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FOMC FAQS: FISCAL OR NO FISCAL?

John J. Canally, Jr., CFA *Chief Economic Strategist, LPL Financial*

KEY TAKEAWAYS

The Fed holds its first of eight FOMC meetings of 2017 this Tuesday and Wednesday, 01/31/17–02/01/17.

The fed funds futures market is not pricing in a rate hike this week.

There is no press conference by Fed Chair Janet Yellen, nor is there a new set of economic forecasts or dot plots at this week's meeting, only a statement.

Fiscal policy is unlikely to get a mention in the statement.

WHAT IS THE SCHEDULE OF EVENTS FOR THE FED THIS WEEK?

The Federal Open Market Committee (FOMC) meeting on Tuesday and Wednesday (January 31-February 1, 2017), will be followed by an FOMC statement at 2:00 p.m. ET on Wednesday, February 1, 2017. However, Fed Chair Yellen will not hold a press conference nor will the FOMC release a new set of economic forecasts (gross domestic product [GDP], the unemployment rate, inflation, or fed funds projections). Unfortunately, the FOMC statement is the only way the FOMC will communicate its views on the U.S. and global economy and the expected path for the fed funds rate to investors and the public this week. Markets will have to wait until the next FOMC meeting (March 14–15, 2017) for a new set of economic forecasts and dot plots from the Fed and a Yellen press conference.

HAS THE MARKET PRICED IN A RATE HIKE AT THIS WEEK'S MEETING?

In short, no. As of Monday morning, January 30, 2017, the fed funds futures market is pricing in just a 14% chance of a 25 basis point (0.25%) rate hike at this week's meeting.

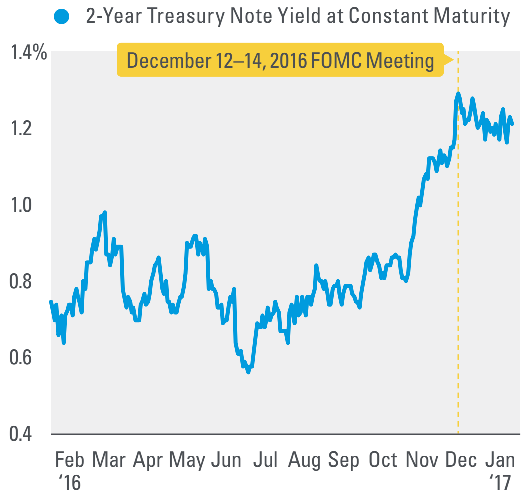
Another good proxy for what the market is pricing in is the yield on the 2-year Treasury note as the Treasury note is most sensitive to the Fed's actions. At 1.21% as of Monday, January 30, 2017, the yield on the 2-year note hasn't moved much since the Fed's 25 basis point rate hike on December 14, 2016. On that day, the 2-year note yield closed at 1.27%. On balance, markets are not expecting a hike this week, and only one of the 96 economists surveyed by Bloomberg News expects a hike this week.

HOW LARGE IS THE DISCONNECT BETWEEN THE FED AND THE MARKET ON RATES?

The FOMC's latest forecast (December 2016) puts the fed funds rate at 1.375% by the end of 2017. The Fed won't provide a new set of dot plots until its March 2017 meeting. The market (according to fed funds futures) puts the fed funds rate at around 1.125% by the end of 2017 [Figure 1], only 0.25% below the Fed's own projections. The latest set of dot plots from the Fed put the fed funds rate at 2.125% by the end of 2018, while the market currently expects the Fed funds rate to be 1.585% at year-end 2018. So, while not perfectly aligned—the FOMC and the market are rarely ever perfectly aligned on the future path of rates—there is general agreement between the Fed and the market.

This "agreement" between the Fed and the market is relatively new. In early 2016, just after the Fed's first rate hike of the cycle in December 2015, the FOMC's dot plots expected eight 0.25% rate hikes in 2016 and 2017. The market expected just two 0.25% hikes. That large disconnect between the market and the Fed was one of the root causes of the imbalances that plagued global financial markets in late 2015 and the first few months of 2016. Cleary, no such disagreement is evident today [Figure 2 & 3].

1 THE 2-YEAR NOTE YIELD-A GOOD PROXY FOR THE MARKET'S VIEW OF THE FED-HASN'T MOVED MUCH SINCE THE LAST FOMC MEETING



Source: LPL Research, U.S. Treasury, Haver Analytics 01/27/17

Performance shown is historical and no guarantee of future results.

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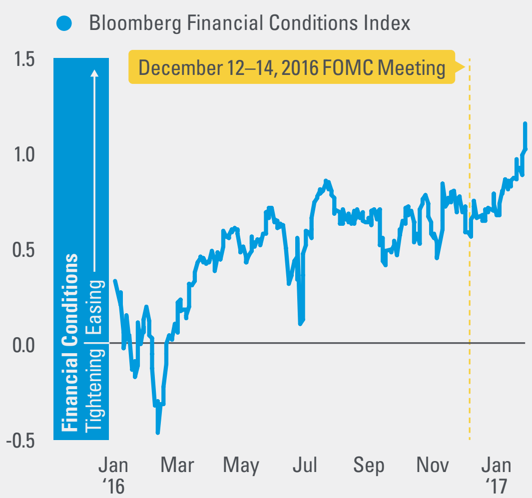
WILL THE ROTATION OF NEW FOMC MEMBERS IN 2017 IMPACT FED POLICY?

