TD Economics

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Data Release: FOMC feels risks tilted to downside, but believes it is premature to alter outlook at this point

- In the first meeting since liftoff, Federal Open Market Committee (FOMC) officials acknowledged that recent global financial market turbulence and subsequent financial tightening could lead to perverse effects on the U.S. economy. Equity declines, as well as increased volatility in global were seen as risks that could potentially lead consumers and businesses to remain cautious with their spending plans. However, the extent of the persistence of global financial jitters and the severity of its impact were seen as unclear, with the Committee judging it "premature" to alter their medium-term economic outlook at this point.

- Meeting participants appeared to see through the weakness in fourth quarter growth, chalking it up to transitory factors such as lower inventory investment and weather related events, with some participants taking the preliminary growth estimate with a 'grain of salt' in light of potential revisions, suggesting that labor market signals tend to be more accurate indicators of economic strength.

- China was discussed, with structural changes and financial imbalances in the Middle Kingdom seen as having the potential to cause a "sharper deceleration" than envisaged and spill over into other EM economies or commodity producers, including Canada and Mexico.

- Nearly all participants agreed that the trio of declining equities, higher dollar, and widening credit spreads for some borrowers, should they persist, would constitute a "further firming in monetary policy." However, some suggested that these do not appear to be having an impact on U.S. economic developments, with some suggesting that equity valuations were now more in line with fundamentals, while few also indicated that CRE market valuations appear to be lofty and "should be closely monitored." Officials were also cognizant of the impact that the flat yield curve may have on bank net interest margins (NIMs).
- A few officials judged the existing slack in the labor market as being "largely eliminated" with low level of unemployment, reports of worker shortages, and firming wage increases. Several expected moderation in employment gains after the large increases at the end of 2015.

- Several officials saw the outlook for price inflation as dependent on further labor market improvement or above average economic growth. Most also viewed survey- and market-expectations of longer-term inflation as relatively well anchored, with some highlighting the difficulty in distinguishing movements in expectations from those related to risk and liquidity premia. Still, some viewed the inflation outlook as "more uncertain" or as having more "downside" risk. The only aspect of the outlook which the Committee fully agreed on was the fact that "uncertainty had increased," with some members suggesting that this poses more of a downside risk to the outlook.

- Symmetry of policy responses was also debated with several noting that currently, monetary policy is better positioned to respond to upside shocks than downside shocks, adding that "waiting" for more information is the prudent approach. Having said that, a couple of participants felt that financial market participants did not "fully appreciate" the data dependent nature of monetary policy.

- FOMC members were also briefed by the Fed staff on the implementation of the rate increase, which was perceived to have been conducted "smoothly" with money markets responding "as anticipated." Take-up in the overnight reverse repurchase agreements – a tool used to control short-term rates – was "as expected." The facility was previously limited, but the aggregate cap was suspended upon the rate hike. Support for reintroducing the aggregate cap was unanimous amongst the Committee, however there was far less consensus as to its timing, with most officials still favoring a relatively high cap level so as to ensure a relatively solid floor under short term rates, with particular need during quarter ends. The Committee still expects to the facility will be phased out when no longer required to control the federal funds rate.

Key Implications

- Minutes from the first meeting after liftoff indicated the Fed is thus far satisfied with the tools put in place at the New York Fed to facilitate rate liftoff, and appear confident that the mechanism can successfully deliver future hikes when they are deemed necessary.

- The tilting to the downside of risks related to a slowdown in China and potential spillovers to the global economy, alongside the firming in monetary policy that falling equities, rising dollar, and widening credit spreads may constitute suggests that the Fed is not going to rush to raise rates at this point. This is further corroborated by the asymmetrical monetary policy capabilities, with the Fed tackling upside risks with more ease than the converse.

- Having said that, officials believe it premature to alter their outlooks at this point. To reiterate, this outlook is made up of three facets: moderate economic growth, a strengthening labor market, and inflation that is likely to remain low in near-term, but track higher over medium-term.

- FOMC participants also appear to be seeing through the slower GDP figures, preferring to concentrate on labor market outcomes, which are seen as better indicators of economic strength and potential price pressures. Given that few officials already believed labor market slack was "largely eliminated" prior to the robust January employment report, and with signs of wage pressures and concerns over CRE valuations growing ever louder, we believe the Fed will gain the confidence it needs to raise rates by the time of its June meeting, with another hike in the second half of 2016 also likely.

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