Central Banks

FOMC Preview: December 15-16th Meeting

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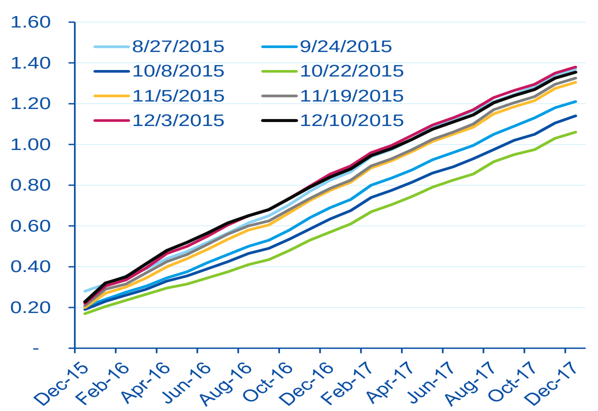
Market Expectations for Liftoff Jump Above 70% as FOMC Heads into Talks

- **Strong market sentiments should help reduce volatility surrounding liftoff**
- **FOMC members likely to set aside inflation concerns to get over this first rate increase**
- **December projections should reveal a slower expected rate path compared to September**

The FOMC is heading into the December meeting with a rate hike announcement in its back pocket. All signs are pointing to a 25 basis point increase in the target range for the federal funds rate, with markets pricing in above 70% probability of liftoff. Labor markets have shown real improvement, with the latest data offsetting the small blip in job growth that caused some concerns of a slowdown back in 3Q15. Inflation remains low, but significant downward pressures seem to have stabilized for the most part. Despite the fact that some economic reports have failed to gain momentum in 4Q15 (especially those related to manufacturing and the strength of the USD), most FOMC members seem comfortable finally raising rates at this time. This holds in line with our expectations for a hike by the end of 2015 yet does not change our view for a very gradual pace of increases in 2016. It is important to remember that the Fed has heavily emphasized the future path of interest rates rather than just the initial jump itself, as this is just one hike of many more to come on the road to normalization.

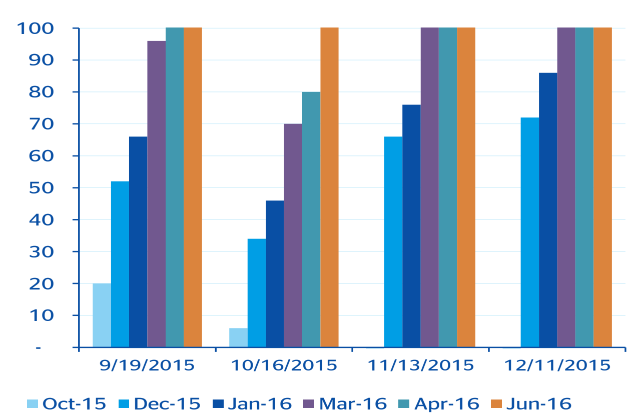
Market expectations have been setting the stage for liftoff ever since the relatively hawkish October FOMC statement. The implied probabilities from federal funds rate futures bounced from a low around 35% in early October to near 80% in the days leading up to the December meeting. While it may not be in the Fed's best interest to let markets completely dictate their policy moves, it would behoove them to take advantage of such market preparedness. This could certainly help reduce any unwanted volatility surrounding the first rate hike and may help push some of the more reluctant doves towards a liftoff decision.

Chart 1
Federal Funds Rate Futures (%)



Source: Bloomberg & BBVA Research

Chart 2
Fed Funds Futures Implied Probabilities (First 25bp, %)



