OBSERVATION

TD Economics

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THE FEDERAL RESERVE'S CONUNDRUM: PART II

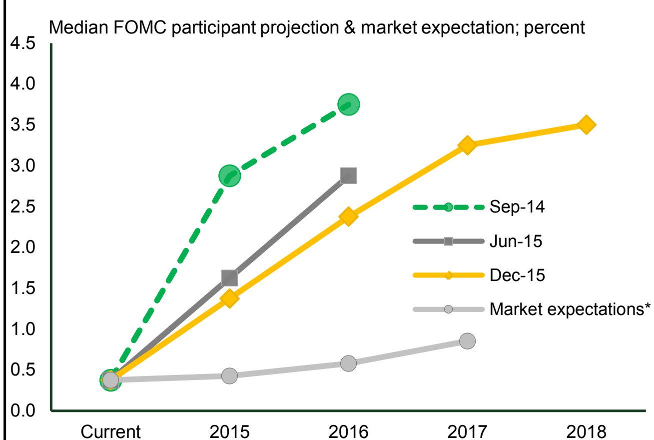
Highlights

- As they did last October, market expectations for interest rate hikes have moved further away from the Federal Reserve's projections. Fed funds futures are now pricing in less than a 10% probability of a rate hike by the end of 2016.
- A March rate hike is certainly off the table, but the market appears to have gone too far in pricing out rate hikes altogether for 2016. A necessary condition for the Fed will be some calming in financial market conditions and evidence of a persistence in solid economic underpinnings, particularly in relation to consumer and housing-led growth. We believe this should be apparent in June, and still view two rate hikes this year as a material probability.
- Part of the Fed's conundrum is in helping markets understand the lower threshold for economic growth necessary to evoke a policy response. While tighter financial conditions and a higher dollar have led us to revise down our economic forecast, we still expect real GDP growth of 1.8% and final domestic demand growth of 2.7%. This is still sufficient to continue to tighten labor markets and support an upward trend in inflation closer to the Fed's target over the medium term.

In October of last year, we discussed the Federal Reserve's conundrum in raising rates amid conflicting market expectations. At that time, markets were discounting the odds that any rate hike would occur by the end of the year, despite FOMC participants' communication of the opposite outcome within their "dot plot". We argued that the economic foundation was sturdy enough to support a modest rise in rates, even with a backdrop of emerging market uncertainty.

In what will likely be a persistent theme, conflicting expectations again dominate the rate outlook. In December, the Fed showed an expectation to raise the fed funds rate by 100 basis points this year. But, amid an intensification of global economic uncertainty and financial market volatility, fed funds futures have moved to the opposite end of the spectrum, carrying less than 10% probability of even a single quarter-point hike before year-end.

CHART 1: FEDERAL FUNDS PROJECTIONS & EXPECTATIONS



*OIS curve, Febraury 9, 2016. Source: Federal Reserve Board, Bloomberg.

As has happened in the past, the Federal Reserve will likely revise down its expectations for the pace of rate hikes closer to the market's view, but not altogether. A March rate hike is pretty much off the table. The headwinds from financial market volatility are simply too great for a Fed that has demonstrated a risk management approach to policy, alongside a preference for a period of relative stability. The Fed also wants to ensure limited transmission of the recent widening in corporate credit spreads and declines in stock market values to the broader economy. By June, the persistence in solid economic underpinnings should be

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evident, particularly in relation to consumer and housing-led growth. In our view, it is simply too early to dismiss the odds of two more rate hikes by the end of this year (June and December). The market appears to have gone too far in this regard.

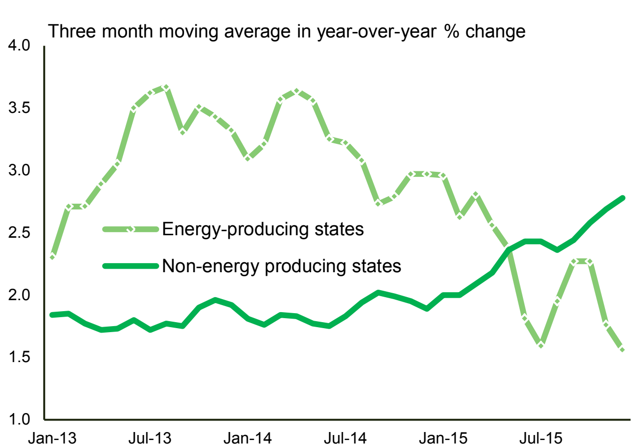
The American economy is still growing, even if slowly

We are mindful that fears of a downturn can become self-fulfilling, but our current modelling of the U.S. economy entering a recession within the next six months puts the probability at 30%, still far from a base case scenario. The more likely outcome is that the bout of risk aversion does not upend the economic recovery; particularly should it dissipate in the coming months.

Nonetheless, we have revised down our near-term economic outlook. This is partly related to handoffs flowing from the end of last year that will depress first quarter growth (now estimated at 1.5%), compounded by unseasonably poor weather. It is also due in part to a somewhat greater drag from net-exports as a result of the dollar's more extended increase. Finally, added to this is a measure of caution to the outlook for business and household spending, reflecting tighter financial conditions, increased risk aversion and lower household wealth. While we expect recent volatility to ease, some of the higher risk premium currently embedded in financial markets is likely to remain.

