TrendMacro

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

Data Insights: FOMC Minutes

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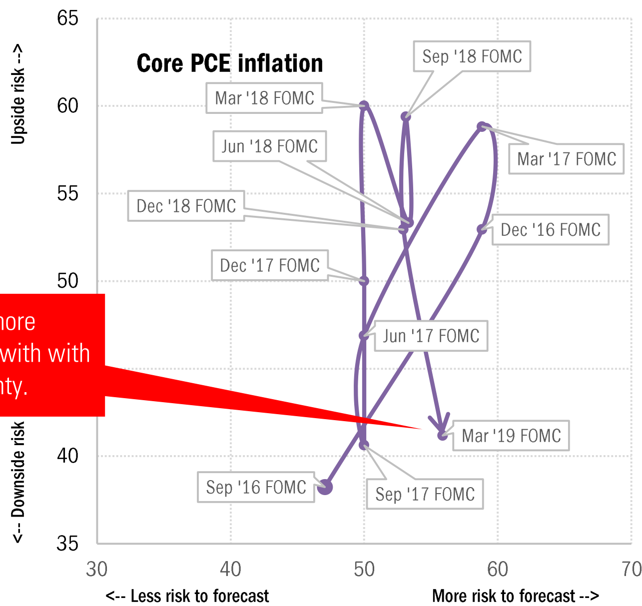
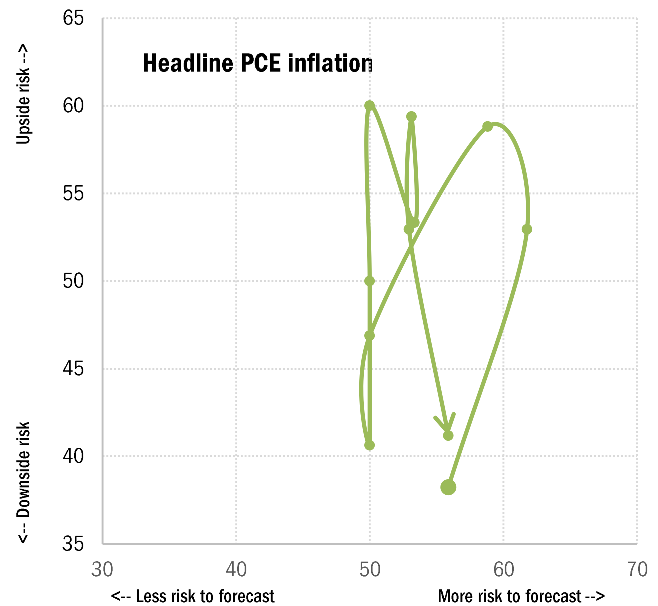
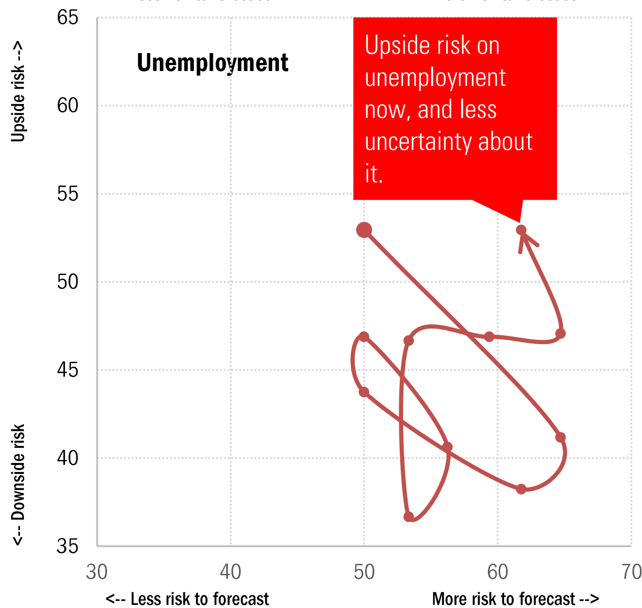
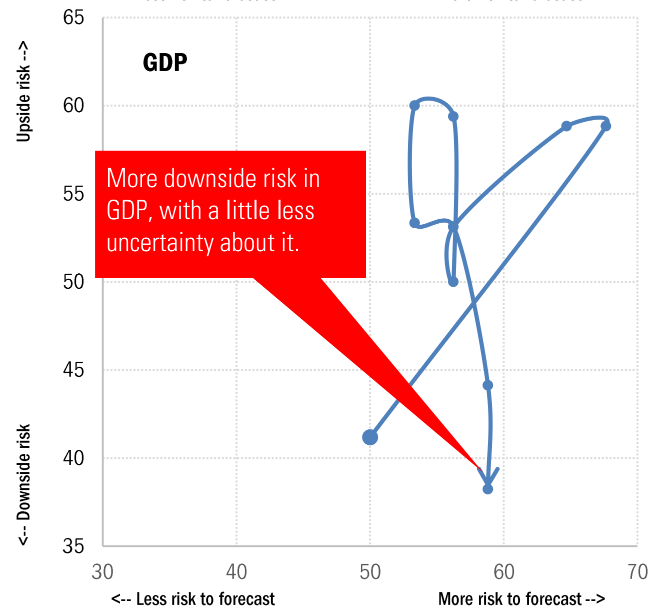
Evolving "uncertainty" Diffusion indices of forecast risks in Summary of Economic Projections