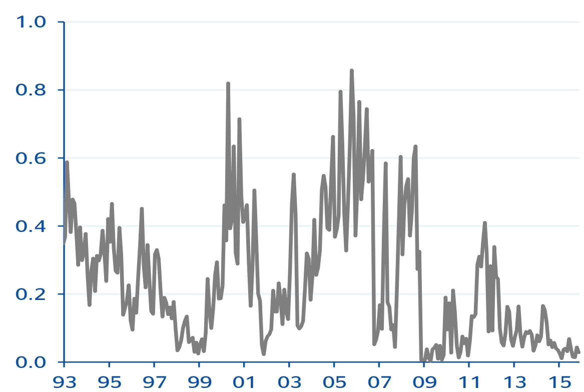
Source: Bloomberg & BBVA Research

Regardless of what markets are saying, economic activity should be the driving force behind the decision on December 16th. The employment situation has certainly improved from more worrisome reports back in August and September, with nonfarm payroll growth back above 200K on a monthly basis and the unemployment rate at 5.0%. Wage growth has also picked up slightly, and the number of involuntary part-time individuals (Yellen's most commonly mentioned indicator) has declined. There are some remaining concerns (i.e. the low participation rate) but most FOMC members are happy with the past year's reduction in underutilization and are convinced that the labor market is close to full employment.

If the Fed were only concerned with employment and could ignore the ongoing stretch of stubbornly low inflation, they probably would have increased rates earlier this year. However, the FOMC doves were adamant about waiting for some signs of movement towards their 2.0% inflation target. Transitory factors have not faded as fast as many had expected, with the strengthening USD and falling import prices still a serious concern that will spill over into 2016. Stanley Fischer (Vice Chairman) recently noted that a 10% appreciation of the USD could reduce core inflation by a half percentage point (with about a two quarter lag). The ongoing weakness in the global economy and the Fed's movement toward normalization will likely add further upward pressure to the dollar, and therefore, downward pressure on inflation. Furthermore, oil prices have recently retreated again below $40/barrel, putting additional downward pressure on inflation trends as we head into the new year. This will certainly be a point of contention among the few FOMC members that will argue to hold off on a rate hike.

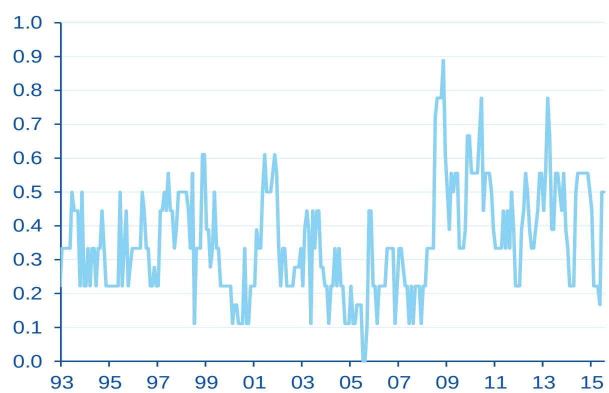
The hawks, however, may point to the latest shift in producer prices as fuel to support a liftoff decision. November's data suggested a 0.3% monthly pick up in both headline and core producer prices, reversing the negative trend of the previous few months. On a YoY basis, headline PPI remains in negative territory while core prices avoided a move below zero, up 0.5% in November. The data indicate a big jump in services PPI, with gains in most subcomponents confirming expectations of strong domestic demand to close out 2015. Still, it is hard to argue with just one report that deflationary pressures are totally easing. Most of the drivers in the PPI report are extremely volatile on a month-to-month basis and therefore are not a clear sign of inflationary pressures at the moment. With weakness still stemming from the goods side of PPI, FOMC doves are likely to push for at least another few months of strong producer prices before conceding to the hawks.

Chart 3
St. Louis Fed Price Pressures Measure (Probability, %)



Source: St. Louis FRB & BBVA Research

Chart 4
BBVA Research Deflation Vulnerability Index (%)



Source: BBVA Research

Regardless, it is safe to say that this period of below-target inflation will drag on at least through next year. Recent analysis from the St. Louis Fed suggests a near-zero probability that core PCE inflation (the Fed's preferred measure, which sits at just 1.3% now) will reach 2.5% in the next 12 months. Our own analysis suggests that deflationary pressures are still very real. While this may not impact the timing of liftoff, it will certainly have an influence on the projected rate trajectory in 2016.

