U.S. FOMC Review

- FOMC: tapering to begin in October
- Interest rate intentions shift only marginally

Michael Moran
Daiwa Capital Markets America
212-612-6392
michael.moran@us.daiwacm.com

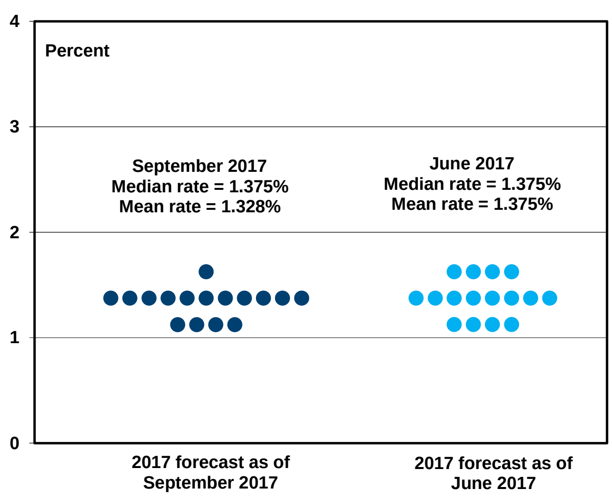
FOMC

The Federal Open Market Committee, as widely expected by market participants, announced today that the Fed would begin to taper its balance sheet in October. As previously announced, The Fed will redeem $6 billion of Treasury securities and $4 billion of agency and mortgage-backed securities for the next three months. These amounts will be increased by $6 and $4 billion every three months until they reach $30 billion and $20 billion. The Fed did not provide any information on how long redemptions would continue or what the ultimate size of the balance sheet might be.

In terms of interest rate policy, the Committee remained on board for additional tightening. The dot plots changed from those in June, but only marginally so. The median rates in the dot plots remained the same, with the rates signaling one additional hike this year and three next year. The means of the distributions fell, which could be viewed as a signal that officials are less inclined to tighten, but even the means showed that officials envision a noticeable shift in rates. The new mean for the end of 2018 is 2.039 percent, 71 basis points higher than the mean for year-end 2017, a difference that implies 2.8 tightenings.

One element of the dots might argue for limited policy action next year: the distribution of views on rates is still quite wide for 2018. Given the wide range of views -- two seeing no change in policy and five seeing four or more shifts (one envisioning six tightenings) -- it might be difficult for officials to find agreement.

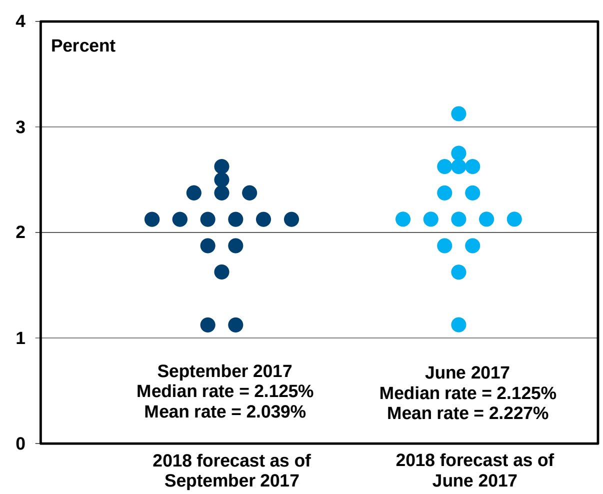
Expected Fed Funds Rate (Year-End 2017)*



Each dot represents the expected federal funds rate of a Fed official. Normally, this graph would contain 19 projections (seven governors of the Federal Reserve Board and 12 reserve bank presidents), but three governorships were open at the times of the June and September meetings.

Source: Federal Open Market Committee

Expected Fed Funds Rate (Year-End 2018)*



Each dot represents the expected federal funds rate of a Fed official. Normally, this graph would contain 19 projections (seven governors of the Federal Reserve Board and 12 reserve bank presidents), but three governorships were open at the times of the June and September meetings.

Source: Federal Open Market Committee

We saw a possibility that the new economic projections might signal less tightening next year, but again, the evidence pointing in this direction was weak. A lower projection for the rate of inflation next year could push the Fed to the sideline, but views changed only marginally (1.9 percent versus 2.0 percent in June). Similarly, a drop in the long-run unemployment rate could have been viewed as a signal that officials could allow the economy to run hot for a longer time, but there was no change in the perceived long-run (presumably full-employment) unemployment rate.

Economic Projections of the FOMC, September 2017*

	2017	2018	2019	2020	Longer Run
Change in Real GDP	2.4	2.1	2.0	1.8	1.8
June projection	2.2	2.1	1.9	--	1.8
Unemp. Rate	4.3	4.1	4.1	4.2	4.6
June projection	4.3	4.2	4.2	--	4.6
PCE Inflation	1.6	1.9	2.0	2.0	2.0
June projection	1.6	2.0	2.0	--	2.0
Core PCE Inflation	1.5	1.9	2.0	2.0	--
June projection	1.7	2.0	2.0	--	--
Federal funds rate	1.4	2.1	2.7	2.9	2.8
June projection	1.4	2.1	2.9	--	3.0

* *Median projections*

Source: Supplemental materials released with the September 20, 2017 FOMC Statement

The FOMC reduced its estimate of the long-run (i.e. neutral) federal funds rate, now 2.8 percent versus 3.0 percent in June. This could be viewed as a sign that officials see current policy as being closer to neutral than it was previously, and therefore less tightening is needed. We would not draw this conclusion, as other elements of the forecast suggest that the long-run is still two to three years away. Most Fed officials still see policy as currently accommodative (and financial conditions in a broad sense as friendly) and thus envision a need for more tightening in the months ahead.

Given these considerations, we continue to look for an additional tightening this year (probably December) and three next year.