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US Economics & Rates Strategy

FOMC Minutes: Setting Up September

At its August meeting, the FOMC mapped out its fall agenda by signaling a change in forward guidance, deeper discussion over the balance sheet, and the risk of a "major escalation" in trade tensions—all with the backdrop of an economy with "considerable momentum" that warrants further hikes.

US Economics

- Minutes from the July 31-August 1 FOMC meeting carried the upbeat tone presented in the statement, but that tone was belied by ample discussion of stresses related to the balance sheet, heightened concerns about trade, and how to conduct policy in the event of a downturn that sends rates back to the effective lower bound.
- The minutes suggest that a change to forward guidance is coming, as early as the September meeting, as well as a discussion of the operating framework that we expect will include the pros and cons of adopting permanently a floor vs corridor system, and opening the door to a second technical adjustment.
- We continue to look for two more hikes this year—in September and December. Thereafter, we look for two additional hikes in 2019, at the March and June meetings, where we expect the FOMC to rest in this hiking cycle.

US Rates Strategy

- If the FOMC statement in September no longer contains the sentence describing policy as "accommodative", but replaces it with a statement suggesting the September policy tightening moved policy closer to a neutral setting, we would not expect the market to react.
- We believe the discussion by the Board staff and FOMC participants about the effective lower bound (ELB) will nudge the FOMC to maintain the floor system for controlling the effective federal funds rate instead of reverting to the pre-crisis corridor system.
- We continue to suggest 2s10s and 2s30s Treasury curve flatteners, an EDM9/EDZ9 Eurodollar futures curve flattener (to play for the market to price a pause after the Fed reaches 2.75-3.00% after 4 more hikes from here), and a long-duration trade via UST 10y notes.

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Decisions must be made

With no pressing need to change its current course of action, the FOMC found ample time to discuss numerous issues at its July 31-August 1 meeting. Though the tone describing the current state of the economy and near-term outlook was quite upbeat —"favorable factors" that were supporting "above-trend" growth with "considerable momentum" in household and business spending—underlying structural concerns and concerns over trade overshadowed the optimism. Perhaps this **presages what we can expect from Chair Powell when he discusses "Monetary Policy in a Changing Economy" at this year's Kansas City Fed's Annual Economic Policy Symposium. In his speech scheduled to be delivered on Friday, August 24, at 10AM ET, the Chair will likely balance a discussion of longer-term structural factors that have implications for calibrating the appropriate stance of policy versus the undeniable evidence warranting further increases in the federal funds rate at this time**.

We continue to look for two more hikes this year—in September and December. Thereafter, we look for two additional hikes in 2019, at the March and June meetings, after which we expect the FOMC to rest in this hiking cycle. We continue to expect it to begin winding down the runoff of its balance sheet beginning in March 2019.

What to expect in September

Forward guidance

With each rate hike, the bar falls for the Fed to pause. The median participant has cast an expectation that the nominal neutral rate lies around 2.875%. With each rate hike, the Committee moves its target rate closer to neutral and the current language describing the policy stance as "accommodative" becomes outdated. **"Many" participants believe that in the "not-too-distant future " the description needs to be revised.** We see two options: 1) change "accommodative" to "modestly accommodative", or 2) replace the sentence with one that describes the target rate as having moved "closer to the range of estimates of its neutral level."

> Many *participants noted that* ***it would likely be appropriate in the not-too-distant future to revise the Committee's characterization of the stance of monetary policy in its postmeeting statement****. They agreed that the statement's language that "the stance of monetary policy remains accommodative" would, at some point fairly soon, no longer be appropriate. Participants noted that the federal funds rate was moving closer to the range of estimates of its neutral level. A number of participants emphasized the considerable uncertainty in estimates of the neutral rate of interest, stemming from sources such as fiscal policy and large-scale asset purchase programs. Against this background, continuing to provide an explicit assessment of the federal funds rate relative to its neutral level could convey a false sense of precision.* [emphasis added]

Operating framework

Though discussion of the Fed's balance sheet at its August meeting was scarce, Chair Powell suggested the need for further discussion in the "fall". The Fed must decide on the framework under which it will manage policy in the long run, which warrants a discussion around the relative merits of a floor versus corridor system (see US Economics, US Fixed Income Strategy, and Banks: A Surprisingly Early End to Balance Sheet Normalization (12 July 2018)).

It may also become clearer as we approach the September FOMC meeting that a second technical adjustment could be needed in the coming months. Our rates strategists have noted that the discussion of an additional adjustment may be prompted by the observation that the effective federal funds rate has sat 3bp below the IOER for 4 consecutive days.