The latest Fed speeches have touched on this lack of confidence in the inflation outlook, though most FOMC members seem willing to ignore their concerns in order to finally kick start normalization. If they follow through with the rate hike, we are likely to see a dissent or two at the meeting, with some doves wanting to wait for further signs of inflationary pressures before liftoff. Charles Evans (Chicago FRB) is a likely candidate for dissent as he has admitted "to some nervousness about our upcoming decision." He has even admitted to the risk of possibly needing to cut back rates again if premature liftoff proves that they "have misjudged the strength of the economy or the upward tilt in inflation." However, other members such as James Bullard (St. Louis FRB, voting in 2016) will push for liftoff now with the feeling that "it was probably a mistake to delay from September."

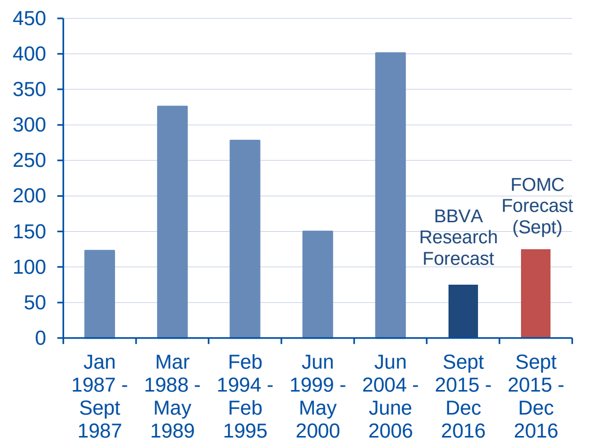
Chart 5
Recent Fed Speak

FOMC Voting Members	Fed Funds Rate	Employment	Inflation
Janet Yellen (Chair)	"When the Committee begins to normalize the stance of policy, doing so will be a testament, also, to how far our economy has come in recovering…it is a day that I expect we all are looking forward to."	"Despite these substantial gains, we cannot yet, in my judgment, declare that the labor market has reached full employment."	"I anticipate that the drag from the large declines in prices for crude oil and imports over the past year and a half will diminish next year…I expect inflation to move up to the FOMC's 2 percent objective over the next few years."
Stanley Fischer (Vice Chair)	"While we at the Fed continue to scrutinize incoming data, and no final decisions have been made, we have done everything we can to avoid surprising the markets and governments when we move, to the extent that several emerging market (and other) central bankers have, for some time, been telling the Fed to 'just do it'"	"…the U.S. economy has performed relatively well--as is visible especially in our steady progress toward full employment…"	"Some of the forces holding down inflation in 2015, particularly those due to a stronger dollar and lower energy prices, will begin to fade next year."
William Dudley (New York FRB)	"I see the risks right now of moving too quickly versus moving too slowly as nearly balanced…But I can't tell you today precisely what I'd favor doing in the future, because that future remains uncertain."	"We are now much closer to our goal of maximum sustainable employment than at the start of the year."	"I have greater concerns because we continue to fall substantially short of our inflation objective…If the economy continues to grow at an above-trend pace, then I think worries about inflation remaining too low should begin to recede."
Lael Brainard (Governor)	"…'gradual and low' is likely to be the new normal."	"One way to think about the spillover from abroad is how much adjustment in the federal funds rate might be necessary to insulate domestic employment from an appreciation in the dollar that is expected to persist."	"The persistent weakness in core price inflation deserves continued vigilance."
Jerome Powell (Governor)	No recent commentary		
Daniel Tarullo (Governor)	"There's been an awful lot of talk about specific months…I think probably a little too much talk to be as useful in conveying the views of the Fed to markets."	"…no question we've made progress in the labor market."	"It's hard to overlook the fact that both market-based measure of inflation compensation and survey-based measures of inflation expectations are sort of near historic lows … it will be important for us to keep our eye on both those kinds of measures."
Charles Evans (Chicago FRB)	"Should we raise rates or not? I admit to some nervousness about our upcoming decision."	"I don't think we're quite there yet, but we have made good progress toward meeting our employment mandate."	"Before raising rates, I would prefer to have more confidence than I do today that inflation is indeed beginning to head higher."
Jeffrey Lacker (Richmond FRB)	"I've thought the case was strong for over six months now. I'm hoping I can be more persuasive in December."	"I don't see slack in the labor market. I think we are in confidence bounds of every estimate I've ever seen of full employment or maxium employment."	"The actual behavior of inflation in recent years does not warrant such pessimism."
Dennis Lockhart (Atlanta FRB)	"I, personally, am ready. I think the conditions are satisfactory, I think the market is well prepared."	"I think the economy is closing in on full employment. As we approach that condition, I would expect to see confirming evidence that labor markets have tightened up."	"As the economy evolves in 2016 and 2017, I am one who will be looking for more direct evidence of converging to the inflation target. I'm comfortable with making a first move; I would be less comfortable with making subsequent moves without supporting evidence our inflation objective, especially, is in the process of being achieved."
John Williams (San Francisco FRB)	"The first step in bringing policy closer to normal was when we ended QE. The next appropriate step is to raise rates. My preference is sooner rather than later for a few reasons."	"I see a labor market that's growing ever stronger and will reach maximum employment on a broad set of measures later this year or early next year."	"The economy is a moving target, and waiting until we see the whites of inflation's eyes risks overshooting the mark."

