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Headline: Likely trajectory of Fed policy far from settled

COMMENTARY

Likely trajectory of Fed policy

"Although global developments tend to be wild cards, the much publicised trade tension between China and the US juts out like a veritable cowlick. This seemingly nagging consideration has the potential to complicate aggregate dynamics, sway broad market conditions and disturb the path of monetary policy."

By Thomas Lam and Davi d Fernandez

ALTHOUGH the November Federal Open Market Committee (FOMC) meeting was a sleeper, the December 18-19 one is expected to generate some buzz.

Firstly, we anticipate the FOMC raising the target range for the federal funds rate by 25 basis points (bps) to between 2.25 and 2.50 per cent in December. Effectively, this puts the funds rate either roughly in line with, or just a hairline below, the lower-end range of the longer-run nominal funds rate projected by Fed participants.

Secondly, we think that the overall tone of the December statement, despite the hoo-ha in financial markets, is likely to be reasonably upbeat. Also, we deem the chances of altering the phraseology of the forward guidance in December – a shift from hand-holding market participants to stepping-up the emphasis on data dependency and incoming information – to be fairly high.

Thirdly, we believe the composition of the funds rate projections by Fed participants is likely to shift down on average, though adjustments to the median forecast might be a close call. The odds of the 2019 median projection either remaining at three hikes or falling to two increases might be a coin-flip (while plausibly preserving one hike in 2020). Although we suspect the updates to the near-term economic projections are likely to be a shade weaker, minor changes to the longer-run estimates can possibly garner more attention.

Conceivably, the new FOMC lineup in 2019 – with four incoming rotating voters – will elicit more dissents. While a press conference is scheduled at every FOMC meeting next year, it is debatable whether the new setup would add clarity to the Fed reaction function or merely introduce unintended variability in policy expectations. (Nonetheless, the Fed will be reviewing "strategies, tools and communication practices" in 2019.)

We maintain our baseline Fed call of two rate hikes (50bps in total) in 2019, evidently flatter than the median forecast path of Fed participants at this time. This call is partly shaped by our view that inflation is unlikely to be an urgent concern next year as the risk of headline growth deceleration increases.

Given the latest split within Congress, we also anticipate fiscal policy to be incrementally less positive and the political environment to be decidedly more combative, further introducing a greater dose of uncertainty generally. Besides, the longer-term (slightly more than 12 months on average) likelihood of a recession, according to our model-based estimate, has edged up, hovering in the neighbourhood of 40 per cent at this time, though remains below the alert threshold of 75 per cent.

These assumptions imply that the recovery in the shorter-run neutral funds rate – the pertinent yardstick for assessing the near-term policy path – might be more tempered and less likely to run materially beyond the level of the longer-run equilibrium rate (as implied by the longer-run dot-plot). Hence, we do not think it is necessary to hoist the funds rate noticeably above our longer-run nominal rate estimate of roughly 3 per cent.

However, an alternative perspective on Fed policy suggests that, in an attempt to preserve the economic expansion, it is crucial to guard against the risk – or perhaps the mirage – of overheating. Basically, when fiscal policy nudges positively in one direction, along with the unem-

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ployment rate wiggling near a 50-year low, the Fed has to push back, regardless of the inflation backdrop and even as financial markets wobble. Furthermore, some contend that the shift from "headwinds" to "tailwinds", on net, might prospectively lift the shorter-run neutral funds rate above its longer-run trend, perhaps encouraging a higher federal funds rate, all else equal.

Therefore, "risk management" considerations would essentially incline the FOMC toward prolonging a gradual policy firming path until the weight of the evidence shifts. But our general reading of the tea leaves at this time suggests that a flatter Fed rate path is probably more prudent than a progressively steeper inclination.

THE ALTERNATIVE VIEW

Guardedly, however, we are not entirely unsympathetic to the preceding alternative view, partly because of the lingering concern of insufficient conventional monetary policy space in the next downturn. Given our baseline forecast, our calculations imply that additional unconventional policy thrust of at least US$1 trillion to roughly US$2.5 trillion will likely be needed during the next recession.

Aside from the policy rate debate, the normalisation of the Fed balance sheet, while more-or-less running on autopilot at this time, is also thought-provoking. Essentially, the concurrent slimming down of the balance sheet, all else equal, lifts the term premium, raises longer-term rates and tightens financial market conditions broadly. Clearly, policymakers heed the signals from and the state of general market conditions when they deliberate monetary policy.

But a mélange of factors surrounding the balance sheet has led the Fed to adopt a trial-and-error approach at this time, without committing to the ultimate size of securities held. This could potentially introduce additional volatility in longer-term rates.

Separately, the pace of balance sheet normalisation, when reserve scarcity issues emerge over time, can also exert some upward pressure on the effective funds rate. This dynamic can further compound the complex mix of policy considerations and communication hurdles in the future. At this juncture, however, the adjustments needed to promote the trading of the effective rate within the target range are largely because of "technical" developments, less influenced by the reduction in reserves.

Although global developments tend to be wild cards, the much publicised trade tension between China and the US juts out like a veritable cowlick. This seemingly nagging consideration has the potential to complicate aggregate dynamics, sway broad market conditions and disturb the path of monetary policy. At this time, we assume additional imposition of tariffs in 2019, potentially sapping US headline growth by several tenths. But our considered guess is that, eventually, as they say, the "unity of a common enemy" might help to defuse the tension.

Indeed, the continuing debate on the likely trajectory of Fed policy in 2019 and thereafter remains far from settled at this time. To paraphrase Paul Samuelson, monetary policymaking, like economics broadly, is "less than a science but more than an art".

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