Central Banks

FOMC Statement: December 15-16th

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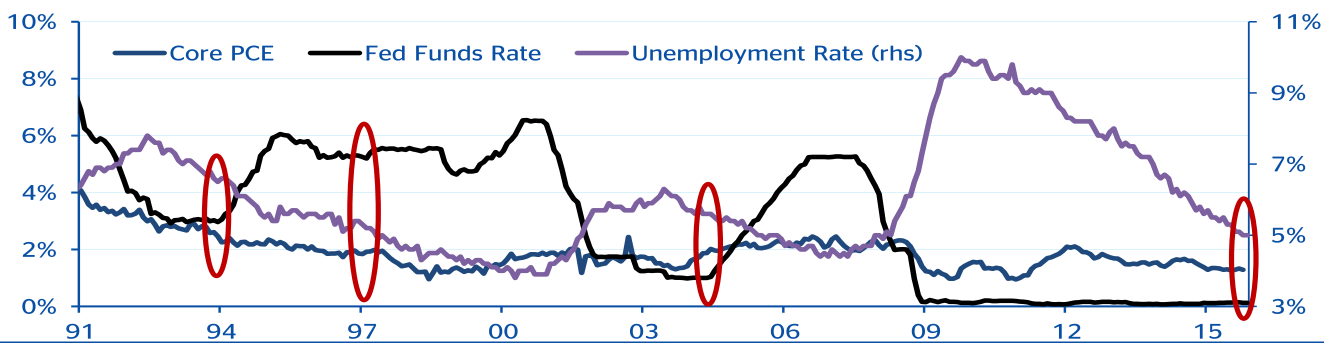
The Force Awakens: Yellen and Fellow FOMC Jedis Announce Rate Hike

- **25 basis points increase we have**
- **FOMC reasonably confident in their outlook**
- **Dovish undertone confirms our expectation of a cautious and gradual approach**

Finally, we have liftoff! Today, as we expected, the FOMC made the bold decision to raise the federal funds rate for the first time since June 29, 2006 (when the rate was increased to a whopping 5.25%). This announcement came on the back of increased signaling from financial markets but still widespread opinion and uncertainty among Committee members as they battled views on persistently low inflation against sufficient labor market improvement. Ultimately, FOMC members unanimously agreed that this was an appropriate time to begin the long process toward policy normalization. In doing so, they have given us a boost of confidence that the U.S. economy is strong enough to handle higher interest rates, despite the risks from abroad that are still lingering. In starting the normalization process, the Fed is betting that economic data continue to improve.

So after all this time, what made the FOMC finally decide to power up the Death Star? The statement emphasized that "taking into account domestic and international developments, the Committee sees the risks to the outlook for both economic activity and the labor market as balanced." However, current circumstances are much different than in previous tightening cycles, making it harder to justify this historic move. In fact, some dovish members have spoken out in recent weeks on their concerns that core PCE inflation is much lower now than it was in the past few decades. Back in June 2004, for example, core PCE inflation had already hit 2.0% before the Fed decided it was time to increase the federal funds rate. Inflation is as low today as it was prior to the July 1999 tightening cycle, but the unemployment rate was at a very low 4.3%. Currently, the unemployment rate is not too far away at 5%. The biggest difference, though, is that rates have never been this low for such a long period of time, adding even more uncertainty to the decision. If things go south after liftoff, there's little wiggle room left for the Fed to bring rates back down again in order to fight off another recession.

Chart 1
Unemployment, Inflation, and the Federal Funds Rate (%, YoY % Change, %)



Source: BLS, BEA, FRB, & BBVA Research

In general, the FOMC judged that “there has been considerable improvement in labor market conditions this year,” reflecting members were mostly comfortable with the reduction of slack in the economy. Most notably, the unemployment rate has fallen to 5.0%, the lowest since April 2008, settling in at the Fed’s long-run equilibrium forecast. Furthermore, there has been a significant decline in long-term unemployment (27+ weeks), dropping below the level of short-term unemployed (less than 5 weeks) for the first time since before the crisis. Wage growth has also shown signs of increasing momentum in recent months, and the ongoing rise in job availability and working hours suggests that businesses are nearly ready to increase wages in order to boost their workforce.

The Committee also felt “reasonably confident that inflation will rise, over the medium term, to its 2 percent objective.” The latest inflation data, while low, has proved to the FOMC that transitory factors are still playing a huge role. Excluding the more volatile energy component, core inflation appears stable and the Fed seems to believe that prices will increase at a faster pace once these temporary headwinds fade. According to the statement, the Committee is also “recognizing the time it takes for policy actions to affect future economic outcomes.” This suggests that the hawks were able to win over the doves under the assumption that the impact on inflation is lagged and could even overshoot the target. With this in mind, “the Committee continues to monitor inflation developments closely.”

