Weekly Wander

Commitment Issues
Fed leaves its options wide open

Mar 16, 2017

- **"Don't get too excited" appears to be the key message from FOMC's meeting yesterday. Yes, it hiked rate by 25bps as expected. But, no, it did not signal – much less commit to – a more hawkish path of hikes for the rest of the year.**
- **Given the big unknowns, it is wise for the Fed to refrain from over-promising on hikes, as per before. Details of Trump's economic policies are still scarce and the 'feel good factor' boosting US economy might not last, for instance.**
- **Overall, Asia's policymakers should feel relieved, especially given that USD has pulled back further. Still, nothing can be taken for granted and they know that the Fed can suddenly sing a very different tune yet again. Best to hold tight on policy rates and use this window to accumulate foreign reserves.**

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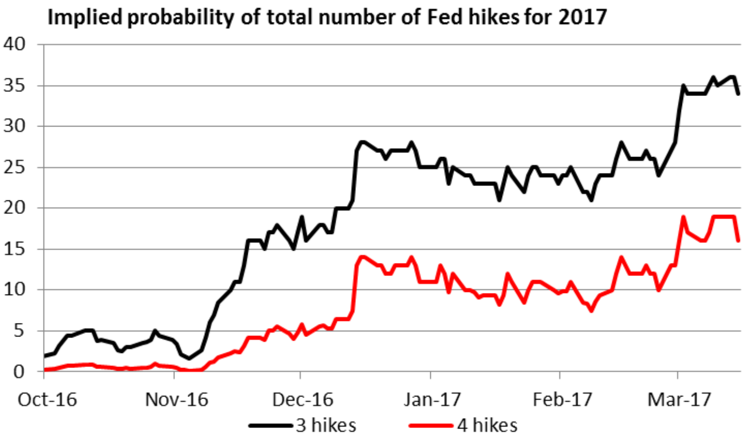
Understanding the misunderstanding

"I guess I should warn you, if I turn out to be particularly clear, you've probably misunderstood what I've said." – Alan Greenspan –

Well, at least he bothered to state *that* clearly. In contrast, ahead of this week's FOMC meeting, there had been a host of comments from various Fed officials which brought about some market anticipation that not only would the Fed be hiking its policy rate in March, it would also be signalling a tightening pace for the remainder of the year that is more hawkish than before.

In January, Chair Janet Yellen warned at an event in Stanford that "allowing the economy to run markedly and persistently "hot" would be risky and unwise." Just last month, she highlighted the risk of the Fed having to raise rates more rapidly later on if the Fed waits too long to hike rates, in her Congressional testimony.

As a result, not only did market start to expect a March rate hike, it began to entertain the idea of a higher number of rate increases for the rest of the year. Indeed, not only was the probability of three rate hikes for 2017 picking up, the implied expectation for four hikes picked up noticeably, as well, after these comments.



Source: Bloomberg, OCBC.

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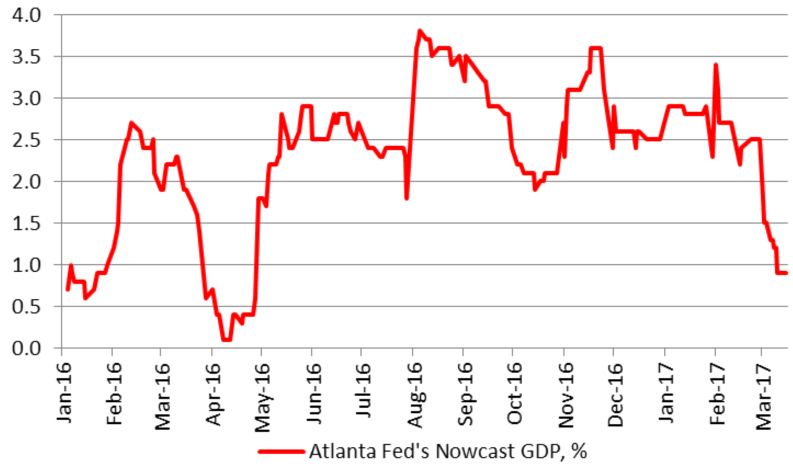
Alas, as it turned out, the FOMC does not appear to be in a mood to entertain the idea of four hikes this year just yet.

There are a few ways to read this apparent disconnect. One is that the officials were merely trying to push up the anticipation of a March rate hike by talking up the danger of not tightening enough in general, just so that it would not surprise the market too much when it pulled the trigger in this particular meeting. Recall, for instance, that the market-implied probability for this very rate hike was merely around 1-in-3 just one month ago.

Another way to see this is that the outlook for the US economy in the coming months has grown more uncertain since the officials gave their relatively hawkish signals earlier.

