GENERALI INVESTMENTS

Focal Point

The Fed to hike rates at least three times in 2018

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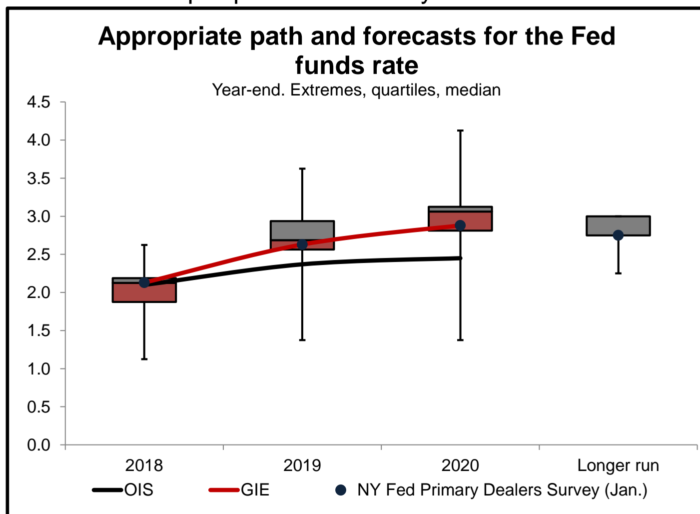
- In our baseline projection, we expect the Fed to deliver three rate hikes this year. The first increase should take place at the March meeting, followed by two further ones in both June and September.
- The recent increase in inflation and additional evidence of labor market tightening are consistent with the Fed outlook, and therefore do not warrant a revision in the pace of monetary tightening. Financial conditions are expected to tighten, but not to an extent capable of becoming a hurdle to higher rates.
- Stronger growth and productivity will lead to a higher equilibrium interest rate, underpinning the case for higher policy rates.
- Risks are clearly titled to the upside, in light of a possible quicker tightening of the labor market or positive surprises in core inflation or a more hawkish bias in the FOMC. A fourth rise in December and an upward revision to the long term 'dots' have a non-negligible probability. That said, any changes of view are not likely be announced at the March meeting, as data should be still quite volatile and the FOMC turnover will not yet be completed.

In 2017 the Fed delivered on the three interest rate increases envisaged by the 'dots', despite initial market skepticism and the drop in core inflation since the end of Q1. Economic conditions are increasingly backing the three hikes the FOMC deems appropriate for this year. This is also our forecast, but it has become subject to upside risk. In what follows we recap the expected evolution of the key variables the Fed looks at and assess the likelihood of a steeper path of monetary normalization.

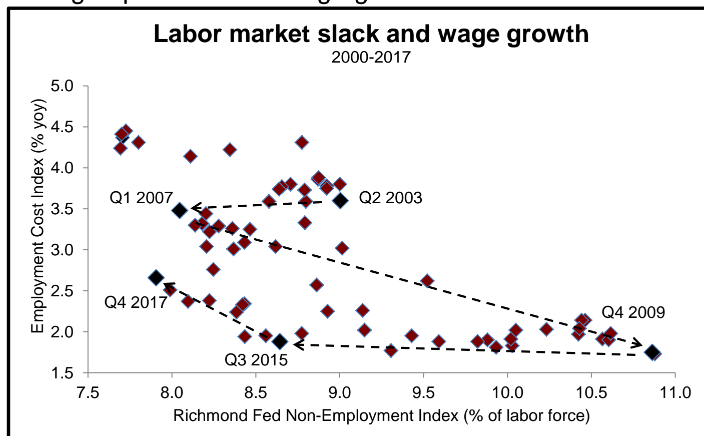


Convincing evidence of higher inflation…

The large drop in core inflation seen since March 2017 raised doubts on the viability of monetary normalization. The Fed attributed this to temporary factors and stuck to this view throughout the year. The recent price data vindicate this position. In January core inflation, at 1.8%, beat expectations. Most importantly, reflation is taking place across all major sectors, including those (like wireless communication and air fares) which caused the plunge in the core rate. Inflation continues to respond to demand pressures and to labor market tightening, as we have recently shown ("US inflation beats expectations", Market Commentary, February 13). Therefore we expect the ongoing strength of consumption (up by 3.8% qoq annualized in Q4, the fastest pace since 2003) to feed through prices. Moreover, external factors, first and foremost a relatively weaker dollar, will support the core rate.

