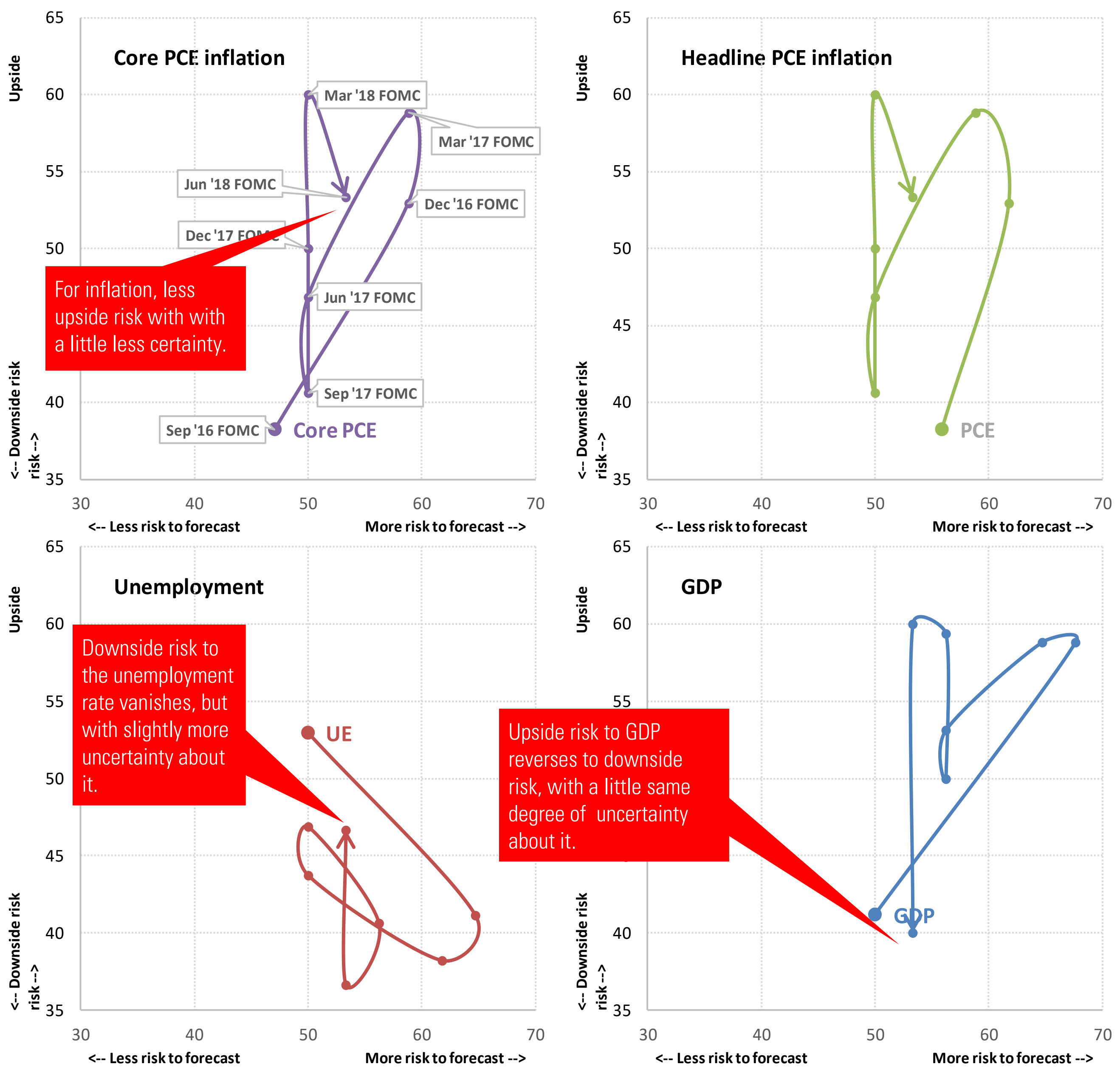
Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
Thomas Demas, Managing Director
Michael Warren, Energy Strategist

Data Insights: FOMC Minutes

Thursday, July 5, 2018

Evolving "uncertainty" Diffusion indices of forecast risks in Summary of Economic Projections
From ● September 2016 FOMC to → June 2018 FOMC



Source: FOMC, TrendMacro calculations

June minutes: key signaling language

Based on current projections, principal payments on the Federal Reserve's holdings of agency MBS would likely be lower than the monthly cap on redemptions that will be in effect beginning in the fall of this year. Consistent with the June 2017 addendum to the Policy Normalization Principles and Plans, reinvestment purchases of agency MBS then are projected to fall to zero from that point onward. However, principal payments on agency MBS are sensitive to changes in various factors, particularly long-term interest rates. As a result, agency MBS principal payments could rise above the monthly redemption cap in some future scenarios and thus require MBS reinvestment purchases. In light of this possibility, the deputy manager described plans for the Desk to conduct small value purchases of agency MBS on a regular basis in order to maintain operational readiness.

