FOMC Preview: Ending 2019 on a silent note

- At the conclusion of the two day FOMC meeting over 10-11 December, we expect the FOMC to maintain status quo on policy rates and its balance sheet program as the economy is showing signs of stabilizing around its trend level
- However, we expect the message to remain dovish reflecting concerns about the inflation outlook
- The dot plot could be aligned to indicate that the FOMC is on a prolonged pause
- There could also be upward revisions made to GDP growth projections for 2019 and downward revisions made to the inflation projections over 2019-22
- Market response in both the rates and FX markets to this policy meeting is likely to remain limited. Instead, ‘Brexit’ developments and US-China trade negotiations are likely to emerge as the dominant drivers of price action in the near-term

Economy: Limited case for further easing

While 2019 will go down in US monetary policy history as the FOMC delivering an ultimate reversal in terms of its stance and policy action, we see limited case for additional easing at the current juncture. The FOMC has already delivered a 75 bps cut that has been defined as a ‘mid-cycle’ adjustment. The monetary easing undertaken over 2019 has worked to support interest rate sensitive sectors such as consumer durables goods and the housing sector respectively. Labour markets remain robust and most indicators show that private consumption growth remains fairly solid. Although the supply-side of the economy remains weak, the outlook for the demand-side remains fairly constructive. Hence, concerns about the growth outlook have diminished considerably. However, risks to the outlook remains to the downside given that uncertainty about US trade policy has not disappeared altogether. Nevertheless, recent statements made by US and Chinese policymakers show that there could be some progress being made towards a ‘phase-one’ trade deal that will filter into the FOMC’s decision making.

However, the one area of concern remains the persistent lack of inflation. The Core PCE deflator that is the Fed’s implicit inflation targeting variable softened in October to 1.6% YoY from 1.7% in September-2019 remaining well below the 2% implicit target level. An important source of concern is the continued break-down in the US Phillips Curve with inflation not rising to the same degree as the tightness seen in the labour market. One possible reason for this could be that the US economy is importing disinflation pressures from the global economy. An appreciating USD and deflation in Chinese PPI have emerged as the primary contributors to this trend restraining price pressures in the US economy. Inflation expectations remain much lower than the levels seen in 2018 that will come into consideration for the FOMC in preparing policy.

Policy action: Status quo with a dovish message

Our sense is that the FOMC and the Fed Chair will maintain status quo but provide a dovish message by continuing to emphasize that inflation is undershooting its target level. With growth showing signs of stabilizing around trend level, the FOMC is unlikely to extend its ‘mid-cycle’ adjustment to a prolonged easing cycle. The central bank will want time to assess the full-effect of its easing before it takes a fresh look at what it needs to do next. The medium to longer-term monetary policy outlook will yet again be determined by the manner in which the ‘trade-war’ pans out. A possible ‘phase-one’ trade deal in Q12020 could ensure that the FOMC moves into a prolonged status quo.
We expect the following at the conclusion of the FOMC meeting:

- **Status-quo**: We expect the FOMC to keep rates unchanged at 1.50%-1.75% range. We see increased consensus within the FOMC as indicated by recent commentary from the majority of members.

- **Policy statement**: We do not anticipate substantial changes to be made in the policy statement, although there could be modest changes made to reflect near-term developments in the economy.

- **Press conference**: The Fed Chair is expected to continue to sound constructive on the outlook of the economy. However, we expect him to express concerns about disinflationary pressures. He is expected to provide a dovish guidance on inflation. We expect him to yet again re-emphasize the Fed’s neutral stance and that the bar for a move in either direction remains fairly high.

- **‘Dot-plot’**: The FOMC will update its dot plot as it does in every alternate policy meeting. The last time the ‘dot plot’ was provided in September, the median of the FOMC showed that the members only saw 50 bps easing in 2019, status quo in 2020 and one rate hike each in 2021 and 2022. Given that cumulative 75 bps easing have already been delivered, the median for 2019-20 is likely to move lower by 25 bps to reflect the easing undertaken over 2019. A further lowering in the median projections of the dot is unlikely as the FOMC will want to signal status quo. Rate hikes could still be signaled for 2021-22 but it is unlikely to influence markets. The longer-run neutral rate is unlikely to be lowered from 2.5% either.

- **Economic projections**: There could be a modest upward revision in growth for 2019 from 2.2% to 2.4% while the profile for 2020-22 could be left unchanged. Inflation projections could be lowered as could the unemployment projections for the forecast horizon.
Market impact: Not responding to FOMC this time

The Fed maintaining status quo is priced in by the market. Hence, market response to the FOMC is likely to remain limited both in the US rates and FX markets respectively. In the US rates market, we find that the uptrend seen in the US 10 year sovereign yields has come on the back of an increase in the ‘term premium’ component since September-2019. This was the period in which there appeared to be a de-escalation in the US-China trade battle that subsequently resulted in diminished demand for ‘safe-haven’ assets. We divide the US 10-year nominal yield into the embedded policy rate expectations that reflects market pricing of the Fed’s policy projections and the term premium that is a proxy for demand for the security. A rising term premium (less negative value) implies a reduction in demand for that security that has taken place because of change in risk sentiment. Hence, we think that developments in the US-China trade battle is expected to work as the dominant driver for appetite for the US 10 year that will influence the term premium. A de-escalation could push the term premium higher driving more upside in the US 10-year nominal sovereign yield and vice-versa. The DXY is also unlikely to be moved by this round of the FOMC meeting with ‘Brexit’ and the outcome of the trade battle expected to work as the dominant drivers in the near-term.

Chart 2: US term premium has started to increase

Source: Federal Reserve Bank of New York & ICICI Bank Research
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