Source: FRB & BBVA Research

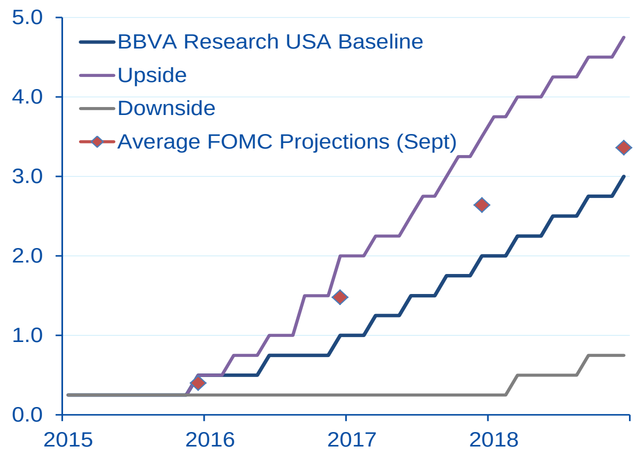
The December meeting will produce another round of economic projections, and we expect to see further revisions compared to September's release, particularly as it relates to the future path of interest rates. In September, the median FOMC projections hinted at approximately five rate hikes by the end of 2016, including liftoff this December. Our expectations were much more pessimistic, implying only three hikes by the end of next year. With the updated Summary of Economic Projections, we expect that the Fed will revise down their projected path under the assumption that they will want to wait at least one quarter between the first and second increase in order to assess the first hike's impact on the real economy. If all things go well, they may pick up the pace in the second half of the year – though with the presidential election in November they may be less willing to push ahead full steam. How the economy reacts to this first hike will be extremely telling as to how fast or slow the Fed will be able to move with additional rate increases.

Chart 6
Average Change in Federal Funds Rate Per Tightening Period (Basis Points)



Source: FRB & BBVA Research

Chart 7
Federal Funds Rate Projections (%)



Source: FRB & BBVA Research

Bottom Line: All Signs Pointing to December Liftoff but Slow Pace in 2016

The FOMC is on track to finally increase the federal funds rate on December 16th after establishing the near-zero threshold nearly seven years ago. Inflation may be running low, but labor market improvements and the readiness from financial markets are providing a solid footing for the Fed to finally push forward with policy normalization. Starting now should help keep the Fed on a smoother trajectory going forward, as long as they stick to a clear communication strategy to keep economic and financial reactions under control. Regardless, the FOMC is not necessarily looking for perfect consensus at the meeting, just enough support for liftoff at this time. There may be more certainty on a rate hike now, but there is still a lot unknown about how markets will react and the pace at which the Fed will feel comfortable moving ahead in 2016.