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FOCUS NOTES

September FOMC: Downplays softness in inflation and maintains its hiking signals

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- As broadly expected, the Federal Reserve maintained its target range for the fed funds rate at 1.00-1.25% and announced the start of the balance sheet normalization process at the 20 September monetary policy meeting. In line with its "Policy Normalization Principles and Plans" introduced back in June, the balance sheet drawdown will begin in October with monthly caps of $10bn initially ($6bn Treasuries and $4bn MBSs), rising by $10bn every three months until they reach a limit of $50bn ($30bn Treasuries and $20bn MBSs). Should the Fed follow that path, the balance sheet is estimated to shrink from $4.5tn currently to ca. $2.8tn by the end of 2020.

- In the FOMC post-meeting statement, the updated economic projections did not include any major changes compared to June, highlighting that the potential disruptions from various hurricanes are expected to prove short-lived and not to alter the US economic outlook over the medium term. Hence, the adjustments to the Summary of Economic Projections were modest, with a slight downward revision in the unemployment rate in 2018 and 2019 (to 4.1% from 4.2% previously for both years) and a downward revision in core PCE inflation for both 2017 and 2018 (to 1.5% from 1.7% and to 1.9% from 2.0%, respectively) being balanced by a higher GDP forecast for 2017 and 2019 (to 2.4% from 2.2% and to 2.0% from 1.9%, respectively). Despite persistently low inflation, the FOMC did not make changes in the wording related to the inflation outlook. In the press conference that followed the conclusion of the meeting, Fed Chair Janet Yellen explained the Committee's view that core inflation weakness in 2017 is "largely unrelated to broader economic conditions", expressing their expectation that, when the various temporary factors fade, inflation will return to the Fed's medium-term target of 2.0%.

- The median "dot" expectations for the fed funds rate was unchanged for 2017 and 2018, with the Committee expecting one more rate hike in 2017 and three further 25bps increases in 2018. Nevertheless, the median forecast for 2019 was reduced by 25bps, probably due to the reduction in the Committee's longer-run neutral rate, which was also revised down from 3.00% to 2.75%. Fed Chair Janet Yellen explained that the 2.75% projection is based on the expectation of an increasing neutral rate, given that the current level of the neutral rate is below 3.0%. She also repeated that monetary policy is close to neutral at the moment so, looking ahead, interest rate hikes are on the back of an increasing neutral rate. If the neutral rate does not increase in line with expectations, then the hiking cycle could end sooner than investors expect.

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- Reacting to the above, Treasury yields increased to multi-month highs on Wednesday, with long-dated paper outperforming as the equilibrium rate was lowered to 2.75% from 3.00% in June. As a result, the 5/30-yr yield curve undertook some bearish flattening with the corresponding spread falling to a three month low of ca.93bps, before retreating marginally to levels around 94bps on Thursday. In FX markets, the USD moved higher across the board in reaction to an upward shift in short-term FOMC rate hike expectations following the more hawkish than anticipated tone of the policy statement and comments by Fed Chair Janet Yellen at the press conference. Against this background, the EUR/USD consolidated around levels of 1.1900 in late European trade on Thursday, after closing near a 7-day low of 1.1860 on Wednesday, below a year-to-date peak of 1.2092 marked earlier this month.

- Looking ahead, we expect the Fed to resume its gradual pace of hiking at its December meeting, with most Fed officials focusing more on labor market data compared to inflation data. Future implied probability currently stands at 64% for a 25bps Fed rate hike in December, up from ca. 50% before the September meeting and roughly 2 hikes by year-end 2018. We believe that it is difficult to assess the Fed's hiking path in the next couple of years given the increasing number of vacant seats in the Board of Governors and uncertainty regarding economic and inflation developments, especially ahead of upcoming discussions in Congress on tax reform and the Fiscal 2018 Budget.

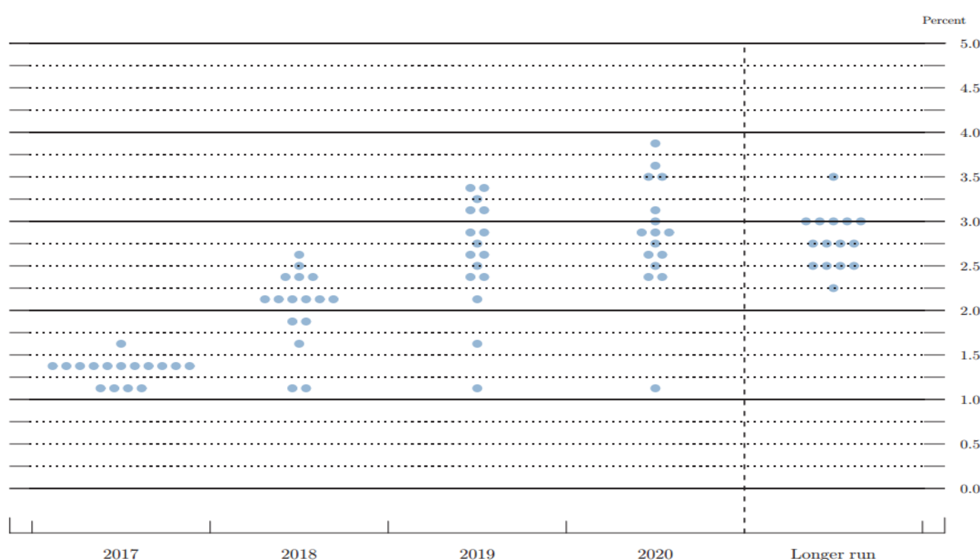
Table 1
Economic Projections of Federal Reserve Board Members and Federal Reserve Bank Presidents, September 2017

		Median* (percent)			
USA	**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
Unemployment 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	-	
Fed Funds Rate	**1.4**	**2.1**	**2.7**	**2.9**	**2.8**
June projection	1.4	2.1	2.9	-	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

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