While the jobs market looks robust enough and sentiment of manufacturers still looks supported, there have been pockets of weaknesses in the economy. For one, February's retail sales posted the smallest gains in half a year. While this may have been driven by temporary factors such as a delay in tax refunds, it has nonetheless served as a reminder not to expect too much out of an economy that has been experiencing a shallow recovery.



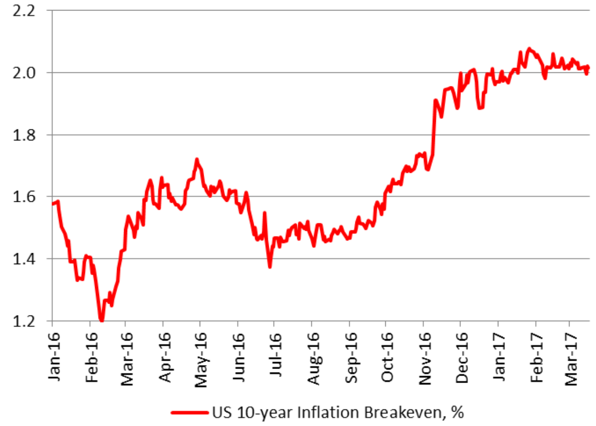
Source: Bloomberg, OCBC.

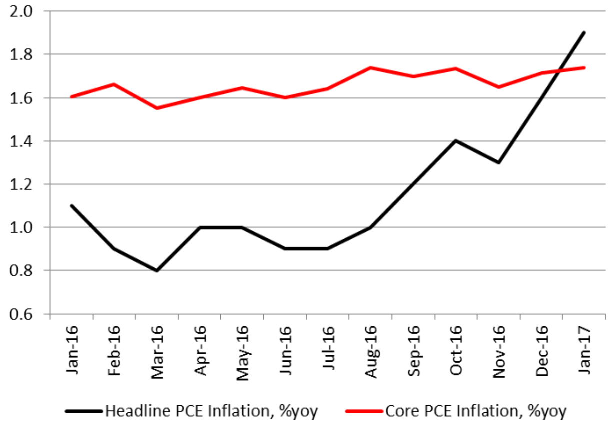
Indeed, a now-cast model that the Atlanta Fed has just updated suggests that the US economy might grow at just 0.8% annualized pace in Q1 compared to 1.2% estimated a week ago, and as high as 3.4% in early February. This signals some likelihood that the US economy might be losing some momentum in the near-term.

Apart from the possible dampening in near-term momentum, there is also the bigger unknown of just how supportive President Trump's economic policies would turn out to be. For that, very little is known at this point still. Moreover, with his administration increasingly caught up in the tussles over health care reform, Russian intervention suspicion, immigration policies, and wiretapping versus "wiretapping" saga and whatnot, the day that we will find out enough details about his economic agenda to assess whether it is enough to meet market expectation of its growth boost is itself an unknown.

As Yellen succinctly put it in her press conference overnight, "There is great uncertainty about the timing, the size and the character of policy changes that may be put in place." For good measure, indicating a deal-with-it-when-it-comes thinking, she added that "I don't think that's a decision or set of decisions that we need to make until we know more about what policy changes will go into effect."

Even as the uncertainty about Trump's economic impact curtails the FOMC's enthusiasm for a more hawkish rate path, it might have also inadvertently given the committee the space to keep their options open for now. This is because inflation expectations, having ramped up after Trump's election on his reflationary promises, have since stabilized as suggested by the 10-year breakeven rates.



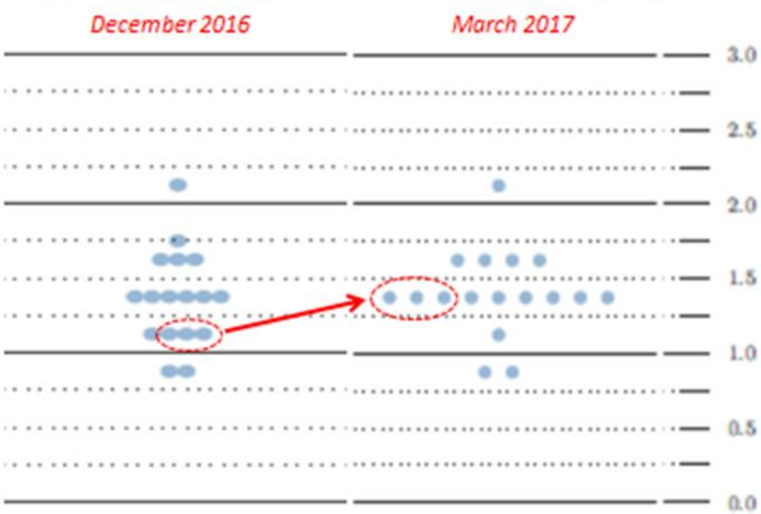


Source: Bloomberg, OCBC.

