FENWICK ADVISERS

FOMC: On a Fast Track to Normalization?

The FOMC decided to raise the fed funds rate to 0.75% and have penciled in an extra rate hike in 2017. The media would have us believe that the faster pace of normalizing the policy rate to its long term norm now estimated at about 3% reflects both a stronger US economy and expectations of outsized fiscal stimulus under a Trump presidency. Neither of these conjectures is correct. Indeed, it appears that the staff forecast, which heavily influences the views of most FOMC participants (summarized in Table 1 below),is essentially unchanged from the September version. In my opinion, incoming data including the upward revision to Q3 GDP along with the strength of employment, earnings and household spending in Q4 can explain virtually all the small upward revisions to economic activity in both 2016 and 2017. Only the tiny revision to GDP growth in 2019 might be interpreted as a nod in the direction of incorporating more government spending or tax cuts under Trump, but I doubt that as well. The staff does not deal in speculating about future fiscal policies. Rather, its public sector forecasts are based on actual outlays and receipts coupled with data on congressional appropriations, none of which has occurred yet.

The staff forecast process begins with revisions to the current **level** of GDP based on data revisions and incoming data. In this case, many of the latest numbers have surprised forecasters to the upside, as has the sharp decline in the unemployment rate to 4.6% in November. Data on the labor market, especially the payroll survey, carry a heavy weight in the current quarter estimates at least until other flow data becomes available. Not only is employment the most up-to-date data, it also is telltale because of the simple notion that employers do not hire workers unless business is good. An upward revision to Q4 GDP also tends to have some carry-forward into the Q1 **level** of GDP in the staff's forecast exercise, thereby explaining the small 2017 revision. That leaves the tiny revision to 2019, which is hardly worth mentioning. At 1.9% that forecast remains at or below the US long term potential growth of about 2%, which in itself is at the high end of the staff's latest estimate of 1.5% to 2%.

December 2016 Projections

Economic projections of Federal Reserve Board members and Federal Reserve Bank presidents under their individual assessments of projected appropriate monetary policy, December 2016

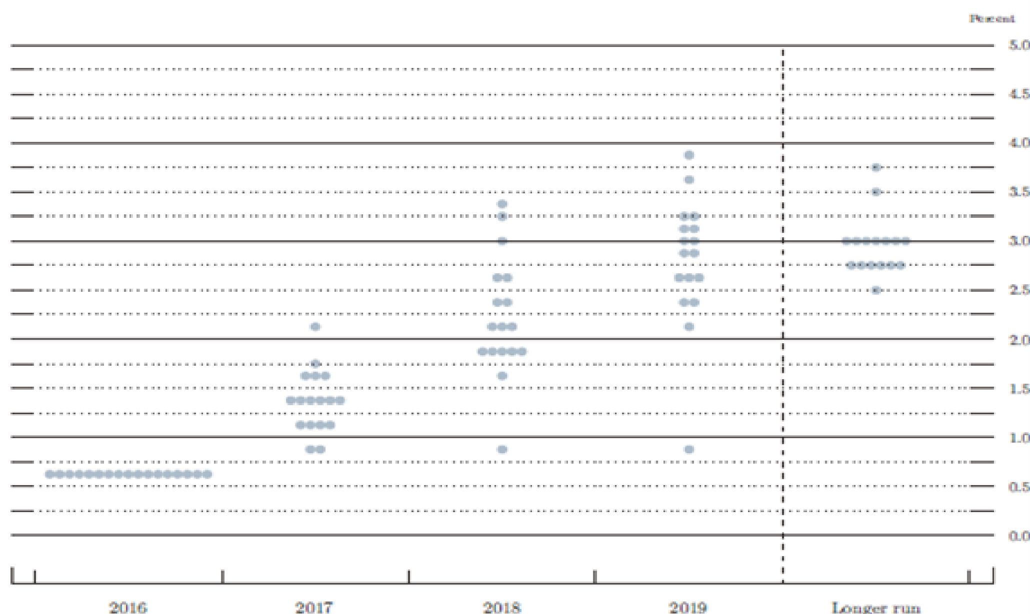
Advance release of table 1 of the Summary of Economic Projections to be released with the FOMC minutes