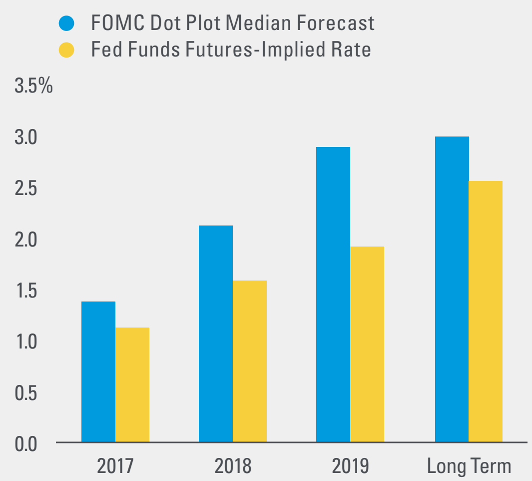
The FOMC consists of 19 members: 12 voting members and seven nonvoting members. The 19 members are the presidents of each of the 12 regional Federal Reserve Banks (Boston, New

2 FINANCIAL CONDITIONS HAVE EASED SINCE THE DECEMBER 2016 FOMC MEETING



Source: LPL Research, Bloomberg 01/27/17

3 THE FED AND THE MARKET ARE GENERALLY IN AGREEMENT ABOUT THE PATH OF MONETARY POLICY IN 2017



Source: LPL Research, Federal Reserve 01/27/17

York, Philadelphia, Richmond, etc.) and the seven members of the Board of Governors of the Federal Reserve. The seven board members include Fed Chair Yellen and Vice Chair Stanley Fischer. At the moment, there are only five sitting board members, which allow President Trump to appoint two members to fill out the roster. These appointments need to be confirmed by the Senate.

Beginning at this week's meeting and continuing throughout 2017, the Minneapolis Fed's Neel Kashkari, a policy dove, will replace Boston Fed's Eric Rosengren, also a policy dove (please see Figure 4 for a description of hawks and doves). Philadelphia's Patrick Harker replaces Cleveland's Loretta Mester in a hawk-for-hawk swap. The president of the Chicago Fed, Charles Evans, a dove, will replace the St. Louis Fed's James Bullard, who was considered a hawk at the start of 2016, but became a dove over the course of 2016—a rare instance of a public official of any kind changing his or her mind. Finally, the Dallas Fed's Robert Kaplan, a hawk, will replace the Kansas City's Esther George, who is also a hawk.

All in all, the balance of power between hawks and doves on the FOMC didn't really change as 2016 ended and 2017 began. The balance of power, however, may shift as President Trump fills the two vacancies on the Fed Board and those voters begin to put their stamp on policy, and of course Fed Chair Yellen's term as chair ends in February 2018, providing President Trump an additional opportunity to put his stamp on monetary policy.

WILL FISCAL POLICY GET A MENTION THIS WEEK?

Fiscal policy is not likely to get mentioned in the FOMC statement this week, although the minutes of the meeting (set to be released in late February 2017) may contain discussion of fiscal policy and its potential impact on the economy. In a speech in California on January 19, 2017, Fed Chair Janet Yellen noted:

> Finally, I would mention the potential for changes in fiscal policy to affect the economic outlook and the appropriate policy path. At this point, however, the size, timing, and composition of such changes remain uncertain. However, as this discussion highlights, the course of monetary policy over the next few years will depend on many different factors, of which fiscal policy is just one.

This suggests that the Fed is, of course, thinking through the potential impact on the economy from the various fiscal policy proposals floating around Washington, D.C. in the early weeks of the Trump administration, but until details are known, they are not likely to base their deliberations on it. For example, President Obama's $787 billion fiscal

4 NO CHANGE IN HAWKS OR DOVES AMONG VOTING MEMBERS OF THE FOMC IN 2017 VS. 2016

IN			OUT		
Name	District	Policy Tilt	Name	District	Policy Tilt
Neel Kashkari	Minneapolis	Dove	Eric Rosengren	Boston	Dove
Patrick Harker	Philadelphia	Hawk	Loretta Mester	Cleveland	Hawk
Charles Evans	Chicago	Dove	James Bullard	St. Louis	Dove
Robert Kaplan	Dallas	Hawk	Esther George	Kansas City	Hawk

Source: LPL Research, Federal Reserve 01/17/17

Hawks: Fed officials who favor the low inflation side of the Fed's dual mandate of low inflation and full employment.

Doves: Fed officials who favor the full employment side of the Fed's dual mandate.

stimulus package was signed into law on February 17, 2009. The FOMC statement from January 28, 2009 did not mention fiscal policy, while the statement from March 17–18, 2009 meeting did mention fiscal policy. We'd expect the Fed to use that same approach this time.

WHAT'S NEXT FOR FED WATCHERS?

The minutes of this week's FOMC meeting are due out on February 22, 2017, and are likely to provide some detail on what committee members were thinking with respect to fiscal policy. At around the same time, mid- to late-February, Fed Chair Yellen will deliver her semiannual Monetary Policy testimony to Congress, formerly known as the Humphry Hawkins testimony. That appearance will provide members of Congress an opportunity to question Yellen about her views on fiscal policy and its impact on the economy. ■

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