The same applies to wages. Several explanations have been proposed for the apparently muted response of labor costs, ranging from stagnant productivity, the structural impact of the crisis or demographic considerations. The most recent data show that these factors are likely to have just delayed the wage uptick. The 2.9% yoy increase posted by weekly earnings in January has probably to be discounted a bit, given the volatility of the indicator. Yet data

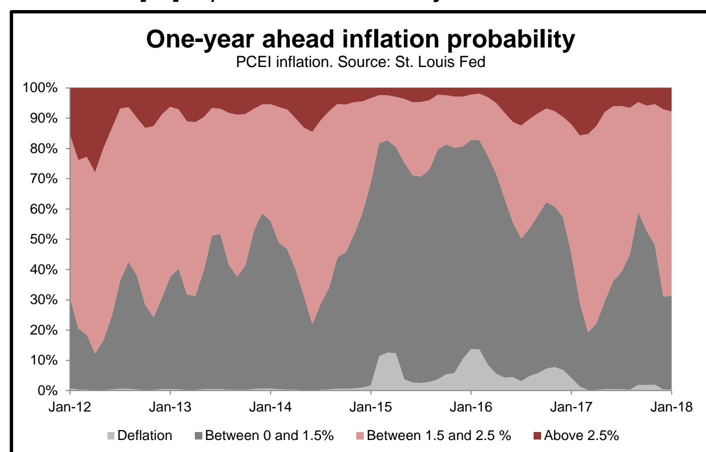
for Q4 2017 show that not only a tighter labor market is strengthening employment cost growth, but also that the latter is becoming more responsive. Yet higher wages may prompt more people to re-enter the labor force, preventing a large upward drift in wage growth.



…in line with the Fed's expectations

These developments are in line with the economic projections made by the FOMC in December, which see the core PCE rate climb from the 1.5% yoy of December 2017 to 1.9% yoy by the end of this year. Should this trend be confirmed, there would be little need for the FOMC to revise expectations. This position was nicely summarized by John Williams, the San Francisco Fed president, in a recent talk: *"Given the economy is performing almost exactly as expected, you can expect policy makers to do the same".*

Indeed the minutes of the January meeting show an increased confidence in the economic outlook and the three-hike projection. Back in December two members voted against the rate increase, and the dots below the median projections of three hikes in 2018 outnumbered by six to four those above it. In the January meeting, however, *"several commented that recent developments had increased their confidence in the outlook for further progress toward the […] 2 percent inflation objective".*



The data released afterwards (the employment report and CPI for January) confirmed this view, but one should not read too much into them, as seasonality may have played a role. More and stronger evidence on inflation overheating will be needed for the Fed to change course.

The increase in government expenditure decided at the end of January clearly constitutes a big source of upside risk. Given the time frame of the extra spending and the lags between demand and prices, the inflationary impact of the fiscal boost will likely peak around mid-2019. However, it is not sure that it will be strong enough to trigger a pre-emptive action by the Fed. The FOMC projections show a deceleration in growth, from 2.5% in 2018 to 2.1% next year, so the fiscal boost will largely offset a cyclical weakening.

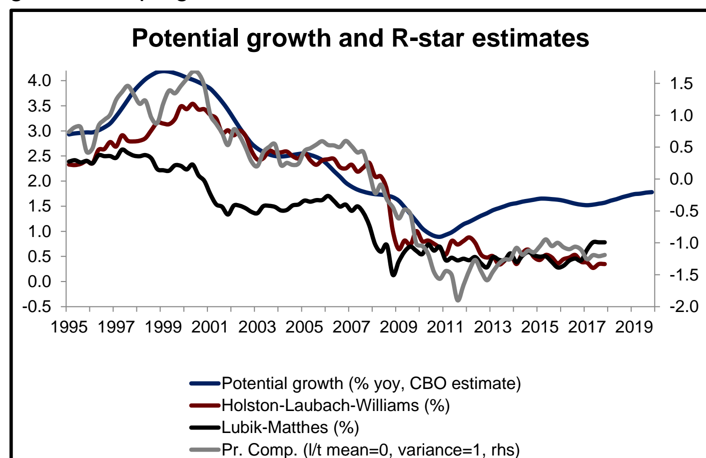
Financial conditions remain supportive

The final piece of the outlook the Fed has proposed in order to motivate its gradual tightening is the expected increase in the equilibrium interest rate (known as r-star, the short term real rate consistent with balanced growth).

Estimating r-star is notoriously difficult; however, evidence gathered from two model-based approaches used by the Fed and a more agnostic one, based on the statistical analysis of a set of financial, economic and demographic variables point to a mild recovery in r-star over the last quarters. It should edge further up for at least two reasons:

First of all, in the short run, the tax reform would at the same time reduce overall savings and add to the ongoing pick up in investment. Or, put in another way, the recent fiscal packages and the move towards a smaller Fed balance sheet will increase the net supply of low risk assets (Treasuries), pushing r-star higher.

