple of participants noted that the recent oil price decline could also be associated with increasing oil supply rather than softening global demand.

…Participants observed that both overall and core PCE price inflation remained near 2 percent on a 12-month basis, but that core inflation had edged lower in recent months. A few participants noted that the recent declines in energy prices would likely only temporarily weigh on headline inflation. Several participants remarked that longer-term TIPS-based inflation compensation had declined notably since November, concurrent with both falling oil prices and a deterioration in investor risk sentiment. A few participants pointed to the decline in longer-term inflation compensation as an indication that longer-run inflation expectations may have edged lower, while several others cited survey-based measures as suggesting that longer-run expectations likely remained anchored. Participants generally continued to view recent price developments as consistent with their expectation that inflation would remain near the Committee's symmetric 2 percent objective on a sustained basis. Although a few participants pointed to anecdotal and survey evidence indicating rising input costs and pass-through of these higher costs to consumer prices, reports from business contacts and surveys in some other Districts suggested some moderation in inflationary pressure.

In their discussion of financial developments, participants agreed that financial markets had been volatile and financial conditions had tightened over the intermeeting period, as equity prices declined, corporate credit spreads widened, and the Treasury yield curve continued to flatten. Some participants commented that these developments may reflect an increased focus among market participants on tail risks such as a sharp escalation of trade tensions or could be a signal of a significant slowdown in the pace of economic growth in the future. A couple of participants noted that the tightening in financial conditions so far did not appear to be restraining real activity, although a more persistent tightening would undoubtedly weigh on business and household spending. Participants agreed to continue to monitor financial market developments and assess the implications of these developments for the economic outlook.

…In their consideration of monetary policy at this meeting, participants generally judged that the economy was evolving about as anticipated, with real economic activity rising at a strong rate, labor market conditions continuing to strengthen, and inflation near the Committee's objective. Based on their current assessments, most participants expressed the view that it would be appropriate for the Committee to raise the target range for the federal funds rate 25 basis points at this meeting. A few participants, however, favored no change in the target range at this meeting, judging that the absence of signs of upward inflation pressure afforded the Committee some latitude to wait and see how the data would develop amid the recent rise in financial market volatility and increased uncertainty about the global economic growth outlook.

With regard to the outlook for monetary policy beyond this meeting, participants generally judged that some further gradual increases in the target range for the federal funds rate would most likely be consistent with a sustained economic expansion, strong labor market conditions, and inflation near 2 percent over the medium term. With an increase in the target range at this meeting, the federal funds rate would be at or close to the lower end of the range of estimates of the longer-run neutral interest rate, and participants expressed that recent developments, including the volatility in financial markets and the increased concerns about global growth, made the appropriate extent and timing of future policy firming less clear than earlier. Against this backdrop, many participants expressed the view that, especially in an environment of muted inflation pressures, the Committee could afford to be patient about further policy firming. A number of participants noted that, before making further changes to the stance of policy, it was important for the Committee to assess factors such as how the risks that had become more pronounced in recent months might unfold and to what extent they would affect economic activity, and the effects of past actions to remove policy accommodation, which were likely still working their way through the economy.

Participants emphasized that the Committee's approach to setting the stance of policy should be importantly guided by the implications of incoming data for the economic outlook. They noted that their expectations for the path of the federal funds rate were based on their current assessment of the economic outlook. Monetary policy was not on a preset course; neither the pace nor the ultimate endpoint of future rate increases was known. If incoming information prompted meaningful reassessments of the economic outlook and attendant risks, either to the upside or the downside, their policy outlook would change. Various factors, such as the recent tightening in financial conditions and risks to the global outlook, on the one hand, and further indicators of tightness in labor markets and possible risks to financial stability from a prolonged period of tight resource utilization, on the other hand, were noted in this context.

Participants discussed ideas for effectively communicating to the public the Committee's data-dependent approach, including options for transitioning away from forward guidance language in future postmeeting statements. Several participants expressed the view that it might be appropriate over upcoming meetings to remove forward guidance entirely and replace it with language emphasizing the data-dependent nature of policy decisions.

Participants supported a plan to implement another technical adjustment to the IOER rate that would place it 10 basis points below the top of the target range for the federal funds rate. This adjustment would foster trading in the federal funds market at rates well within the FOMC's target range.

…With regard to the postmeeting statement, members agreed to modify the phrase "the Committee expects that further gradual increases" to read "the Committee judges that some further gradual increases." The use of the word "judges" in the revised phrase was intended to better convey the data-dependency of the Committee's decisions regarding the future stance of policy; the reference to "some" further gradual increases was viewed as helping indicate that, based on current information, the Committee judged that a relatively limited amount of additional tightening likely would be appropriate. While members judged that the risks to the economic outlook were roughly balanced, they decided that recent developments warranted emphasizing that the Committee would "continue to monitor global economic and financial developments and assess their implications for the economic outlook."

Source: Federal Reserve Board