# Weekly Market Summary

**September 22nd, 2017**

## US Federal Reserve Meeting & Announcement - What to Expect When You're Least Expecting!!

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Two days back, I provided a summary update on where markets stood in terms of expectations for the Fed's upcoming policy announcement (see below reproduced write-up, in case you missed it on Wednesday). I also noted that the real action at this September FOMC meeting will come from the Fed's description of the economy, the quarterly economic projections (Summary of Economic Projects and updated Fed's Dots) and Chair Janet Yellen's ensuing press conference – adding that whilst markets expect the totality of the commentary to lean dovish as the Fed expresses concerns about the inflation outlook (and possibly refer to the current political stalemate in the US), the surprise would be a Fed that still leans more heavily toward the hawkish side of policy spectrum (i.e. continues pushing for one more rate hike for 2017 and three "25 bps" hikes in 2018, in line with the Fed's last projections, released on June 14th, 2017). And SURPRISE is what we got from this Fed on Wednesday evening!

US Federal Reserve policy makers – as widely expected - left the benchmark interest rate unchanged in a range of 1% to 1.25%, moved to dismantle a pillar of crisis-era support for the world's biggest economy and stuck with its forecast to raise interest rates again this year, saying hurricane damage would not derail an otherwise healthy expansion. "*Storm-related disruptions and rebuilding will affect economic activity in the near term, but past experience suggests that the storms are unlikely to materially alter the course of the national economy over the medium term*," the Federal Open Market Committee ("FOMC") said in its statement on Wednesday following a two-day meeting in Washington. In that same announcement, the Fed set October for the start of their previously announced plan to shrink its $ 4.5 trillion balance sheet. "*We continue to expect that the ongoing strength of the economy will warrant gradual increases in that rate to sustain a healthy labour market and stabilize inflation around our 2% longer-run objective*," Chair Janet Yellen said during a press conference. She called this year's inflation undershoot a "*mystery*." Treasury prices fell (yields jumped roughly 5 basis points on the day) and the US dollar rose (EUR/USD traded to a low of 1.1861 and USD/YEN to a high of 1.1255) as investors weighed the Fed's plans to press ahead with gradual policy tightening. U.S. stocks - surprisingly - were little changed!

The announcement is a third big policy step by Yellen, now in the final year of her term as Fed Chair: She has overseen the end of large-scale asset purchases in 2013; the lift-off of rates from zero in December 2015; and now the pullback from an unprecedented balance-sheet build-up without disruption to financial markets or the economy (so far!). "*The labour market has continued to strengthen*" and economic activity "*has been rising moderately so far this year*," the Fed statement said. The FOMC repeated language saying "*near- term risks to the economic outlook appear roughly balanced*," and reiterated that interest rates are likely to rise at a "*gradual*" pace going forward (Fed officials estimates three quarter-point rate hikes would be appropriate next year - the same number they saw in June - based on the median in the so-called dot plot of interest-rate forecasts). The Fed's decision to exit from balance-sheet policies comes a decade after the global financial crisis began to tip the economy into a recession at the end of 2007, and is a milestone in the global retreat from crisis-era stimulus. The reduction in assets will be slow - just $10 billion a month to start ($6 billion in Treasuries and $4 billion in mortgage-backed securities per month, rising every three months until the amounts reach $30 billion and $20 billion per month, respectively). The Fed anticipates ending the runoff at some point, though it doesn't yet have a specific date.

Most analysts agree with the Fed's plans to slowly deflate its balance sheet, but find it much harder to understand the central bank's hawkish tone on interest rates. In their view (I personally disagree), raising rates is unnecessary as inflation has slowed well below the Fed's 2% target and policymakers have lowered their median projection this year and next, with core inflation looking especially soft despite a solid labour market. Janet Yellen, the Fed Chair, has offered various explanations for the persistent shortfall in inflation over the past couple of years, ranging from spare capacity in the jobs market following the recession, to falling energy prices and dollar strength. Yet she admits this year's undershoot of the inflation target is "*more of a mystery*". The Fed is hardly alone in this dilemma: In the Eurozone, UK and Japan, policymakers are also struggling to understand why decent growth and falling unemployment do not appear to be creating any pressure on wages or consumer prices (plausible theories include the growth of online retail and digital platforms that make workers in advanced economies more vulnerable to global competition. Additionally, poor productivity growth and demographic change are boosting people's propensity to save).

One reason for the Fed - and for that matter the Bank of England - to signal rate rises may be simply to warn investors against complacency. The question then is whether monetary policy is the right tool to tackle asset bubbles, especially given recent enhancements brought to the macro-prudential policy tools since the global crisis. "*While there are risks that inflation could continue below 2%, which we need to take account of in monetary policy, monetary policy also operates with a lag and experience suggests that tightness in the labour market gradually tends to push up wage and price inflation*," Yellen suggested. The Fed should not sit back and let the economy "*overheat*", she added (well said!!). As Stephen Roach - former Morgan Stanley's Asia chief, currently serving as senior fellow at Yale University - rightly puts it: Central Banks' interventions are fraught with peril, inflation is a lagging indicator, policy levers are still largely at crisis setting (when they should have rationally returned to normal settings), financial stability needs to be inserted into Fed's and other central bankers' mandate, and the US Fed needs to figure out now what their new mission is!

