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Economic Flash!

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Federal Reserve: Near-Term Clarity, Long-Term Confusion

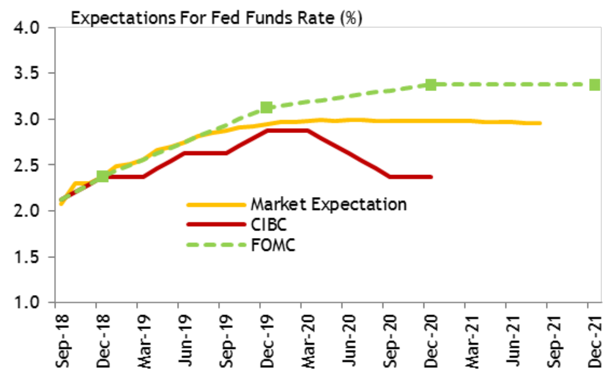
- The FOMC came together, saw that the economy was still strong, and hiked rates 25bps for the third time this year. No surprise there. Guidance for the near-term trajectory of interest rates, in terms of the dot plot and statement language, was also little changed. However, guidance for longer term interest rate prospects appeared somewhat confused, with the statement dropping the phrase that "monetary policy remains accommodative", but the "longer-term" interest rate projection actually moving up slightly.

- For the next twelve months or so, it seems that the Federal Reserve is content to keep raising interest rates at the current pace of 25bps a quarter. The statement still said that "further gradual increases" will be needed to keep growth, labor market conditions and inflation consistent with its mandate. The dot plot projections also still showed one more hike this year, and three in total for 2019. That's unchanged from the June projections and only slightly more in terms of cumulative increases than our projection and market expectations (Chart 1).

- It's the longer term guidance from the FOMC that diverges more from our own forecasts, and also appears to show differing opinions within the Fed itself. Today's statement, for example, removed the phrase that "monetary policy remains accommodative", suggesting that we are too close to a perceived neutral rate for the committee to classify that as accommodative. However, the median dot plot forecast for the "long-term" rose slightly to 3%, from 2.875%, and Chair Powell mentioned in his opening remarks that financial conditions were still accommodative, before then specifically talking about how the dropping of that phrase in the statement didn't reflect a change in thinking from policymakers.

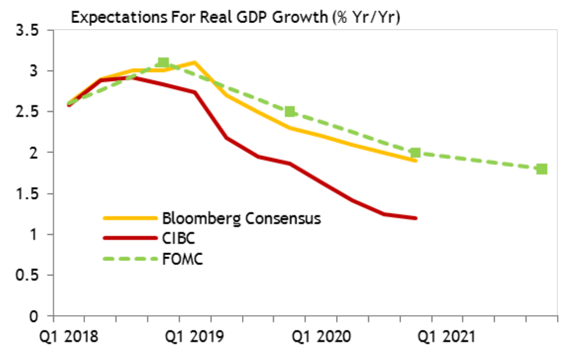
- Even without that apparent confusion, the Fed's longer term projections for interest rates differ quite a bit from ours, because we're unconvinced that the Fed can keep raising interest rates further above neutral in 2020 when fiscal policy turns from being a tailwind to a headwind. Indeed, with fiscal policy by 2020 likely to be shaving about 0.7%-pts from GDP, having added about the same amount in 2018 and 2019, growth could see quite a notable slowdown and interest rate cuts could be in the cards.

Chart 1 – Interest Rate Forecasts



Source: Federal Reserve, Bloomberg, CIBC

Chart 2 – GDP Forecasts



Source: Federal Reserve, Bloomberg, CIBC

- As such, we expect a much slower growth profile than the median of FOMC projections which today were actually upgraded slightly, not just for 2018 (3.1% from 2.8%) but also 2019 (2.5% from 2.4%). While the 2% median forecast for 2020 was unchanged from the June projections, it's still quite a long way above our forecast (Chart 2).

- The Fed's economic outlook was also extended to 2021 for the first time and showed that policymakers expect a slowdown in q4/q4 GDP growth to its long-term trend rate. According to their forecast, that will be enough to nudge the average unemployment rate in Q4 up a sliver while remaining below the level that the Fed sees as its longer term equilibrium. And while a slight loosening in labor market conditions could see inflationary pressures ease a hair, they will remain slightly above the Fed's 2% target, justifying their forecast for an unchanged Fed funds rate in 2021.

- We still see the Fed moving towards taking a more cautious approach to monetary policy than projected in the statement, given the magnitude of the expected fiscal drag in 2020 which will likely push the unemployment rate up.