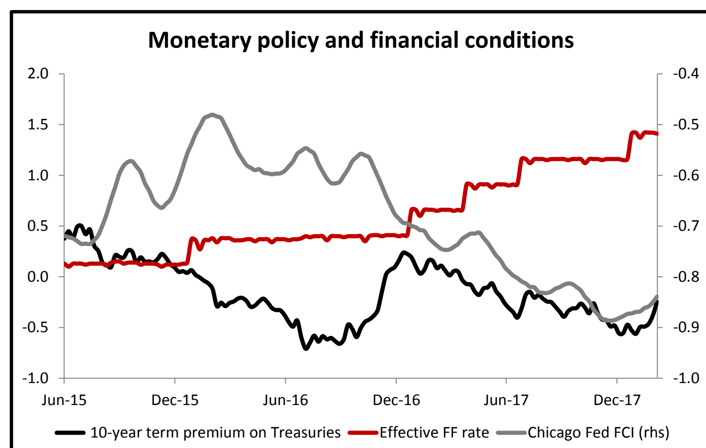
Secondly, economic theory posits a positive relationship between r-star and the trend growth of the economy, which is broadly found in the data. According to the Congressional Budget Office (CBO) estimates, an uptick in productivity and the recovery in investment will nudge up potential growth, helping the further increase in r-star.



Since the December 2016 rate hike, broad financial conditions have been basically disconnected from the path of policy rates, likely dampening the effect of monetary normalization to economic activity. Easy financial conditions were seen as one of the reasons behind the policy rate tightening in 2017, despite the persistent undershooting of core inflation. In turn, the gradual approach taken by the Fed may have contributed to easier financial conditions; Investors' risk taking may have increased as they faced low uncertainty on the expected path for monetary policy.

The recent market turmoil has proved, so far, short lived and mostly confined to equities and HY. Therefore financial conditions have tightened only marginally as a result of that. We expect the upward trend in Treasury yields to continue; this and the widening of credit spread will lead to less favorable financial conditions. This will reduce the

need for a very aggressive policy rate tightening, but will not constitute a significant obstacle to monetary policy normalization.



What could trigger a fourth hike in 2018?

Given the robust growth outlook and the signs of inflationary pressures, risks are clearly tilted to the upside. We then think that there is a probability of at least 20% that the Fed raises rates for a fourth time in December, adding a hike to the path presented at the December 2017 FOMC meeting. Currently markets assign a probability of just above 25% to at least four hikes by year-end.

Such a scenario would require a stronger acceleration in inflation and a sharper fall in unemployment. Given the expected volatility in price data at the end of Q1, with the unwinding of the adverse base effects which have compressed core inflation so far, the evidence available by the March meeting will be far from conclusive. Data for Q2 will have then to be watched: We expect the core PCE inflation rate to reach 1.8% by that period; should it get closer to 2% (a threshold we expect to be crossed around the turn of next year), there could be enough agreement to move the dots already at the June meeting.

The FOMC projects the unemployment rate to reach 3.9% by the end of the year. The January reading was 4.1%, so there is a material risk of an undershooting, leading to the call for a more aggressive stance. However, uncertainties about the evolution of labor supply may lead FOMC members to simply mark down their estimate of the long term unemployment rate, as they did in March last year.

As an alternative to an additional increase this year, the FOMC could acknowledge the stronger demand pressure induced by higher federal spending and the upward trend in the neutral rate by adding a third hike to the projection for 2019. This would have the advantage of not shaking market confidence in the Fed's gradualism, reducing the risk of a sharp tightening in financial conditions.

At this stage these solutions look to us equally probable. In both cases, the terminal rate of the hiking cycle would move slightly up from the current median estimate of 3.1% to around 3.3%.

The large reshuffle of the FOMC can also play a role in the evolution of the monetary policy stance. The new members appointed so far have mostly mainstream views, with a conservative twist. Moreover the rotation of regional governors into the voting panel is expected to tilt the balance towards a less dovish attitude. Finally, there remain three seats to be filled, and the New York Fed President is expected to retire by mid-2018. In principle, then, the view of the FOMC could be altered quite substantially. Anyway, not all the places will be filled by the March meeting and this should prevent drastic decisions at that meeting.

More generally, it is fair to expect that the new FOMC members will want to get more acquainted with the procedures before committing to large changes in the speed of monetary policy normalization. Therefore any meaningful changes to the outlook for rates should not occur earlier than at the June meeting.

Imprint

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