From ● September 2016 FOMC to → March 2019 FOMC









Source: FOMC, TrendMacro calculations

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March minutes: key signaling language

Balance Sheet Normalization

Committee participants resumed their discussion from the January 2019 meeting on options for transitioning to the longer-run size of the balance sheet. The staff described options for ending the reduction in the Federal Reserve's securities holdings at the end of September 2019 and for potentially reducing the pace of redemptions of Treasury securities before that date. Reducing the pace of redemptions before ending them would be consistent with most previous changes in the Federal Reserve's balance sheet policy and would support a gradual transition to the long-run level of reserves. It could also reinforce the Committee's communications indicating that the FOMC was flexible in its plans for balance sheet normalization and that the process of balance sheet normalization would remain consistent with the attainment of the Federal Reserve's monetary policy objectives. However, continuing redemptions at the current pace through September might be simpler to communicate and would somewhat shorten the transition to the long-run level of reserves. The staff noted that reducing the pace of redemptions before September would leave reserves and the balance sheet slightly larger than continuing redemptions at the current pace through September. However, the longer-run level of reserves and size of the balance sheet would ultimately be determined by long-term demand for Federal Reserve liabilities. Staff projections of term premiums and macroeconomic outcomes did not differ substantially across the two options.

The staff also described a possible interim plan for reinvesting principal payments received from agency debt and agency mortgage-backed securities (MBS) after balance sheet runoff ends and until the Committee decides on the longer-run composition of the System Open Market Account (SOMA) portfolio. Consistent with the Committee's long-standing aim to hold primarily Treasury securities in the longer run, any principal payments on agency debt and agency MBS would generally be reinvested in Treasury securities in the secondary market. These reinvestments would be allocated across sectors of the Treasury market roughly in proportion to the maturity composition of Treasury securities outstanding. However, the plan would maintain the existing $20 billion per month cap on MBS redemptions; principal payments on agency debt and agency MBS above $20 billion per month would

continue to be reinvested in agency MBS. This cap would limit the pace at which the Federal Reserve's agency MBS holdings could decline if prepayments accelerated; the staff projected that the redemption cap on agency debt and agency MBS was unlikely to be reached after 2019.

The staff noted that, once balance sheet runoff ended, the average level of reserves would tend to decline gradually, in line with trend growth in the Federal Reserve's nonreserve liabilities, until the Committee chose to resume growth of the balance sheet in order to maintain a level of reserves consistent with efficient and effective policy implementation.

…Participants reiterated their support for the FOMC's intention to return to holding primarily Treasury securities in the long run. Participants judged that adopting an interim approach for reinvesting agency debt and agency MBS principal payments into Treasury securities across a range of maturities was appropriate while the Committee continued to evaluate potential long-run maturity structures for the Federal Reserve's portfolio of Treasury securities. Many participants offered preliminary views on advantages and disadvantages of alternative compositions for the SOMA portfolio. Participants expected to further discuss the longer-run composition of the portfolio at upcoming meetings.

Participants commented on considerations related to allowing the average level of reserves to decline in line with trend growth in nonreserve liabilities for a time after the end of balance sheet runoff. Several participants preferred to stabilize the average level of reserves by resuming purchases of Treasury securities relatively soon after the end of runoff, because they saw little benefit to further declines in reserve balances or because they thought the Committee should minimize the risk of interest rate volatility that could occur if the supply of reserves dropped below a point consistent with efficient and effective implementation of policy. Some others preferred to allow the average level of reserves to continue to decline for a longer time after balance sheet runoff ends because such declines could allow the Committee to learn more about underlying reserve demand, because they judged that such a process was not likely to result in excessive volatility in money market rates, or because they judged that moving to lower levels of reserves was more consistent with the Committee's previous communications indicating that it would hold no more

securities than necessary for implementing monetary policy efficiently and effectively. Participants noted that the eventual resumption of purchases of securities to keep pace with growth in demand for the Federal Reserve's liabilities, whenever it occurred, would be a normal part of operations to maintain the ample-reserves monetary policy implementation regime and would not represent a change in the stance of monetary policy. Some participants suggested that, at future meetings, the Committee should discuss the potential benefits and costs of tools that might reduce reserve demand or support interest rate control.

