Fed Policy: Accentuate the Positive

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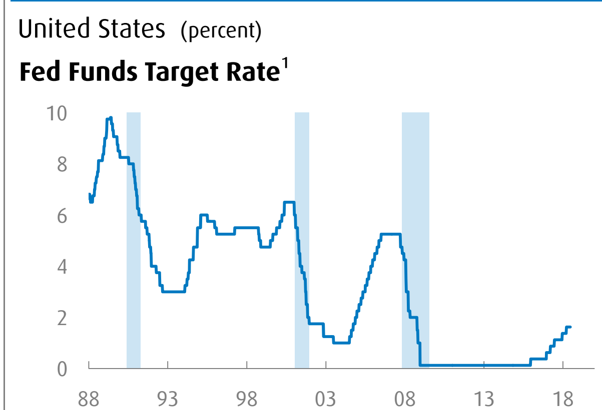
On June 13, the FOMC lifted the target range for the federal funds rate by 25 bps to 1.75%-to-2.00%, the seventh increase since rate hikes commenced 175 bps and 2½ years ago (*Chart 1*). The move also marked an **important milestone** in the normalization process, with the new 1.875% midpoint now sitting above current core PCE inflation (1.8% y/y) for the first time since March 2008 (*Chart 2*). Although real policy rates will still be slightly negative relative to total PCE inflation (2.0%), the decade-long run of negative real rates has largely come to an end.

Having passed this milestone, **the next critical node for normalization is the neutral policy rate**, when the Fed's foot will be fully off the gas pedal but not yet tapping the brake. This is defined as the neutral real policy rate (commonly referred to as "r*") plus inflation. In the partial Summary of Economic Projections (SEP), the FOMC's longer-run median projection for the fed funds rate is 2.9%, within a tight central tendency range of 2.8%-to-3.0%. Given unanimity on longer-run inflation hitting the 2% target, this puts the median longer-run r* at 0.9%, within a 0.8%-to-1.0% range.[1] We are still four rate hikes away from the neutral policy rate.

The **Fed still intends to get to neutrality gradually**, which likely means no quicker than quarterly steps for now.[2] The latest policy pronouncements repeated the FOMC's expectation for *"further gradual increases in the target range for the federal funds rate"*. But, they also revealed heightened determination to get to neutrality, in dropping the phrase that has been in place since rate hikes started in December 2015, *"the federal funds rate is likely to remain, for some time, below levels that are expected to prevail in the longer run"*, which also likely means no slower than a quarterly clip for now.

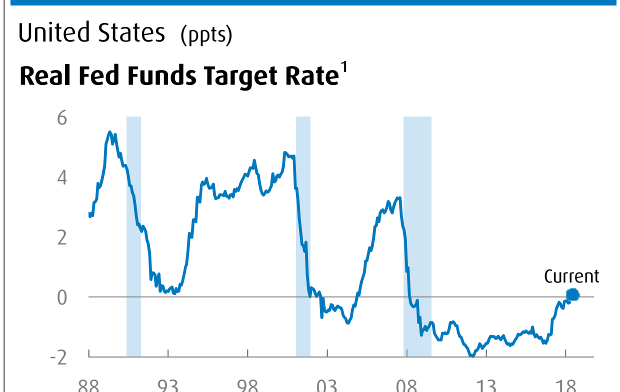
This is consistent with our forecast for a quarterly rate-hike cadence to continue at least until the FOMC reaches its longer-term median projection of 2.75%-to-3.00% in June 2019. Our base case is that the Fed pauses at this point, exhibiting some caution before pushing rates into restrictive territory with a couple of rate hikes in 2020. The caution reflects an effort not to jeopardize, as of July 2019, the longest economic expansion in U.S. history unless absolutely necessary. **We judge there are net upside risks to our Fed call**, with rate hikes potentially continuing in 2019H2 and 2020 should

Chart 1
Pulling Up on the Gas Pedal



Shading marks U.S. recessions [1] range midpoint since Dec. '08
Sources: BMO Economics, Haver Analytics

Chart 2
Real Positive



Shading marks U.S. recessions
[1] nominal minus PCE inflation; range midpoint since Dec. '08
Sources: BMO Economics, Haver Analytics

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[1] These are much lower than the historical average for the real fed funds rate, 1.8%, or above 2% if excluding the recent run of negative rates. This reflects such factors as slower potential economic growth and an aging population.

[2] Making the case for continued gradualism, the shorter-run neutral real policy rate (current r*) is still likely below the longer-run level (longer-run r*), as it has been since the Great Recession. But unlike the depths of the recession when current r* was negative and drifting down, it's now positive, drifting up, and poised to converge with longer-run r* by next year. What drives current r* below longer-run r* is the combination of significant degrees of economic slack and headwinds that prevent economic growth from reducing slack more quickly. Currently, there is very little slack left in the economy (the output gap was 0.2% in Q1 after a record-long 41-quarter run in negative territory and a peak gap of 6.5% in 2009Q2). Meantime, the economy looks to continue growing at an above-potential pace for at least the next year thanks to the emergence of an overall net tailwind (a.k.a., fiscal stimulus).

inflation trends warrant. And, it's appropriate to peg these net upside risks a bit higher given the latest "dot plot".

