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June FOMC: Downplays softness in inflation and payroll data; balance sheet normalization will begin "relatively soon"

- As widely expected, the Federal Reserve increased its target range for the fed funds rate by 25bp to 1.00-1.25% at the 13-14 June monetary policy meeting. The FOMC post-meeting statement revealed a slightly more upbeat assessment of economic activity, with household spending picking up in recent months and business investment continuing to increase. With labor markets strengthening further, the Committee noted that economic activity "has been rising moderately so far this year", compared to March when it had stated that economic activity had slowed. Downplaying recent slower payroll growth, the Fed is of the view that the average monthly increase in employment has moderated but has been rather "solid", with unemployment below the Committee's downwardly revised level of NAIRU. That said, the Fed continues to expect that labor market conditions will strengthen further, partly due to ongoing monetary stimulus. At the press conference that followed the conclusion of the meeting, Fed Chair Janet Yellen said that the labor market was tight enough to warrant a gradual removal of monetary policy accommodation so as to avoid falling behind the curve and finally be forced to embark on a more aggressive tightening cycle that could potentially lead to a recession.

- Despite disappointing inflation readings over the last couple of months with both headline and core inflation running below the Committee's 2.0% medium-term target, the Fed maintains the view that inflation has been held back by one-off reductions in certain categories (cell phone services and wireless prices, prescription drug prices), creating base effects that can weigh on annual inflation rates through March 2018. Nevertheless, above-trend growth, expectation of further improvement in labor markets and the passing of these one-off factors is anticipated to push inflation toward the Committee's 2% target by the end of next year.

- The updated Fed's projections were largely in line with market expectations, with the median "dot" expectations for the fed funds rate largely unchanged pointing one more hike by end 2017, three hikes in 2018 and a long-run neutral Fed funds rate at 3.0%. However, there was a marginal change at the individual dots as four FOMC members expect no additional hikes this year, versus only three members in March, but this could reflect a change in the FOMC members who submitted the dots. Obviously, FOMC members that probably voted against further interest rate increases this year might have been James Bullard (non-voter) who has recently repeated his view that the Fed's expected rate hike path is overly aggressive and Neel Kashkari who dissented yesterday. The other two FOMC members might be Charles Evans and Lael Brainard (voters) who seemed quite concerned about the recent softness in domestic inflationary pressures. If that's the case, is seems that three of the nine voting FOMC members are relatively dovish, which raises the bar for a more gradual tightening cycle ahead.

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- Turning to the updated macro projections, the Fed modestly upgraded 2017 real GDP growth to 2.2% (from 2.1% in March) and marked down its forecast for 2017 headline PCE inflation to 1.6% (from 1.9% previously) and core PCE inflation to 1.7% (from 1.9% previously), while continuing to forecast 2.0% in 2018 and 2019. On the unemployment front, the Fed expects the unemployment rate to average 4.3% in 2017 (from 4.5% in March) and move broadly sideways over the next couple of years, with a marginal one-tenth downward revision in the long-run unemployment rate to 4.6%.

- The major surprise in the FOMC statement was the indication that the Fed intends to start reducing its balance sheet this year, as long as the US economy continues to expand in line with the Central Bank's projections. In more detail, the monthly balance sheet caps for the rate of runoff of Fed holdings at maturity were set at $10bn initially with the intention to increase over a 12-month interval to up to $50bn ($6bn for Treasuries and $4bn for mortgage-backed securities intending to increase these cap sizes on quarterly intervals to up to $30bn and $20bn, respectively). If implemented, the Fed would shrink its balance sheet up to $300bn during the first year (60% Treasuries and 40% mortgage-backed securities) and up to $600bn per year in the following years until the Fed's target is finally reached. Although the final size of the Fed's balance sheet has not yet been officially announced, the Fed recognizes that the magnitude of reserves holdings should be higher than pre-crisis levels, given that demand for central bank reserves has improved amid increasing financial regulation. Adding to this, Chair Janet Yellen stated that the Committee has confidence in the current system for controlling the level of the fed funds rate, without requiring active management of the excess reserves' levels (i.e. selling outright a portion of Fed's holdings) but instead a passive balance sheet runoff (via phasing out reinvestments). She added that the balance sheet normalization will continue for a number of years, so as not to cause large disruption to the financial markets as well as the banking system. On the timing of the initial taper, the chair has guided markets to balance sheet runoff "this year: and "relatively soon", indicating that September is more likely than December for announcing the beginning of balance sheet reduction.