...The deputy manager also discussed the transition to a long-run regime of ample reserves, following the Committee's January announcement that it intends to continue to implement monetary policy in such a regime. Once the size of the Federal Reserve's balance sheet has normalized, the Open Market Desk will at some point need to conduct open market operations to maintain a level of reserves in the banking system that the Committee deems appropriate. In doing so, the Desk will need to assess banks' demand for reserves as well as forecast other Federal Reserve liabilities and plan operations to maintain a supply of reserves sufficient to ensure that control over short-term interest rates is exercised primarily through the setting of administered rates.

The deputy manager described a possible operational approach in an ample-reserves regime based on establishing a minimum operating level that would be a lower bound on the daily level of reserves. The assessment of the minimum operating level of reserves would be based on a range of information, including surveys of banks and market participants, data on banks' reserve holdings, and market monitoring. Under the proposed approach, the Desk would plan open market operations to maintain the daily level of reserves above the minimum operating level. Consistent with the Committee's intention to maintain a regime that does not require active management of the supply of reserves, the Desk could plan these open market operations over a medium-term horizon. The average level of reserves over the medium term would then be above the minimum operating level, providing a buffer of reserves to absorb daily changes in nonreserve liabilities.

Following the manager and deputy manager's report, some participants commented on various aspects of the minimum operating level approach. Decisions regarding

how far to allow reserves to decline would need to balance important tradeoffs. On the one hand, a lower minimum operating level might increase the risk of excessive interest rate volatility. On the other hand, a lower minimum operating level could provide more opportunities to learn about underlying reserve demand or could be viewed as more consistent with moving to the smallest securities holdings necessary for efficient and effective monetary policy implementation. However, the scope for reducing the level of reserves much further after the end of balance sheet runoff might be fairly limited.

…The U.S. economic projection prepared by the staff for the March FOMC meeting was revised down a little on balance. This revision reflected the effects of weaker-than-expected incoming data on both aggregate domestic spending and foreign economic growth that were only partially offset by a somewhat higher projected path for domestic equity prices and a lower projected trajectory for interest rates. The staff forecast that U.S. real GDP growth would slow markedly in the first quarter, reflecting a softening in growth of both consumer spending and business investment. But the staff judged that the first-quarter slowdown would be transitory and that real GDP growth would bounce back solidly in the second quarter.

…Participants continued to view a sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2 percent objective as the most likely outcomes over the next few years. Underlying economic fundamentals continued to support sustained expansion, and most participants indicated that they did not expect the recent weakness in spending to persist beyond the first quarter. Nevertheless, participants generally expected the growth rate of real GDP this year to step down from the pace seen over 2018 to a rate at or modestly above their estimates of longer-run growth. Participants cited various factors as likely to contribute to the step-down, including slower foreign growth and waning effects of fiscal stimulus. A number of participants judged that economic growth in the remaining quarters of 2019 and in the subsequent couple of years would likely be a little lower, on balance, than they had previously forecast. Reasons cited for these downward revisions included disappointing news on global growth and less of a boost from fiscal policy than had previously been anticipated.

…Participants also commented on the apparent slowing of growth in business fixed investment in the first quarter. Factors cited as consistent with the recent softness in investment growth included downward revisions in forecasts of corporate earnings; relatively low energy prices that provided less incentive for new drilling and exploration; flattening capital goods orders; reports from contacts of softer export sales and of weaker economic activity abroad; elevated levels of uncertainty about government policies, including trade policies; and the likely effect of recent financial market volatility on business sentiment. However, many participants pointed to signs that the weakness in investment would likely abate. Some contacts in manufacturing and other sectors reported that business conditions were favorable, with strong demand for labor, business sentiment had recovered from its recent decline, and recent reductions in mortgage interest rates would provide some support for construction activity. Agricultural activity remained weak in various areas of the country, with the weakness in part reflecting adverse effects of trade policy on commodity prices. Recent widespread severe flooding had also adversely affected the agricultural sector.

Participants noted that the latest readings on overall inflation had been somewhat softer than expected. However, participants observed that these readings largely reflected the effects of earlier declines in crude oil prices and that core inflation remained near 2 percent. Most participants, while seeing inflation pressures as muted, expected the overall rate of inflation to firm somewhat and to be at or near the Committee's longer-run objective of 2 percent over the next few years. Many participants indicated that, while inflation had been close to 2 percent last year, it was noteworthy that it had not shown greater signs of firming in response to strong labor market conditions and rising nominal wage growth, as well as to the short-term upward pressure on prices arising from tariff increases. Low rates of price increases in sectors of the economy that were not cyclically sensitive were cited by a couple of participants as one reason for the recent easing in inflation. A few participants observed that the pickup in productivity growth last year was a welcome development helping to bolster potential output and damp inflationary pressures.