…During the intermeeting period, global financial markets were buffeted by increased concerns about the outlook for foreign growth and political developments in Italy, but these concerns subsequently eased. …Over the intermeeting period, macroeconomic data releases signaling moderating growth in some foreign economies, along with downside risks stemming from political developments in Italy and several EMEs, weighed on prices of foreign risk assets. These developments, together with a still-solid economic outlook for the United States, supported an increase in the broad trade-weighted index of the foreign exchange value of the dollar.

…The dollar appreciated notably against several EME currencies (primarily those of Argentina, Turkey, Mexico, and Brazil), as the increase in U.S. interest rates since late 2017, along with political developments and other issues, intensified concerns about financial vulnerabilities. EME mutual funds saw slight net outflows, and, on balance, EME sovereign spreads widened and equity prices edged lower. In the AFEs, sovereign spreads in some peripheral European countries widened and European bank shares came under pressure, as investors focused on political developments in Italy. Broad equity indexes in the euro area, with the exception of Italy, ended the period little changed, while those in Canada, the United Kingdom, and Japan edged higher. Market-based measures of expected policy rates were little changed, on balance, and flight-to-safety flows reportedly contributed to declines in German longer-term sovereign yields.

…In the U.S. economic forecast prepared for the June FOMC meeting, the staff continued to project that the economy would expand at an above-trend pace. Real GDP appeared to be rising at a much faster pace in the second quarter than in the first, and it was forecast to increase at a solid rate in the second half of this year. Over the 2018-20 period, output was projected to rise further above the staff's estimate of its potential, and the unemployment rate was projected to decline further below the staff's estimate of its longer-run natural rate. Relative to the forecast prepared for the May meeting, the projection for real GDP growth beyond the first half of 2018 was revised down a little in response to a higher assumed path for the exchange value of the dollar. In addition, the staff continued to anticipate that supply constraints might restrain output growth somewhat.

…The staff viewed the uncertainty around its projections for real GDP growth, the unemployment rate, and inflation as similar to the average of the past 20 years. The staff saw the risks to the forecasts for real GDP growth and the unemployment rate as balanced. On the upside, recent fiscal policy changes could lead to a greater expansion in economic activity over the next few years than the staff projected. On the downside, those fiscal policy changes could yield less impetus to the economy than the staff expected if, for example, the marginal propensities to consume for groups most affected by the tax cuts are lower than the staff had assumed. Risks to the inflation projection also were seen as balanced. The upside risk that inflation could increase more than expected in an economy that was projected to move further above its potential was counterbalanced by the downside risk that longer-term inflation expectations may be lower than was assumed in the staff forecast.

…Participants reported that business fixed investment had continued to expand at a strong pace in recent months, supported in part by substantial investment growth in the energy sector. Higher oil prices were expected to continue to support investment in that sector, and District contacts in the industry were generally upbeat, though supply constraints for labor and infrastructure were reportedly limiting expansion plans. By contrast, District reports regarding the construction sector were mixed, although here, too, some contacts reported that supply constraints were acting as a drag on activity. Conditions in both the manufacturing and service sectors in several Districts were reportedly strong and were seen as contributing to solid investment gains. However, many District contacts expressed concern about the possible adverse effects of tariffs and other proposed trade restrictions, both domestically and abroad, on future investment activity; contacts in some Districts indicated that plans for capital spending had been scaled back or postponed as a result of uncertainty over trade policy. Contacts in the steel and aluminum industries expected higher prices as a result of the tariffs on these products but had not planned any new investments to increase capacity. Conditions in the agricultural sector reportedly improved somewhat, but contacts were concerned about the effect of potentially higher tariffs on their exports.

…With economic growth anticipated to remain above trend, participants generally expected the unemployment rate to remain below, or decline further below, their estimates of its longer-run normal rate. Several participants, however, suggested that there may be less tightness in the labor market than implied by the unemployment rate alone, because there was further scope for a strong labor market to continue to draw individuals into the workforce.

Contacts in several Districts reported difficulties finding qualified workers, and, in some cases, firms were coping with labor shortages by increasing salaries and benefits in order to attract or retain workers. Other business contacts facing labor shortages were responding by increasing training for less-qualified workers or by investing in automation. On balance, for the economy overall, recent data on average hourly earnings indicated that wage increases remained moderate. A number of participants noted that, with the unemployment rate expected to remain below estimates of its longer-run normal rate, they anticipated wage inflation to pick up further.

…In general, participants viewed recent price developments as consistent with their expectation that inflation was on a trajectory to achieve the Committee's symmetric 2 percent objective on a sustained basis, although a number of participants noted that it was premature to conclude that the Committee had achieved that objective. The generally favorable outlook for inflation was buttressed by reports from business contacts in several Districts suggesting some firming of inflationary pressures; for example, many business contacts indicated that they were experiencing rising input costs, and, in some cases, firms appeared to be passing these cost increases through to consumer prices...