With respect to the current price movement, the core PCE inflation that the Fed focuses on has been holding steady. Even as the broader headline PCE inflation has ticked up to 1.9% - very close to the Fed's 2% target – the central bankers have thus far been largely ascribing it to the effect of fuel prices. Moreover, Yellen herself has suggested a relative nonchalance in having inflation temporarily overshooting the target. She said yesterday that the 2% inflation goal is "symmetric" and that it is a target, not a ceiling.

Still, overall, it is best not to be carried away in thinking that the Fed has turned utterly dovish. For one, it has just broken the ultra-gingerly pattern of one rate hike a year. Moreover, the three rate hikes that it is looking at this year are still significant in recent history. On top of that, there is really nothing stopping the Fed from singing a different tune as time comes, should inflation or growth pick up more than anticipated. After all, this March rate hike was far from a certainty – until it was, after pointed nudges by the Fed officials.

FOMC's Dot Plot: Projection for Fed Funds Rates by end of 2017

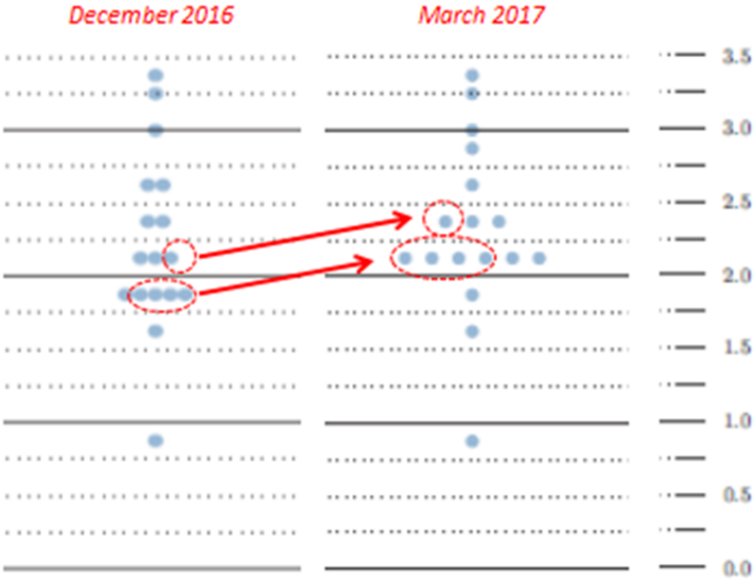


Source: Federal Reserve, OCBC.

Furthermore, the latest FOMC dot plots may suggest a heavier tinge of hawkishness than realized. To be sure, the median expectation of the 17 members who offered their projection for end-2017 policy rate indeed remains at 1.25-1.5% (3 rate hikes in 2017), unchanged from the last time the information was released in December 2016. However, looking more closely at the details, we can see that even as the median remains the same, there has actually been a hawkish shift by three members, who have changed their views from expecting 2 hikes to now 3 hikes.

A similar dynamics can be seen in terms of FOMC members' projections for where rates will be by end of 2018. While the median remains unchanged from three months ago, there has also been an upward shift in the number of members expecting more rate hikes next year.

FOMC's Dot Plot: Projection for Fed Funds Rates by end of 2018



Source: Federal Reserve, OCBC.

Hence, one way to read these changes is that, despite the appearance that the overall FOMC has retained their views on the upcoming pace of interest rate hikes, there has actually been a tell-tale shift towards the hawkish end of the spectrum.

What this all means is that the Fed's commitment issues run rather deep. Not only is it reluctant to commit to more rate hikes this year than previously suggested, at some level, it is also refraining to commit to that non-commitment, as well. In other words, it wants to keep its options wide open.

As with relationships in general, dealing with someone who has commitment issues is not easy. For Asian central banks which have to take cues from the relationship of their policy rates with the Fed funds rate, it thus makes things complicated. On one hand, they would be happy to see that the Fed has not gone all out and revise up its projection for the degree of rate hikes as a whole. On the flip side, however, they must realize too that things can change rather quickly.

To push the relationship analogy further, an Aunt Agony-type advice in this case will be for the regional central banks to enjoy the moment and to hope for the best but also prepare for the worst.

Indeed, an exemplary way to deal with the situation can be seen in the case of Indonesia. Its central bank is due to announce its monetary policy decision today. If we are right, Bank Indonesia is highly likely to play safe and refrain from cutting its policy rate further. Even as its currency has been stable, supported by dollar weakness post-friendly Fed, BI is unlikely to get carried away and risk it. With an eye for the worst, it has also been busy socking away inflows into foreign exchange reserves. That pile now stands at USD119.9bn, usefully at its highest level since mid-2011 and ready for as and when the Fed has a change of heart.

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