Percent

Variable	Median[1]					Central tendency[2]					Range[3]				
	2016	2017	2018	2019	Longer run	2016	2017	2018	2019	Longer run	2016	2017	2018	2019	Longer run
Change in real GDP	1.9	2.1	2.0	1.9	1.8	1.8 – 1.9	1.9 – 2.3	1.8 – 2.2	1.8 – 2.0	1.8 – 2.0	1.8 – 2.0	1.7 – 2.4	1.7 – 2.3	1.5 – 2.2	1.6 – 2.2
September projection	1.8	2.0	2.0	1.8	1.8	1.7 – 1.9	1.9 – 2.2	1.8 – 2.1	1.7 – 2.0	1.7 – 2.0	1.7 – 2.0	1.6 – 2.5	1.5 – 2.3	1.6 – 2.2	1.6 – 2.2
Unemployment rate	4.7	4.5	4.5	4.5	4.8	4.7 – 4.8	4.5 – 4.6	4.3 – 4.7	4.3 – 4.8	4.7 – 5.0	4.7 – 4.8	4.4 – 4.7	4.2 – 4.7	4.1 – 4.8	4.5 – 5.0
September projection	4.8	4.6	4.5	4.6	4.8	4.7 – 4.9	4.5 – 4.7	4.4 – 4.7	4.4 – 4.8	4.7 – 5.0	4.7 – 4.9	4.4 – 4.8	4.3 – 4.9	4.2 – 5.0	4.5 – 5.0
PCE inflation	1.5	1.9	2.0	2.0	2.0	1.5	1.7 – 2.0	1.9 – 2.0	2.0 – 2.1	2.0	1.5 – 1.6	1.7 – 2.0	1.8 – 2.2	1.8 – 2.2	2.0
September projection	1.3	1.9	2.0	2.0	2.0	1.2 – 1.4	1.7 – 1.9	1.8 – 2.0	1.9 – 2.0	2.0	1.1 – 1.7	1.5 – 2.0	1.8 – 2.0	1.8 – 2.1	2.0
Core PCE inflation[4]	1.7	1.8	2.0	2.0		1.7 – 1.8	1.8 – 1.9	1.9 – 2.0	2.0		1.6 – 1.8	1.7 – 2.0	1.8 – 2.2	1.8 – 2.2	
September projection	1.7	1.8	2.0	2.0		1.6 – 1.8	1.7 – 1.9	1.9 – 2.0	2.0		1.5 – 2.0	1.6 – 2.0	1.8 – 2.0	1.8 – 2.1	
Memo: Projected appropriate policy path															
Federal funds rate	0.6	1.4	2.1	2.9	3.0	0.6	1.1 – 1.6	1.9 – 2.6	2.4 – 3.3	2.8 – 3.0	0.6	0.9 – 2.1	0.9 – 3.4	0.9 – 3.9	2.5 – 3.8
September projection	0.6	1.1	1.9	2.6	2.9	0.6 – 0.9	1.1 – 1.8	1.9 – 2.8	2.4 – 3.0	2.8 – 3.0	0.4 – 1.1	0.6 – 2.1	0.6 – 3.1	0.6 – 3.8	2.5 – 3.8

By contrast, the ‘dot plot’ of FOMC participants’ assessment of the appropriate monetary policy, shown in Figure 2, has captured the headlines. While it is true that the average level of the policy rate in December calls for three rate hikes of 25 basis points in 2017, instead of the two hikes envisioned at the September meeting, the new outlook still remains less aggressive that what participants envisioned in June, and in the interim most participants seem to have signed on to the latest staff research showing strong evidence that demographics can explain all of the decline in the long term neutral rate of interest rate to less than 1% in real terms (3% in nominal terms if inflation is stable at its target of 2%). A few members remain outliers in calling for the fed funds rate to rise to 3.5% to 4% but that dissenting view is increasingly out of sync with the majority.

Figure 2. FOMC participants' assessments of appropriate monetary policy: Midpoint of target range or target level for the federal funds rate



Source:Federal Reserve

We should not dismiss, however these views for different reasons. Namely, absence additional fiscal stimulus the FOMC already estimates the actual GDP exceeds its inflation-stable potential. Otherwise, inflation would not rise in the staff forecast toward the target of 2% over the next year. If so, then Trump’s proposed $1 trillion fiscal package is far too aggressive for an economy that already is flirting with full employment as measured by the empirical evidence. At 4.6% the unemployment rate is significantly below the staff’s inflation-stable estimate of 5%, so it is little wonder that financial market have priced higher inflation into long-dated bonds.

Moreover, if Congress does approve an outsized fiscal package, the staff forecast will be revised upward commensurately with the inescapable consequence of having to raise the inflation forecast for 2018 and beyond. **Inflation lags growth by about one year after actual GDP exceeds its potential which is now the case.** Worse yet, inflation does not recede until after the **level** of actual GDP falls below potential, which means in effect we would need a recession to break the

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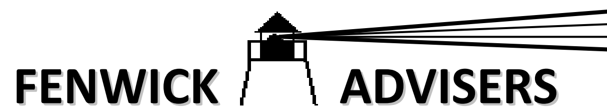

wage-price nexus that perpetuates inflation at full employment. The FOMC wants to avoid that conundrum, reminiscent of the 1980s, and hence would be more proactive in raising the policy rate faster if excessive fiscal stimulus becomes a reality in the next Congress. In short, upward surprises in either economic growth or in the nation's fiscal policy setting are likely to translate into a more aggressive Fed. The December FOMC decision is not yet the clarion call for higher rates at a faster pace, but it is a red flag for things to come if politicians think fiscal policy is a free lunch. Unfortunately, they missed that window over the past seven years and now they are late to the game.

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