- Although the outcome of the FOMC meeting was widely perceived somewhat hawkish, the most significant market move came after the soft US CPI data that were released a few hours before the monetary policy announcement. As a result of the inflation data, the USD sold-off almost by -0.8% but made a perfect U-turn after the FOMC to finish little unchanged yesterday. EUR/USD hit a 7-month high of 1.1297 after the CPI data posting a new high for the year, but ended at 1.1218 y-day following the post meeting press conference by Fed Chair Yellen, before falling to a 2-week low of 1.1132 earlier today after data on US jobless claims and business conditions pointed to solid labor market conditions. In the rates market, the 10y Treasuries lost 8 bps in yield and closed at 2.13% yesterday, not far from a 7-month low of 2.10% after the poor US inflation data, before recovering marginally to ca. 2.15% in early US trade today. The curve faced significant flattening pressures yesterday, with the 2s10s spread narrowing by 5 bps to reach 79bps which is the tightest level seen since September 2016. The 2s10s spread is now approaching the critical level of 75 bps (which is the 2016 low), and should it breach that level then it could be heading for levels not seen since 2007. In a parallel fashion the 5s30s spread closed y-day at 105 bps, marginally above this year's lows.

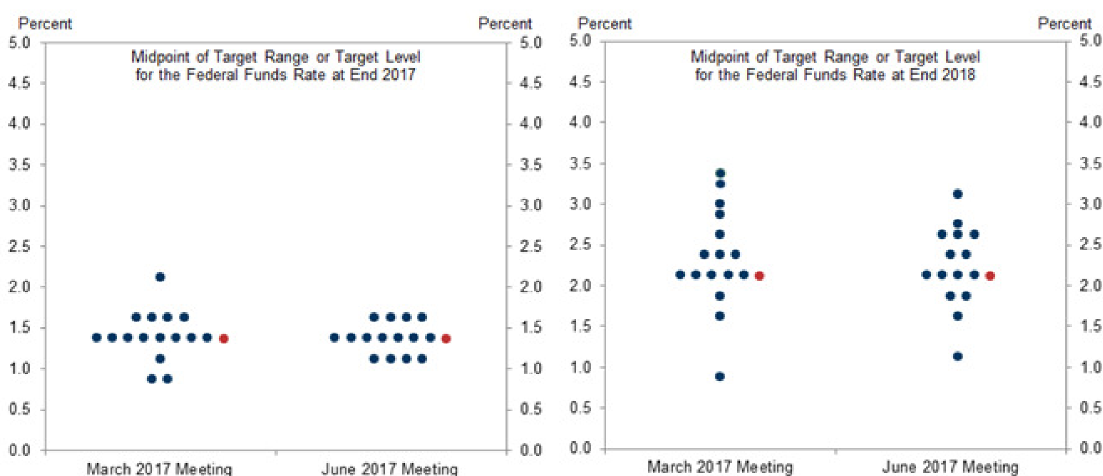
Table 1
Economic Projections of Federal Reserve Board Members and Federal Reserve Bank Presidents, June 2017

	Median* (percent)			
USA	**2017**	**2018**	**2019**	**Longer run**
Change in real GDP	**2.2**	**2.1**	**1.9**	**1.8**
March projection	2.1	2.1	1.9	1.8
Unemployment rate	**4.3**	**4.2**	**4.2**	**4.6**
March projection	4.5	4.5	4.5	4.7
PCE inflation	**1.6**	**2.0**	**2.0**	**2.0**
March projection	1.9	2.0	2.0	2.0
Core PCE inflation	**1.7**	**2.0**	**2.0**	
March projection	1.9	2.0	2.0	
Fed Funds Rate	**1.4**	**2.1**	**2.9**	**3.0**
March projection	1.4	2.1	3.0	3.0

* For each period, the median is the middle projection when the projections are arranged from lowest to highest. When the number of projections is even, the median is the average of the two middle projections

Source: Federal Reserve, Eurobank Research

Figure 1
FOMC participants' assessments of appropriate monetary policy



Source: Federal Reserve, VTB Capital, Eurobank Research

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