In their discussion of indicators of inflation expectations, participants noted that market-based measures of inflation compensation had risen modestly over the intermeeting period, although they remained low. A couple of participants stressed

that recent readings on survey measures of inflation expectations were also still at low levels. Several participants suggested that longer-term inflation expectations could be at levels somewhat below those consistent with the Committee's 2 percent inflation objective and that this might make it more difficult to achieve that objective on a sustained basis.

…Participants commented on a number of risks associated with their outlook for economic activity. A few participants noted that there remained a high level of uncertainty associated with international developments, including ongoing trade talks and Brexit deliberations, although a couple of participants remarked that the risks of adverse outcomes were somewhat lower than in January. Other downside risks included the possibility of sizable spillovers from a greater-than-expected economic slowdown in Europe and China, persistence of the softness in spending, or a sharp falloff in fiscal stimulus. A few participants observed that an economic deterioration in the United States, if it occurred, might be amplified by significant debt service burdens for many firms. Participants also mentioned a number of upside risks regarding the outlook for economic activity, including outcomes in which various sources of uncertainty were resolved favorably, consumer and business sentiment rebounded sharply, or the recent strengthening in labor productivity growth signaled a pickup in the underlying trend. Upside risks to the outlook for inflation included the possibility that wage pressures could rise unexpectedly and lead to greater-than-expected price increases.

In their discussion of financial developments, participants observed that a good deal of the tightening over the latter part of last year in financial conditions had since been reversed; Federal Reserve communications since the beginning of this year were seen as an important contributor to the recent improvements in financial conditions. Participants noted that asset valuations had recovered strongly and also discussed the decline that had occurred in recent months in yields on longer-term Treasury securities. Several participants expressed concern that the yield curve for Treasury securities was now quite flat and noted that historical evidence suggested that an inverted yield curve could portend economic weakness; however, their discussion also noted that the unusually low level of term premiums in longer-term interest rates made historical relationships a less reliable basis for assessing the implications of the recent behavior of the yield curve. Several participants pointed to the increased

debt issuance and higher leverage of nonfinancial corporations as a development that warranted continued monitoring.

…With regard to the outlook for monetary policy beyond this meeting, a majority of participants expected that the evolution of the economic outlook and risks to the outlook would likely warrant leaving the target range unchanged for the remainder of the year. Several of these participants noted that the current target range for the federal funds rate was close to their estimates of its longer-run neutral level and foresaw economic growth continuing near its longer-run trend rate over the forecast period. Participants continued to emphasize that their decisions about the appropriate target range for the federal funds rate at coming meetings would depend on their ongoing assessments of the economic outlook, as informed by a wide range of data, as well as on how the risks to the outlook evolved. Several participants noted that their views of the appropriate target range for the federal funds rate could shift in either direction based on incoming data and other developments. Some participants indicated that if the economy evolved as they currently expected, with economic growth above its longer-run trend rate, they would likely judge it appropriate to raise the target range for the federal funds rate modestly later this year.

Several participants expressed concerns that the public had, at times, misinterpreted the medians of participants' assessments of the appropriate level for the federal funds rate presented in the SEP as representing the consensus view of the Committee or as suggesting that policy was on a preset course. Such misinterpretations could complicate the Committee's communications regarding its view of appropriate monetary policy, particularly in circumstances when the future course of policy is unusually uncertain. Nonetheless, several participants noted that the policy rate projections in the SEP are a valuable component of the overall information provided about the monetary policy outlook. The Chair noted that he had asked the subcommittee on communications to consider ways to improve the information contained in the SEP and to improve communications regarding the role of the federal funds rate projections in the SEP as part of the policy process.

Participants also discussed alternative interpretations of subdued inflation pressures in current economic circumstances and the associated policy implications. Several participants observed that limited inflationary pressures during a period of historically

low unemployment could be a sign that low inflation expectations were exerting downward pressure on inflation relative to the Committee's 2 percent inflation target; in addition, subdued inflation pressures could indicate a less tight labor market than suggested by common measures of resource utilization. Consistent with these observations, several participants noted that various indicators of inflation expectations had remained at the lower end of their historical range, and a few participants commented that they had recently revised down their estimates of the longer-run unemployment rate consistent with 2 percent inflation. In light of these considerations, some participants noted that the appropriate response of the federal funds rate to signs of labor market tightening could be modest provided that signs of inflation pressures continued to be limited. Some participants regarded their judgments that the federal funds rate was likely to remain on a very flat trajectory as reflecting other factors, such as low estimates of the longer-run neutral real interest rate or risk-management considerations. A few participants observed that the appropriate path for policy, insofar as it implied lower interest rates for longer periods of time, could lead to greater financial stability risks. However, a couple of these participants noted that such financial stability risks could be addressed through appropriate use of countercyclical macroprudential policy tools or other supervisory or regulatory tools.

Source: Federal Reserve Board