United States

Rich, deep, serious

- **The Fed decided to leave monetary policy unchanged. It however clearly announced a hike is more than likely before year-end.**
- **At the same time, FOMC members lowered the likely path and magnitude of the current tightening cycle.**
- **To sum-up, this week FOMC was a hawkish status quo full of dovish nuances.**
- **That might sound quite complicate but in the end, the Fed managed to have financial markets cheer up a monetary tightening in the making…**

The FOMC meeting ended on a status quo, but policy was tweaked: a hawkish status quo full of dovish nuances, a mastery if such thing does exist in monetary policy. Hawkish because the Fed almost pre-committed to a hike by the end of the year, stressing that "near-term risks to the economic outlook appear roughly balanced". That feeling of hawkishness was accentuated by the dissent from three different regional Fed presidents that would have preferred to increase rates on Wednesday. As for two of them, we can be sure that their vote was motivated by concerns about financial stability. Esther L. George, from Kansas City, was always a likely dissenter: from March (with the exception of the June meeting), she voiced her preference for a rate hike, after having been a constant hawkish dissenter in 2013 (until the Fed finally decided to taper QE3 in December). The second one is Eric S. Rosengren (Boston). For a long-time, he was a "centrist dove", often seen as broadly in line with Janet L. Yellen. But over the recent months, he became concerned by the commercial real estate market, and we assume his decision to dissent is related. The third one, Loretta J. Mester (Cleveland), in her most recent comments, in July, pointed to the three usually mentioned risks: acting too late might prompt to acting too bluntly afterwards, too-low rates might jeopardise the ability of monetary policy to respond to a slowdown and… risks on financial stability. We may know more about what mainly worry her when she speaks in New York on October the 7th.

There are also several dovish elements, especially when it comes to the medium to long-term outlook. Updated projections from FOMC members included a new point-year: 2019. Downward everything came, from growth to inflation and to the projected path for the Fed Fund Target. The message is that growth is stuck in the current slow-mode of 2%. Such a low rate of growth, even if sufficient to keep the unemployment rate close to the estimated level of the NAIRU (Non-Accelerating Inflation Rate of Unemployment), would not be enough to pull inflation back towards the Fed's 2% target before 2018. Even the most hawkish member(s) does not see inflation over-shooting the target (at 2.1%) before 2019.

The projected path for the Fed Fund Target (the famous "dots") once more got shortened (the projected final level of rates is down from 4.2% as of January 2012 to 2.6% currently) and lengthened (by 2019, the Fed Fund Target is projected to remain below the long-term equilibrium level, at 2.6% vs 2.9%). That revision goes beyond what is directly related to a downgraded economic growth. Long-term projections for GDP, from the highest to the most recent, have been cut by 70 percentage points. For the long-term level of interest rates, that downgrade is 130 pp.

In the long-term, we are all doves

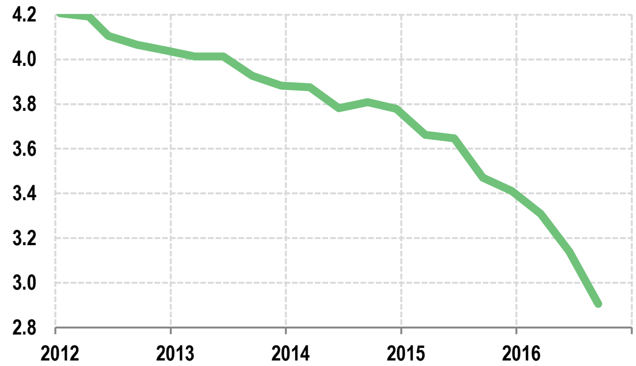

Chart Source: FOMC

FOMC members have told that the natural rate of interest had come down for some time now, usually adding that its current level was probably close to zero. During her press brief, Janet Yellen reiterated such remarks, adding that "the federal funds rate [being] modestly below the neutral rate, the current stance of monetary policy should be viewed as **modestly** accommodative". This reinforces the message of the dots: the Fed is serious when claiming the normalisation of monetary policy will be very gradual and now expects it to be even more measured than previously thought. FOMC members project, following the 25 basis points hike this year (December is more likely than October-November), to tighten by 50 bp in 2017, 75 bp during each of the following two years. This puts the cumulative tightening at 225 bp. In 2015 and 2014, this 3-year projected path was 325 bp.

Telling the public that the tightening cycle will be less steep, will take longer to be completed at a lower final point is a clear dovish message. Answering questions during the press brief, Janet Yellen sent another highly dovish message, declaring that the FOMC does not "want the economy to overheat and **significantly** overshoot [their] 2% inflation objective". That sounds like overshooting is not excluded…

In the end, the strategy of the Fed, in signalling the next hike was coming soon while stressing that over the medium-term they were planning an easier policy stance, was successful when it comes to managing financial markets: the stock markets closed up, as well as the bond market and the dollar was broadly unchanged. If the Fed had chosen to increase rates this week, the story would have been way different…