In addition to meeting the dual mandate, the decision also reflects the cost-benefit analysis associated with delaying liftoff. Yellen and her colleagues have emphasized the importance of increasing rates sooner to allow for a more gradual pace of future hikes and to avoid causing significant disruption in financial markets. In activating their lightsabers, the FOMC is allowing more time for adjustment, rather than being forced to increase rates at a faster pace in later quarters, with the risk that such a disruption could cause another downturn in economic activity. The statement clearly noted that the FOMC expects “only gradual increases in the federal funds rate” and that it “is likely to remain, for some time, below levels that are expected to prevail in the longer run.” This dovish bias helps to contain any over reactions in financial markets. Furthermore, the commitment to continue rolling over maturing securities and reinvesting principal payments reinforces the highly accommodative monetary policy stance.

Chart 2
Federal Reserve Forecast Comparison: December vs. September FOMC Statement and Press Conference (Central Tendency)

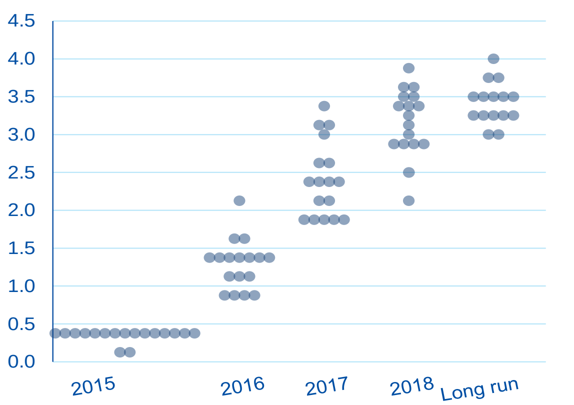
	December 2015 FOMC Projections				
	2015	2016	2017	2018	Longer run
GDP, 4Q yoy % change					
Low	2.1	2.3	2.0	1.8	1.8
High	2.1	2.5	2.3	2.2	2.2
Unemployment rate, 4Q %					
Low	5.0	4.6	4.6	4.6	4.8
High	5.0	4.8	4.8	5.0	5.0
Core PCE, 4Q yoy % change					
Low	1.3	1.5	1.7	1.9	
High	1.3	1.7	2.0	2.0	

	September 2015 FOMC Projections				
	2015	2016	2017	2018	Longer run
GDP, 4Q yoy % change					
Low	2.0	2.2	2.0	1.8	1.8
High	2.3	2.6	2.4	2.2	2.2
Unemployment rate, 4Q %					
Low	5.0	4.7	4.7	4.7	4.9
High	5.1	4.9	4.9	5.0	5.2
Core PCE, 4Q yoy % change					
Low	1.3	1.5	1.8	1.9	
High	1.4	1.8	2.0	2.0	

Source: Federal Reserve & BBVA Research

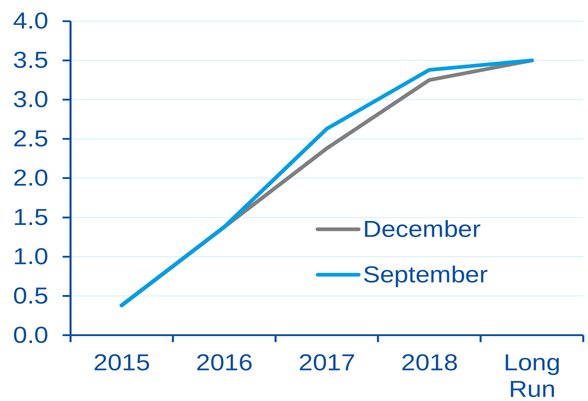
Also with today's statement, the FOMC released another round of modest revisions to the Summary of Economic Projections. The most notable changes were made to core PCE inflation forecasts, with downward revisions to the outlook for the next few years. At the same time, unemployment rate forecasts also shifted down slightly in light of the fact that we have already hit the 5.0% threshold. Minor revisions to GDP growth forecasts suggest a more centralized view of the economy holding at or below the 2.5% pace. The expected path of future interest rate hikes was mostly unchanged, with the Committee as a whole still seeing at least another three rate hikes in 2016. This, of course, assumes that economic data evolve in line with their projections. In any case, the dot plot continues to show high dispersion, underlying a variety of opinions on the meaning of "gradual" as it relates to the speed of normalization.