And if you thought implementing those changes would amount to a challenging task in normal times, just picture what it would qualify as during periods of heightened tensions: Indeed, North Korea threatened overnight to detonate a hydrogen bomb in the Pacific! That follows recent warnings by Kim Jong Un that Donald Trump would "*pay dearly*" for his threat this week to "totally destroy" North Korea if America was forced to defend itself and its allies. In a statement hours after the US imposed more sanctions on Pyongyang yesterday, Mr. Kim has called Mr Trump "*mentally deranged*", and a "*gangster fond of playing with fire*", who was "*unfit to hold the prerogative of supreme command of a country*". The North Korean dictator added that Mr Trump's speech to the UN General Assembly - where the US president declared that "Rocket Man is on a suicide mission" - had convinced him that his decision to continue developing nuclear weapons was the "correct path"!

*Wednesday Pre-FOMC Meeting "Warm Up" Write-Up*

At a time President Donald Trump was bluntly threatening North Korea - during his first speech to the United Nations General Assembly - with annihilation if it menaces the U.S. or its allies, whilst also vowing to crush the "loser terrorists" who have struck violence across the globe and urging nations to join together to stop Iran's nuclear program (declaring the Iran nuclear deal an "embarrassment" for the US), the US Federal Reserve was holding its 2-day meeting – with an unchanged rate announcement expected for later this evening (9:00 pm Bahrain time) as well as a long awaited signal that balance sheet normalization will start in early October (i.e. giving the go-ahead to reducing the size of the US central bank's balance sheet - currently at $ 4.5 trillion – with initial monthly reductions of just $ 10 billion).

Market participants widely expect these two outcomes, so they will come as no surprise. The real action at this September FOMC meeting will come from the Fed's description of the economy, the quarterly economic projections (Summary of Economic Projects and updated Fed's Dots) and Chair Janet Yellen's ensuing press conference. And while markets expect the totality of the commentary to lean dovish as the Fed expresses concerns about the inflation outlook (and possibly refer to the current political stalemate in the US), the surprise would be a Fed that still leans more heavily toward the hawkish side of policy spectrum (i.e. continues pushing for one more rate hike for 2017 and three "25 bps" hikes in 2018, in line with the Fed's last projections, released on June 14th, 2017).

Finally!! ☺ A decade after the financial crisis first erupted, the U.S. is finally set to lead the developed world in exiting unconventional policies (Quantitative Easing) that central banks unleashed to effectively push long-term yields down / equities up and save the global

economy. And whilst it will take years to complete and assess the final impact, the timing - to some analysts - couldn't have been worse: Fed Vice Chairman Stanley Fischer has already announced he is resigning (thus today's Federal Open Market Committee's meeting will be his last) and Fed Chair Yellen's time atop the central banks runs out in February 2018, unless Trump decides to re-nominate her. Those uncertainties – coupled with the lack of progress on Trump's promises and pro-growth agenda as well as rising geopolitical tensions across the globe - are expected to negatively impact future growth.

Asset purchases are now an "important" component of the Fed's monetary policy toolkit, Yellen told the central bank's annual symposium in Jackson Hole, Wyoming, in 2016. Such talk has left some conservative economists uneasy: QE is "unconventional" monetary policy and should NOT be needed under normal business cycle conditions in the future," Harvard University professor Martin Feldstein previously noted. Stanford University professor John Taylor, a potential Fed Chairman once Yellen's term ends in 2018 - has also sharply criticized QE. If the Fed hit the zero lower bound and needed to aid the economy, Taylor would prefer it first used forward guidance -- a communications strategy that commits the Fed to keeping short-term rates lower for longer -- tied to a monetary policy rule to help bring long-term interest rates down.

Moving to the Fed's anticipated new quarterly economic projections, one can note that - in general - policy makers retain an optimistic outlook on economic growth. The second-quarter GDP rebound brings first-half average growth in line with the Fed's full-year expectations. Central bankers will likely also call attention to solid consumer spending and firming business investment in the post-meeting statement, while retaining the GDP forecast for the full year. Yellen & Co. may also bring attention to some disruptions in the data due to recent hurricane activity, but will view any impacts as temporary. Then comes inflation, the sticking point for central bankers looking to retain the Fed's June rate projections. The central bank's preferred inflation indicator stubbornly refuses to cooperate with earlier Fed forecasts of a nearly target rate by the end of this year. Therefore, given the magnitude of the inflation weakness, it seems inevitable that the 2017 inflation projections undergo a downward revision. Moreover, persistently low inflation and soft wage growth would - more likely than not - induce policy makers to lower their estimates of longer-run unemployment, with lower revisions placing downward pressure on rate projections ("dots") for this year and next, assuming the Fed remains true to its reaction function.

In sum, the picture painted by the Federal Reserve should have a slight dovish tint in response to inflation weakness that increasingly looks more persistent than transitory. Still, with growth powering ahead in the US , Europe and Asia, there is a strong case for the Fed to continue sounding bullish and hold to its upbeat growth/rate forecasts (in which case the US$ would rally – last EUR/USD @ 1.2016, whilst US yields continue their upward march – last on UST 10s 2.22%).

Many economists predict the time is not right for Yellen & Co. to rock the boat, especially that market participants are now required to better digest the implications of a Federal Reserve balance sheet that will imminently start running off. Will know more later this evening and keep our clients updated accordingly!

***Fed's Economic Projections (median of central tendency) from June***

| Indicators (%), *latest values in italics* | 2017 | 2018 | 2019 | Longer Run |
|---|---|---|---|---|
| Change in real GDP *First half 2017: 2.1%* | 2.2 | 2.1 | 1.9 | 1.8 |
| Unemployment rate *August 2017: 4.4%* | 4.3 | 4.2 | 4.2 | 4.6 |
| PCE inflation *July 2017: 1.4%* | 1.6 | 2 | 2 | 2 |
| Core PCE inflation *July 2017: 1.4%* | 1.7 | 2 | 2 | |
| Federal funds rate *Current target: 1.0-1.25%* | 1.4 | 2.1 | 2.9 | 3 |

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