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TRENDMACRO LIVE!

# On the January FOMC

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**Donald Luskin**

**The Fed warns of "further" rate hikes – but only because the economy can go "further" too.**

We're having a little correction in stocks – a bit more than 2% for the S&P 500, as of this writing – and nowadays that passes for a big deal. Perhaps it started as a pre-FOMC tantrum, designed to scare departing Chair Janet Yellen into dialing back any new hawkish ideas on her way out the door, especially since the money market curve has already done some of the work for her and built in one new expected rate hike since year-end (see "Bull Market, Meet Your New Fed" January 29, 2018). The tantrum didn't work. *Today's FOMC did get more hawkish – at least as markets conventionally understand that term. This little correction will likely continue while this gets processed and contextualized.*

- *Since the December 2015 FOMC – the one at which relatively new Chair Yellen lifted off from the zero funds rate* (see "On the December FOMC" December 16, 2015) – *every single FOMC statement has included the same precisely identical 43-word sentence about the post lift-off regime. In today's FOMC statement, that became 44 words with the addition of the single word "further."*

  > "The Committee expects that economic conditions will evolve in a manner that will warrant further gradual increases in the federal funds rate; the federal funds rate is likely to remain, for some time, below levels that are expected to prevail in the longer run."

- *We understand this as indicating that the FOMC wishes to signal that, while it is still operating on the assumption that the economy is in a "new normal" state of "secular stagnation," it is nevertheless upgrading its estimate of potential growth, and hand-in-hand, its estimate of the terminal funds rate in equilibrium. It will now take "further" increases, versus what was*

**Ken Kesey's bus *Further***

**Update to strategic view**

**US FED, US MACRO, US STOCKS, US BONDS:** The FOMC added the single hawkish word "further" to its long-standing statement about the gradual pace of rate hikes. At the same time, it made its most confident statement in recent memory about its ability to hit its inflation target. Markets have already built in a new rate hike over the last month, so this isn't a true surprise. It's not truly hawkish, because it only means the Fed will have to "further" index the funds rate as the economy improves "further" – which means policy stays right where it is now, which is at neutral. If this is the excuse for the inevitable small correction in risk-assets, it won't take long to work through.

[Strategy dashboard]

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*previously expected, to reach equilibrium. This will be confirmed when we see the "dot plot" for the "longer-run" funds rate in the March FOMC's Summary of Economic Projections.*

- Pointing in the same hawkish direction was today's statement's recognition that "Market-based measures of inflation compensation have increased in recent months…"
- *On the back of that, the FOMC today made its strongest statement in recent memory of its confidence about hitting its inflation target*: "Inflation on a 12 month basis is expected to ~~remain somewhat below 2 percent in the near term but~~ move up this year and to stabilize around the Committee's 2 percent objective…"
- While markets might see these developments as hawkish, we do not. As we have explained many times, we think the Fed is now committed to indexing the funds rate to its conception of the "natural rate of interest" (see, among many, "Yellen Gives Conservatives Something to Cheer" February 17, 2017, and most recently, again, "Bull Market, Meet Your New Fed").
- In that context, we see the FOMC's seemingly hawkish comment as not hawkish at all – nor dovish, for that matter. It lives on a different continuum than the old hawk/dove duality. It is simply the Fed upgrading its expectations for the natural rate of interest, which would imply that – in order to index to it – a "further" hike, or further "hikes" would be appropriate.
- By indexing to the rising natural rate of interest by hiking the funds rate, the Fed is not tightening – it is maintaining policy exactly where it is now. In this framework, where it is now – at 1.38% – is precisely neutral with respect to the Q3-2017 reading of the Laubach-Williams model for estimating the real natural rate of interest (at negative 0.08%) plus core PCE inflation (at 1.5% year-over-year).
- If the natural rate rises, say, 25 bp and the funds rate is hiked 25 bp, then policy is *still* neutral.
- *Risk-assets have had a nice run this month – safe-haven assets not so much. A correction is inevitable. The word "further" could be as good a trigger as any. But again, markets have already build in one new rate hike this month, so there's really not much of a surprise here. And we have no doubt that the markets will quickly realize that when the economy goes "further" the Fed can go "further" too, and nobody has to get hurt.*

## Bottom line

The FOMC added the single hawkish word "further" to its long-standing statement about the gradual pace of rate hikes. At the same time, it made its most confident statement in recent memory about its ability to hit its inflation target. Markets have already built in a new rate hike over the last month, so this isn't a true surprise. It's not truly hawkish, because it only means the Fed will have to "further" index the funds rate as the economy improves "further" – which means policy stays right where it is now, which is at neutral. If this is the excuse for the inevitable small correction in risk-assets, it won't take long to work through.

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**Recommended Reading**

**Trump is winning**
Ezra Klein
*Vox*
January 29, 2018

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