> *A couple of participants commented on issues related to the operating framework for the implementation of monetary policy, including, among other things, the implications of changes in financial market regulations for the demand for reserves and for the size and composition of the Federal Reserve's balance sheet. These participants judged that it would be important for the Committee to resume its discussion of operating frameworks before too long.* ***The Chairman suggested that the Committee would likely resume a discussion of operating frameworks in the fall.*** [emphasis added]

Trade

Comments on trade generally echoed those presented in the regional Fed manufacturing surveys and the Beige Book. Heightened business uncertainty has also been captured in the softening of our capex plans index in the past few months. That said, concerns about downside risk from trade appear to be mounting. Though financial conditions continue to provide support for the economic outlook, one can imagine the risk that when close to neutral, and facing a possible "large-scale and prolonged dispute over trade" policymakers could lean on trade as a reason to move into a holding position (see Global Economics: Global Supply Chain Impact: Who's Most Exposed? (26 July 2018)).

> *Business contacts in a few Districts reported that uncertainty regarding trade policy had led to some reductions or delays in their investment spending. Nonetheless,* ***a number of participants indicated that most businesses concerned about trade disputes had not yet cut back their capital expenditures or hiring but might do so if trade tensions were not resolved soon.*** *Several participants observed that the agricultural sector had been adversely affected by significant declines in crop and livestock prices over the intermeeting period. A couple of participants noted that this development likely partly flowed from trade tensions.*
>
> *In addition****, all participants pointed to ongoing trade disagreements and proposed trade measures as an important source of uncertainty and risks.*** *Participants observed that if a large-scale and prolonged dispute over trade policies developed, there would likely be adverse effects on business sentiment, investment spending, and employment. Moreover, wide-ranging tariff increases would also reduce the purchasing power of U.S. households. Further negative effects in such a scenario could include reductions in productivity and disruptions of supply chains.* [emphasis added]

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Still accommodative?

As our US economists pointed out, the language describing the degree of accommodation may come out of the September statement. If the Fed simply removed the description altogether, investors might interpret the language to suggest that the Fed had taken policy to its neutral level and that no accommodation remained. It's possible the September statement modifies the word "accommodative" with "somewhat", but the minutes do not suggest the issue was with just the word "accommodative".

Rather, the minutes quote the entire line, which suggests the statement might strike it entirely. That would leave a simple description of the FOMC policy action. Our economists note the Fed could replace it with something similar to the language used in the minutes themselves:

> *They agreed that the statement's language that "the stance of monetary policy remains accommodative" would, at some point fairly soon, no longer be appropriate. Participants noted that the federal funds rate was moving closer to the range of estimates of its neutral level.*

For example, the September statement could read:

> *In view of realized and expected labor market conditions and inflation, the Committee decided to raise the target range for the federal funds rate to 2 to 2-1/4 percent. With this adjustment, the federal funds rate has moved closer to the range of estimates of its neutral level.*

In this way, the FOMC would avoid making a statement about the proximity of the policy rate to its neutral level – a level about which some disagreement and a lot of uncertainty remains. Rather, it would be a statement that simply acknowledges a fact: the range of estimates remains above the current level. **We would not expect the market to react to the removal of the sentence containing "accommodative" if that sentence were replaced by this type of factual language.**

Is the floor system here to stay?

We were looking for FOMC participants to discuss monetary policy frameworks at the July/August meeting. Unfortunately, only "a couple of participants commented on issues related to the operating framework for the implementation of monetary policy, including, among other things, the implications of changes in financial market regulations for the demand for reserves and for the size and composition of the Federal Reserve's balance sheet."

Thankfully, "The Chairman suggested that the Committee would likely resume a discussion of operating frameworks in the fall." We don't recall many instances of a minutes from an FOMC meeting singling out "The Chairman" or "The Chair" other than in procedural sections of the minutes. We take this is a clear indication that the topic of operating frameworks will surface either at the September or November FOMC meeting.

While the minutes did not hint at a decision on the longer-run operating framework for controlling the effective federal funds rate (EFFR), they did provide clues about what the Fed will decide. In the section titled "Monetary Policy Options at the Effective Lower Bound," the Board staff and FOMC participants discussed to what extent "monetary policy tools could provide adequate policy accommodation if, in future economic downturns, the policy rate were again to become constrained by the effective lower bound (ELB)."

In the discussion, the staff suggested a return to the ELB was a meaningful risk:

> *The staff's analysis indicated that under various policy rules, including those prescribing aggressive reductions in the federal funds rate in response to adverse economic shocks, there was a meaningful risk that the ELB could bind sometime during the next decade.*

Then, FOMC participants suggested that, "in their view, spells at the ELB could become more frequent and protracted than in the past, consistent with the staff's analysis." They also "generally agreed that both forward guidance and balance sheet actions would be effective tools to use if the federal funds rate were to become constrained by the ELB." In the event that the FOMC decided to use "balance sheet actions" when next at the ELB, the floor system for controlling the EFFR would be necessary, in all likelihood.

As a result, any longer-term perspective for controlling the EFFR should assume a return to the ELB. And a return to the ELB with the prospect for more quantitative easing should make the floor system a more attractive longer-term solution than the corridor system. As a result, we continue to believe the Fed will adopt the floor system as its longer-run operating framework - which means our expectation for a surprisingly early end to balance sheet normalization remains on track.

Could the Fed revisit negative rates or price level targeting?

One interesting part of the minutes suggested that the Committee should discuss policy options, apart from quantitive easing and forward guidance, at the ELB periodically.