On an annual average basis, we expect real GDP growth of 1.8% in 2016, compared to our previous forecast of 2.4%. This estimate embeds an expansion that will average 2.2% over the final three quarters of the year.

CHART 2: AVERAGE HOURLY EARNINGS



Source: BLS, TD Economics.
Note: Energy-producing states includes: TX, NM, AL, CO, OK, WY, LA and WV.

Markets still adjusting to reality of slower trend economic growth

Makes you wonder: why do we think the Fed will raise rates at all this year?

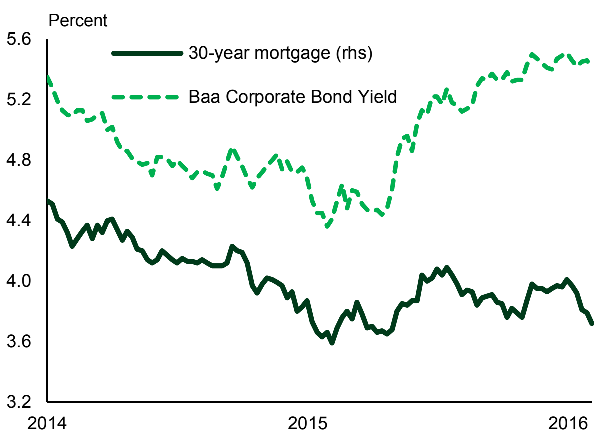
The economic fundamentals remain solid. Granted, unlike in the past, "solid" refers to an economy that grows in a 2%-2.5% range. This is a point we come back to time and time again when interpreting whether data is "surprising" on the upside or the downside. Part of the Fed's conundrum is in helping markets understand the threshold for economic growth that should evoke a policy response. It does not have to be gangbusters to justify gradually higher interest rates. Over the past seven years of the recovery, real GDP growth has averaged just 2.1% annually, which was sufficient to bring the unemployment rate down by over five percentage points. There is growing evidence that the trend level of productivity is even lower than previously thought. A lack of investment relative to depreciation has shrunk the stock of capital available to workers, weighing on labor productivity. At the same time, the pace of innovation appears to have slowed on a more structural basis, reducing total factor productivity growth (increases in output over and above increases in labor and capital).

A lower rate of trend economic growth has important implications for the conduct of monetary policy. Even with slower economic growth there will be continued downward pressure on the unemployment rate. While this suggests a lower end point for the fed funds rate, it also suggests the central bank may have to act sooner than markets are anticipating in order to stem inflationary pressures. Some may find it peculiar that we are discussing wage pressures, but as Chart 2 demonstrates feedthrough effects are already occurring. As long as the U.S. economy continues to post jobs of +100k, the unemployment rate will keep trending down below its natural rate and wage pressures will build. In addition, we have pointed out in past research the escalating risks occurring among some interest-rate sensitive sectors, like commercial real estate.

Don't count out the American consumer

Going forward, it's important to keep in mind that household spending will remain supported by the past decline in energy prices, in addition to the notable acceleration in wage growth that has already occurred. With rising wage growth, both real disposable income and real consumption are in good stead to grow by close to 3.0%. Add to this little

CHART 3: INTEREST RATES



Source: Federal Reserve Board

evidence thus far of contagion effects to the consumer base and housing markets from recent financial market instability. In contrast, mortgage rates have fallen by roughly 30 basis points since the start of the year (Chart 3), and unlike measures of credit standards to businesses, senior loan officers report continued easing in residential mortgage conditions. As long as credit remains available, this should continue to be a source of growth for the American economy.

Any interest rate decision by the Federal Reserve would need to prioritize these domestic conditions over international events. This is a particularly poignant considering that other central banks are pressing harder on the monetary stimulus pedal. Global central banks have gone from being in a somewhat steady state policy stance when the Fed hiked in December, to revving the engine again. On January 21st, Mario Draghi attempted to assuage market fears with mention that the European Central Bank could pump out more money as early as March, if necessary. One week later, the Bank of Japan surprised markets with a cut into negative territory. And last week, the Bank of England lowered their GDP growth expectations, pushing out market expectations for a rate hike on their end.

Bottom line

All of this suggests the Fed will continue to opt for a risk management approach, raising rates as long as the domestic data continue to show improvement, but not ceasing to do so all together in 2016. International developments support the notion of a more tempered pace to the Fed's tightening cycle than the "dot plot" of expectations currently displays. This should adjust downward with time.

The necessary condition for the next policy move is some calming in financial markets and sufficient evidence that recent events did not undermine U.S. economic fundamentals. This makes June the more ideal timing for a second modest lift in rates. As it currently stands, markets have pushed rate-hike expectations too far into the future, reminiscent of September of last year, when expectations of the first hike was pushed to March 2016, only to be pulled back in as data unfolded and markets settled down.

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