…Participants commented on a number of risks and uncertainties associated with their outlook for economic activity, the labor market, and inflation over the medium term. Most participants noted that uncertainty and risks associated with trade policy had intensified and were concerned that such uncertainty and risks eventually could have negative effects on business sentiment and investment spending. Participants generally continued to see recent fiscal policy changes as supportive of economic growth over the next few years, and a few indicated that fiscal policy posed an upside risk. A few participants raised the concern that fiscal policy is not currently on a sustainable path. Many participants saw potential downside risks to economic growth and inflation associated with political and economic developments in Europe and some EMEs.

Meeting participants also discussed the term structure of interest rates and what a flattening of the yield curve might signal about economic activity going forward. Participants pointed to a number of factors, other than the gradual rise of the federal funds rate, that could contribute to a reduction in the spread between long-term and short-term Treasury yields, including a reduction in investors' estimates of the longer-run neutral real interest rate; lower longer-term inflation expectations; or a lower level of term premiums in recent years relative to historical experience reflecting, in part, central bank asset purchases. Some participants noted that such factors might temper the reliability of the slope of the yield curve as an indicator of future economic activity; however, several others expressed doubt about whether such factors were distorting the information content of the yield curve. A number of participants thought it would be important to continue to monitor the slope of the yield curve, given the historical regularity that an inverted yield curve has indicated an increased risk of recession in the United States. Participants also discussed a staff presentation of an indicator of the likelihood of recession based on the spread between the current level of the federal funds rate and the expected federal funds rate several quarters ahead derived from futures market prices. The staff noted that this measure may be less affected by many of the factors that have contributed to the flattening of the yield curve, such as depressed term premiums at longer horizons. Several participants cautioned that yield curve movements should be interpreted within the broader context of financial conditions and the outlook, and would be only one among many considerations in forming an assessment of appropriate policy.

In their consideration of monetary policy at this meeting, participants generally agreed that the economic expansion was progressing roughly as anticipated, with real economic activity expanding at a solid rate, labor market conditions continuing to strengthen, and inflation near the Committee's objective. Based on their current assessments, almost all participants expressed the view that it would be appropriate for the Committee to continue its gradual approach to policy firming by raising the target range for the federal funds rate 25 basis points at this meeting. These participants agreed that, even after such an increase in the target range, the stance of monetary policy would remain accommodative, supporting strong labor market conditions and a sustained return to 2 percent inflation.

…With regard to the medium-term outlook for monetary policy, participants generally judged that, with the economy already very strong and inflation expected to run at 2 percent on a sustained basis over the medium term, it would likely be appropriate to continue gradually raising the target range for the federal funds rate to a setting that was at or somewhat above their estimates of its longer-run level by 2019 or 2020. Participants reaffirmed that adjustments to the path for the policy rate would depend on their assessments of the evolution of the economic outlook and risks to the outlook relative to the Committee's statutory objectives.

Participants pointed to various reasons for raising short-term interest rates gradually, including the uncertainty surrounding the level of the federal funds rate in the longer run, the lags with which changes in monetary policy affect the economy, and the potential constraints on adjustments in the target range for the federal funds rate in response to adverse shocks when short-term interest rates are low. In addition, a few participants saw survey- or market-based indicators as suggesting that inflation expectations were not yet firmly anchored at a level consistent with the Committee's objective. A few also noted that a temporary period of inflation modestly above 2 percent could be helpful in anchoring longer-run inflation expectations at a level consistent with the Committee's symmetric objective.

Participants offered their views about how much additional policy firming would likely be required to sustainably achieve the Committee's objectives of maximum employment and 2 percent inflation. Many noted that, if gradual increases in the target range for the federal funds rate continued, the federal funds rate could be at or above their estimates of its neutral level sometime next year. In that regard, participants discussed how the Committee's communications might evolve over coming meetings if the economy progressed about as anticipated; in particular, a number of them noted that it might soon be appropriate to modify the language in the postmeeting statement indicating that "the stance of monetary policy remains accommodative."

Participants supported a plan to implement a technical adjustment to the IOER rate that would place it at a level 5 basis points below the top of the FOMC's target range for the federal funds rate. A few participants suggested that, before too long, the Committee might want to further discuss how it can implement monetary policy most effectively and efficiently when the quantity of reserve balances reaches a level appreciably below that seen recently.

…With regard to the postmeeting statement, members favored the removal of the forward-guidance language stating that "the federal funds rate is likely to remain, for some time, below levels that are expected to prevail in the longer run." Members noted that, al-though this forward-guidance language had been useful for communicating the expected path of the federal funds rate during the early stages of policy normalization, this language was no longer appropriate in light of the strong state of the economy and the current expected path for policy. Moreover, the removal of the forward-guidance language and other changes to the statement should streamline and facilitate the Committee's communications. Importantly, the changes were a reflection of the progress toward achieving the Committee's statutory goals and did not reflect a shift in the approach to policy going forward.

Source: Federal Reserve Board