Chart 3
Target Federal Funds Rate Forecast, September (Year-end %)



Source: Federal Reserve & BBVA Research

Chart 4
Median Federal Funds Rate Forecast (September vs. December, Year-end %)



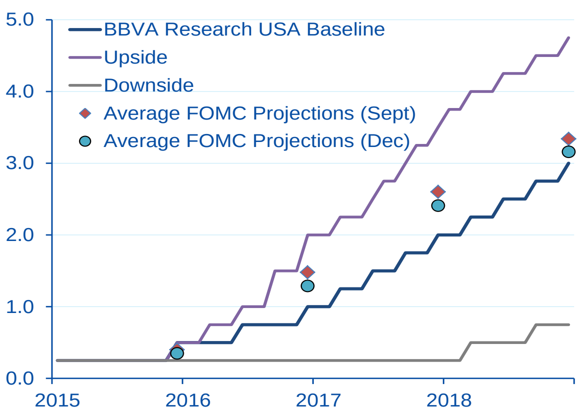
Source: Federal Reserve & BBVA Research

Yellen attempted to downplay today's policy decision at her press conference, emphasizing that monetary policy will remain accommodative for some time following liftoff. She confirmed that their outlined goals set for economic improvement had been "satisfied" and therefore warranted a rate hike at this time. Although the Committee continues to see risks stemming from global developments, Yellen argued that the strength of domestic activity was enough to offset the negative aspects of their outlook. Most importantly, Yellen addressed questions on the future path of rate hikes and policy decision making. She hinted that gradually increasing rates does not necessarily mean "mechanical" – the FOMC is certainly not committing to evenly spaced or sized rate hikes but will continue to respond appropriately to incoming economic data.

Despite diverging strategies of other central banks, the Fed's decision also took into account that markets had priced in an increase and that Congress is ready to pass a major tax and spending bill. Contrary to September's meeting, better market preparedness likely helped to calm the Fed's worries of a significant shock to the system following today's announcement. Markets reacted immediately, with equities finishing the day strong. Treasury yields also increased – the 2-year Treasury jumped to the highest level since April 2010, closing at 1.0045%, while the 10-year Treasury yield ended the day just slightly higher than opening, at 2.3%. In addition, the expectation for further gains in U.S. Dollar drove down oil prices by 3.3%.

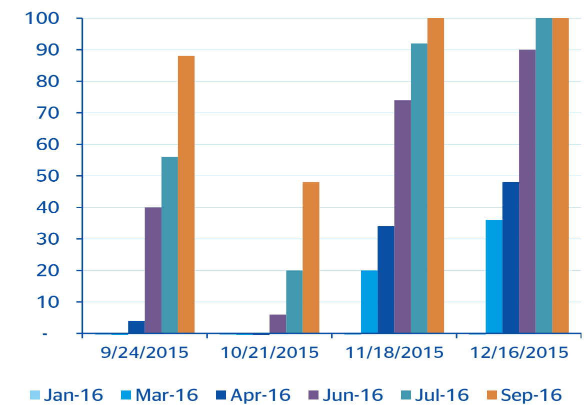
This milestone FOMC announcement allows the Fed to shift the attention from the date of liftoff to the pace of policy normalization. The Fed has overcome a huge obstacle with this first rate hike, but now they need to deal with the reaction and hope that the economy continues to move along in line with their outlook. As long as there are no major consequences to today's rate hike, the Fed can continue along with their data-dependent strategy and take additional steps forward. However, if there are unwanted reactions – increased financial market turmoil and/or a sharp downturn in economic data – then the Fed will need to utilize some additional monetary policy tools to contain some of these risks. Moving forward, we expect that the Fed will take a very gradual approach to future interest rate hikes, with only two more rate hikes to close out 2016 at 1.0%. It is likely that they will hold off on the second increase until 2Q16 as they assess the impact from liftoff.

Chart 3
Federal Funds Rate Forecasts (%)



Source: Federal Reserve & BBVA Research

Chart 4
Federal Funds Rate Futures Implied Probability (Second 25bp hike, %)



Source: Bloomberg & BBVA Research

Lastly, as promised, the Fed released an implementation note with today's statement as a means for further communicating the operational side of their monetary policy decisions in a way that will "increase public awareness and understanding." The note outlined the details of the Fed's announcement today including a rise in the interest rate on excess reserves to 0.5% as well as maintaining overnight reverse repurchase operations at an offering rate of 0.25%, both effective December 17, 2015. Another new item revealed in the implementation note was the removal of the cap on reverse repurchases operations used as necessary by the Open Market Desk to keep the federal funds rate in the FOMC's range.

Bottom Line: First Rate Hike is Only the Beginning of the Saga

Today's federal funds rate hike was an important decision for the Fed, but they are still fighting the dark side of inflation. It is likely that uncertainty will linger even after this initial increase as the Committee takes each additional rate hike on a meeting-by-meeting basis. Now that the target range is 25 basis points higher, the Fed needs to assess how markets react and whether the economy can handle such a change. This will take time, and the Fed will hold tight to their data-dependent strategy, monitoring incoming economic data to confirm that the move is playing out as expected. In doing so, they will continue to emphasize and communicate that the future pace of interest rate hikes will be gradual. Thus, we do not expect to see the next rate hike until 2Q16. Next year will also be interesting because the Fed will seriously begin discussions on implementing other monetary policy tools in order to reduce the size of their balance sheet. This will warrant a trial-and-error process as the Fed evaluates the efficacy of each tool and whether they need to introduce new tools or change existing ones already in place. *May the Force be with them!*

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