U.S. FOMC Rate Decision

Fed Raises Rates and Hoists a More Hawkish Flag

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As expected, the **FOMC lifted the target range for the federal funds rate by 25 bps to 1.75%-to-2.00%**, with the 1.875% midpoint finally rising above core PCE inflation (currently 1.8% y/y) for the first time since March 2008. This marks the **end of a decade-long era of negative real policy rates**.

And, the interest rate on excess reserves (IOER) was raised by only 20 bps to 1.95%, as discussed in the prior FOMC meeting (and mentioned in the Minutes), in order to guide the effective fed funds rate closer to its new midpoint. This was a technical move designed to address the upward pressure in the fed funds market caused by large Treasury issuance and the repatriation of corporate profits.

Also, the statement described the economy in a more upbeat tone. Growth was now *"solid"* compared to *"moderate"* before, and it acknowledged the new cycle low in the jobless rate and that household spending had *"picked up"* from its Q1 pace.

There were several hawkish elements to today's policy pronouncements:

While the FOMC still plans on *"further gradual increases in the target range for the federal funds rate"* they now appear **more determined to get to the longer-run neutral policy rate (2.75%-to-3.00%)**. They dropped the previous reference to policy rates remaining *"for some time, below levels that are expected to prevail in the longer-run"*.

The median forecast for the 2018-end fed funds rate shifted to 2.375% from 2.125%, implying **two more rate hikes for this year** (as we expected). The forecasts for 2019 also shifted to 3.125% from 2.875%, implying **still three rate hikes in total next year** (which we did not expect), but now there's only one in 2020 to 3.375%.

While the forecast profile for the unemployment rate was lowered 2/10s for this year and 1/10 for the out years (3.6%, 3.5% and 3.5%, respectively), the longer-run level remained unchanged at 4.5%. This suggests a bit more urgency for the Fed to get back to a neutral policy rate.

The headline and core PCE inflation forecasts are now all 2.0% or 2.1% (both were 1.9% for 2018 before). And the prior reference to *"market-based measures of inflation compensation remain low"* was removed. It seems that concerns about inflation underperformance have completely evaporated; they dropped the prior reference: *"The Committee will carefully monitor actual and expected inflation developments relative to its symmetric inflation goal"*.

Bottom line: The quarterly rate hike cadence continues, and we see it continuing until at least June 2019. Whether we get additional rate hikes in 2019 H2 (which the Fed is now indicating), an interval when the economy is embarking on the longest business expansion in history, will depend on how heated inflation pressures are at the time. At this point we're sticking to our call for a pause (so only two hikes in 2019), but the already net upside risks for H2 have risen substantially.