> *While the Committee's current toolkit was judged to be effective, participants agreed, as a matter of prudent planning, to discuss their policy options further and to broaden the discussion to include the evaluation of potential alternative policy strategies for addressing the ELB. Building on their discussions at previous meetings, participants suggested that a number of possible alternatives might be worth consideration and agreed to return to this topic at future meetings. Several participants indicated that it would be desirable to hold periodic and systematic reviews in which the Committee assessed the strengths and weaknesses of its current monetary policy framework.*

Alternatives to forward guidance and quantitative easing could involve a discussion around negative interesting rates – the FOMC uses the term "effective lower bound" instead of "zero lower bound" now that the ECB has taken rates negative. In addition, other inflation targeting frameworks, like price level targeting, may be included in those systematic reviews. We don't think such discussions, if they occurred in the near term, would be market-moving events, and we don't see them on the near-term horizon. Nevertheless, in the next downturn, these debates could move markets, so are worth us paying close attention.

Did the minutes change our views?

Not in the slightest. We continue to see downside risks from trade policy helping cap the level of Treasury yields this year. In fact, this sentence from the minutes added to our bullish conviction:

> *Nonetheless, a number of participants indicated that most businesses concerned about trade disputes had not yet cut back their capital expenditures or hiring but might do so if trade tensions were not resolved soon.*

The minutes also hinted that, should trade disputes escalate meaningfully, the Fed would come to a crossroads with policy:

> *Some participants suggested that, in the event of a major escalation in trade disputes, the complex nature of trade issues, including the entire range of their effects on output and inflation, presented a challenge in determining the appropriate monetary policy response.*

It would make sense that, "in the event of a major escalation in trade disputes", the Fed would pause its rate hiking cycle as it determined the "appropriate monetary policy response". Importantly for our yield curve flattener suggestions, such a pause in the hiking cycle would not come immediately, but only after a "major escalation", in all likelihood.

We also don't see recent Fedspeak on the yield curve as a reason to change our view that, if the Fed hikes rates by more than the market is pricing over the coming 12 months, the Treasury yield curve will continue to flatten – and eventually invert. The discussion in the minutes about the yield curve was very two-sided:

> *Several participants cited statistical evidence for the United States that inversions of the yield curve have often preceded recessions. They suggested that policymakers should pay close attention to the slope of the yield curve in assessing the economic and policy outlook. Other participants emphasized that inferring economic causality from statistical correlations was not appropriate.*

So promises from some FOMC participants to avoid hiking rates enough to invert the yield curve do not convey the consensus view on the FOMC, at this point. We continue to suggest 2s10s and 2s30s Treasury curve flatteners, an EDM9/EDZ9 Eurodollar futures curve flattener (to play for the market to price a pause after the Fed reaches 2.75-3.00% after 4 more hikes from here), and a long-duration trade via UST 10y notes.

Trade idea: Maintain long UST 10y note at 2.82%
Trade idea: Maintain UST 2s10s flattener at 22bp
Trade idea: Maintain UST 2s30s flattener at 37bp
Trade idea: Maintain long UST 5y vs. OIS at 19bp
Trade idea: Maintain EDM9/EDZ9 flattener at 10bp

Trade ideas

Exhibit 1: Trade ideas

Trade	Entry Level	Entry Date	Rationale	Risks
Buy UST 10y note	2.90%	22-Jun-18	Continued strength in the US dollar, weakness in EM, ongoing trade tensions, and buying from Japan in July should push 10y yields lower over the summer.	Trade tensions ease and economic data continue to strengthen in the US and rebounds in Europe.
Enter UST 2s10s flatteners	40bp	13-Jun-18	We believe the front end of the yield curve will remain under pressure. Against this backdrop, challenges in emerging markets, the impact of tariffs, and a Fed intent on continue to tighten policy will continue to hang over risk sentiment. This should keep the long end of the yield curve supported.	The risk to the UST 2s10s flattener is better-than-expected economic data going forward, which could raise inflation risk premiums and cause the market to price in a much more aggressive Fed policy path.
Enter UST 2s30s flatteners	62bp	4-May-18	We believe the front end of the yield curve will remain under pressure. Against this backdrop, challenges in emerging markets, the impact of tariffs, and a Fed intent on continue to tighten policy will continue to hang over risk sentiment. This should keep the long end of the yield curve supported.	The risk to the UST 2s30s flattener is better-than-expected economic data going forward, but a Fed which does not respond in kind with a more aggressive removal of policy accommodation.
5y UST vs. OIS spread widener	-19bp	17-Aug-18	Indication by the Fed that a floor system for managing the fed funds rate will be maintained is a tailwind for this trade.	Worries about selling of USTs by foreign FX managers could cheapen USTs.
USD: EDM9 - EDZ9 Flattener	12.5bp	1-Jun-18	We don't think there should be any more risk premium in the forwards beyond the June 2019 date and that it's safe to lean on roll-down to spot for carry.	More risk premium comes back into the curve and the curve steepens.

Source: Morgan Stanley Research

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