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JAN FOMC COMMENTARY – DOUBLE-BARRELED DOVISH ON RATES AND BALANCE SHEET, EXPECT EARLY RUNOFF TAPER

The January FOMC meeting went beyond even our expectations that the Fed would move in a market-friendly / dovish direction on both balance sheet and rates in a double-barreled dovish blast. As our report explains, the shift was across the board in spite of only a slight downgrade of US growth from “strong” to “solid” and appeared to reflect a desire to err in the direction of dovish overkill in a context of global / financial market risks, muted inflation and weak market inflation break-evens.

This is very risk-friendly with Asian EM that benefit from a weaker dollar / lower yields very likely to follow on where US markets left off. The only caution is that the Fed does appear to be cautious about China and Europe growth – rightly in our view, though this caution is not enough to spoil the party. With the Fed now saying policy is “appropriate” and it needs to see a reason to hike again, US central bank support for global risk may prove to have some legs.

On rates, the FOMC chose to drop its tightening bias *and* introduce the word “patient” *and* Powell dubbed the current stance as “appropriate” *and* Powell said he would need to see a reason to tighten further. On balance sheet, the Committee formally announced that it will maintain a large balance sheet / abundant reserves *and* signaled more flexibility *and* Powell pointed to market surveys that suggest a $3.5 to $3.7 trillion steady state *and* Powell acknowledged that the Committee had discussed slowing the pace of runoff.

We reiterate our call that the Fed will start tapering runoff in the second half of this year. In light of the FOMC statement today we also revise down our modal forecast to one more rate increase later this year conditional on sustained stabilization of the global economy and markets. On a probabilistic basis discounting approximately nothing or indeed a fraction of a rate cut looks about right given that if the Fed hikes later on it will probably hike cautiously but if it has to cut it will probably cut aggressively. We will publish a report on the balance sheet tomorrow (Thursday).

To address in a little more detail:

1. **The FOMC left its description of the US economy broadly unchanged, with only a slight downgrade on growth from “strong” to “solid”.** The changes came instead in terms of the characterization of inflation expectations and risks in the statement. Consistent with this Powell in his press conference pointed to the Fed taking actions against downside risks associated with weak global growth in China and Europe, the Q4 tightening of financial conditions and political / geopolitical risks.
2. **The Committee left its language on inflation unchanged but acknowledged (one meeting late in our view) that market break-evens had weakened.** In the press conference Powell elaborated on the notion that muted inflation gives the Fed essentially a

free pass to focus on downside risks, while also reasserting the Fed's commitment to a symmetric inflation target.

3. **The Fed removed its earlier assessment that risks are "roughly balanced" and Powell suggested upside risks had diminished even as downside risks had increased.** Powell said the risks of inflationary overheating had declined materially and that risks of financial excesses had also moderated. This is critically important in the context of a two-sided risk management.
4. **The committee removed its hiking bias by taking out the phrase "some further gradual increases" replacing this with data-dependent "future adjustments" and promised to be "patient" in deciding what to do next.** Most analysts, ourselves included, had expected either "patient" or "adjustments" instead of "increases", but not both. Patient here is all but equivalent to an open-ended pause.
5. **Powell pronounced the current stance of policy as "appropriate" even though it is at the low end of the range of FOMC participants' estimates of the longer-run neutral rate.** This created some difficulties in the press conference, but in our view there is no contradiction. As we have repeatedly argued the short-run neutral rate is not tightly tethered to the longer-run neutral rate and is time-varying moving around with changes in financial conditions, fiscal and trade policy shocks and other developments.
6. **Powell indicated that he would now need to see a reason to hike further – that is more dovish than a simple pause in a rate cycle that is expected to proceed further.** This marks an important shift, as the onus of proof is now on those on the Committee who might favor a further hike or two later in the year. The data will need to make the case for any such move, there is no explicit lean to tighten even upon getting more clarity about the outlook.
7. **It is reasonable to infer from all this that the likelihood that the Fed is at the end of its tightening cycle has increased materially, though we still think the single most likely outcome is that there is one more hike (possibly even two) to go before this is all over.** We think there is a decent chance that easing financial conditions, moderating geopolitical risks including trade and stabilizing global growth later in the year combined with ongoing US labor market momentum will eventually provide the data case that warrants one final nudge higher but this is unlikely to bind for some time.
8. **The Fed broke cover on the balance sheet and made a formal decision to keep a large balance sheet / abundant reserves operating regime with a buffer of reserves beyond those demanded by banks in perpetuity – which implies an early end to balance sheet reduction.** This was totally consistent with our view but the announcement was more forward-leaning even than we expected, with a formal update to the (in our view stale) June 2017 balance sheet plan and extensive discussion by Powell in the press conference.
9. **The Fed also signaled a greater degree of flexibility and responsiveness to economic and financial conditions in its balance sheet plans.** The update to the balance sheet plan repeated that the Fed still views interest rates as the main active tool of policy, but stated that the Fed is "is prepared to adjust any of the details for completing balance sheet normalization in light of economic and financial developments". This apparently replaces the old language that said the Committee would be prepared to resume reinvestment (only) if "a material deterioration in the economic outlook were to warrant a sizable reduction in the Committee's target for the federal funds rate."

10. **We will not litigate whether the balance sheet update is strictly dovish or simply market-friendly – it almost certainly contributed to substantially easing financial conditions on the day so we view it as dovish.** Most Fed officials remain skeptical that QT is responsible for a material part of market stress in recent months and some would object to the characterization of the balance sheet communications today as dovish in monetary policy terms, viewing this as a purely technical decision. In reality, we think the Fed is seeking to sidestep the QT controversy by revealing that it is zeroing in on the balance sheet size it views as likely to be appropriate for operational reasons and therefore will conclude its balance sheet reduction early on its own terms and under its own logic. In the end, policy is as policy does, and the market took this as dovish in a monetary policy sense with financial conditions easing – at a minimum reflecting a perception that the risks associated with a poorly understood form of tightening that was on autopilot until recently have been reduced.
11. **Powell highlighted market estimates that suggest the Fed will need around $1 trillion or slightly more reserves ($1-1.2 trillion) implying a balance sheet that troughs at $3.5 trillion or slightly more ($3.5-$3.7 trillion).** This was what we thought he might do – draw attention to market estimates in a way that suggests the Fed does not violently disagree with them, without formally endorsing these estimates. Indeed the Fed chair said in the press conference that these market estimates were broadly "consistent" with the Fed's own deliberations.
12. **Powell said this implies an earlier end to the Fed's balance sheet reduction than originally envisaged and when pressed appeared to hint at an early taper.** The Fed chair said the Committee had discussed the question of slowing runoff but had not reached any conclusions. In our view it makes no sense for the Fed to maintain maximum runoff right up to the point at which it thinks it will find the equilibrium level of reserves and we expect the next step will be for the Fed to announce that it will start tapering runoff in the second half.

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