As expected, the FOMC's median (midpoint) forecast for the 2018-end fed funds rate shifted to 2.375% from 2.125%, implying two more rate hikes for this year (*Chart 3*). But, unexpectedly, the forecast for 2019 shifted to 3.125% from 2.875%, implying an additional three rate hikes next year (*Chart 4*). The 2020 forecast was unchanged at 3.375%, now suggesting only one rate hike that year. It's tempting to use this as an occasion to revise up our own forecast; but, note that the 2019 median is still only one participant away from returning to 2.875% and could change. **Patience is also warranted by a number of uncertainties clouding the outlook**.

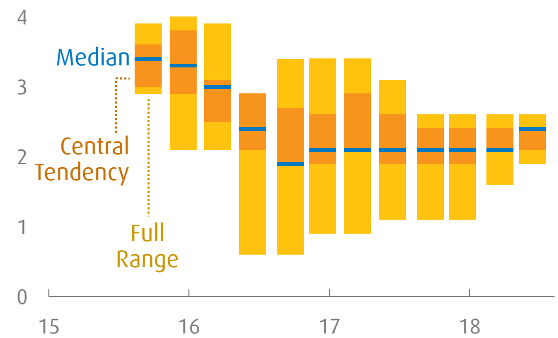
First, **trade protectionism is becoming a growing negative risk**. The cacophony of business complaints about higher duties and tariffs is becoming louder, but these barks have yet to bite into hiring and capex, let alone meaningfully impacting the stock market, but this could change quickly. We're facing $50 billion in tariffs on Chinese goods, a Section 232 investigation into imported vehicles and parts, and the fate of NAFTA.

Second, **potentially negative global economic and political issues** (apart from the trade file) appear to be popping up more regularly; e.g., the U.S. pulling out of the Iran nuclear deal, the countdown to Brexit, Italian politics, along with Turkey and Brazil coming back on the emerging-market radar (obviously, the recent U.S.-North Korea agreement is a geopolitical positive). Should these issues continue to swell, we could see a return of *"global economic and financial developments"* to the Fed's risk-watch list.

Third, in the press conference, Chairman Powell said *"our program for reducing our balance sheet, which began in October, is proceeding smoothly"*. During the past eight-plus months, **the Fed has pared its securities holdings** by $148 billion (*Chart 5*). But, as the paring intensifies this year, there's bound to be a bump or two. We estimate the total shedding at more than $375 billion this year and $450 billion next year. If quantitative easing (QE) is judged to have worked, particularly in boosting asset prices, presumably the best we can hope for is that quantitative tightening (QT) will be neutral. Meantime, the impact of the Fed's actions could be magnified as other global central banks first slow, then stop and eventually reverse their liquidity gravy trains.

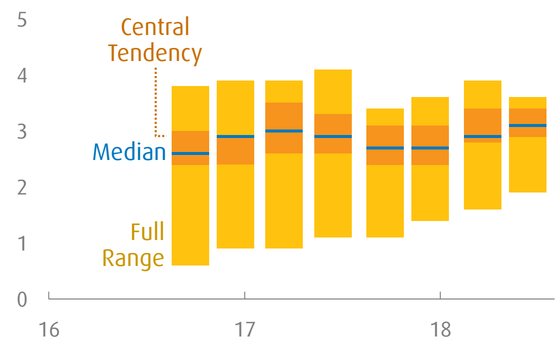
Bottom line: Whether we get additional rate hikes in 2019H2 (which the Fed is now indicating) will depend on how heated inflation pressures become. At this point, we're sticking to our call for a lengthy pause in rate hikes after mid-2019, while acknowledging upside risks.

Chart 3
Two More This Year
United States (percent)
FOMC Projections for 2018-end Fed Funds Target Rate



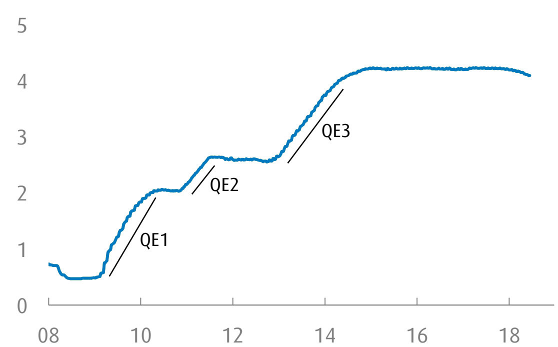
Sources: BMO Economics, Federal Reserve

Chart 4
Three More Next Year
United States (percent)
FOMC Projections for 2019-end Fed Funds Target Rate



Sources: BMO Economics, Federal Reserve

Chart 5
Fed's Balance Sheet Paring to Pick Up
United States (US$ trlns)
System Open Market Account Holdings



Sources: BMO Economics, Haver Analytics