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Fed is More Aggressive, but Not Its Forecasts

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The Fed's actions were perfectly predictable last Wednesday, yet the rate projections did not jibe with the forecast changes. Certainly the Fed hiked 25 bps (no surprise), and the vote was unanimous: no holdouts by the doves or 50 bp advocates among the hawks. The projections of future funds rate were, as expected, far more aggressive. The median funds rate expectation for December 2017 went up 30 bps from 1.1% to 1.4%, the 2018 up 20 bps to 2.1%, and the 2019 up 30 bps to 2.9%. For the first time ever, the committee nudged up the long-term "neutral" funds rate to 3.0% from 2.9%.

The 30bp bump in fund rate predictions actually underestimated the increase in the Fed funds futures markets since the last Fed meeting in September. But the FOMC's underlying economic projections scarcely budged! Since the September meeting, the median estimate of GDP growth next year rose only 0.1%, growth estimates were unchanged for 2018, and rose 0.1% in 2019. Long-term GDP goth also remained unchanged. And the prediction of PCE inflation over each of the next three years *and* in the longer run stayed absolutely constant. Why then did the Committee raise its funds rate up so aggressively? One explanation is that the Fed will raise rates aggressively to squelch the expansionary impact of the Trump program in order to keep inflation low. That view also says that 2% is the speed limit on growth and Trump's policies should not increase that. But I think the real explanation is that the committee is very slow to change its economic forecasts, but they respond to market interest rates far more quickly. In other works, the power of the ten year bond is as potent as ever. Since the election the ten year bond yield has risen by 80 bps and the TIPS by 60 bps. For a given risk premium, that means real growth estimates is up by more than one-half percent (or the real rate needed to suppress higher growth has increased markedly) and inflation expectations are up bit under one quarter percent.

A final comment on the Fed actions. Much has been made of the median estimate of the number of increases next year increasing from 2 to 3. But one should remember that at the December 2015 meeting, the last time the Fed raised rates, the Committee expected 4 hikes this year. So don't take the current estimate of "three" too seriously. The fact is that the Fed itself does not know. Its actions will be completely informed by watching the incoming data over the next year. If it is strong, and the ten year yield continues to rise, the Fed will hike. But if there is another growth scare, as there was last winter, which caused the ten year yield to back down, the Fed will hold off. The ten-year Treasury yield, which was extolled as such a powerful indicators during the Clinton administration but lost its luster in recent years, has reawakened with a roar.

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