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US Monetary Policy Outlook: Delayed Tightening Amid Moderating Growth Prospects

February 23, 2016

Overview

In this paper, we take a look at following topics:

- The Federal Open Market Committee (FOMC) is likely to raise the target range for the federal funds rate by just 50 basis points in 2016.
- The most probable path is for the Committee to delay the next rate increase until September, as it pauses to take stock of more restrictive financial conditions and signs that growth momentum may be waning.
- Indeed, GDP growth will likely moderate to a trend-like pace of around 1.75 percent this year, though the risks to this projection are skewed somewhat to the downside. With less progress towards closing what remains of the output gap, the risks of an inflation overshoot are even lower than the Committee perceived at the time of liftoff.

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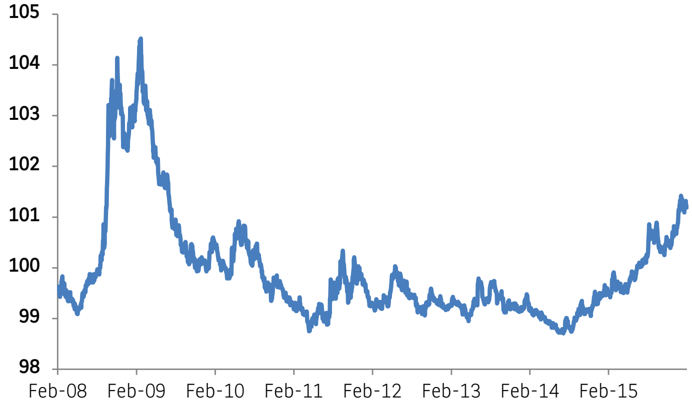
Just two months after starting a policy tightening cycle, the Federal Open Market Committee (FOMC) finds itself in the uncomfortable position of seeing mounting evidence that its 2016 projections for above-trend growth will prove untenable. In fact, recession risk may be higher now than at any point during the post-crisis recovery. As a result, the FOMC will likely delay an additional policy rate increase until at least June, and most likely until September, in order to take stock of downside risks to the outlook. Before policy tightening can resume, a number of pieces will first need to fall into place. At the very least, financial conditions would have to ease and inflation expectations pick up along with realized inflation, and the service sector would need to regain some of the momentum lost over recent months. Our confidence in these outcomes over the near term is not particularly high, as they are dependent on clear signs of improving global growth, resilient consumer and business confidence, an absence of significant dollar appreciation, and a recovery in oil prices.

This note is structured as follows. The next several sections lay out the factors that are likely to cause a deceleration in growth this year or slow progress towards the two percent inflation objective. These factors include tighter financial conditions, falling inflation expectations, slowing service sector momentum, more restrictive bank lending standards for corporate loans, and declining corporate profit growth. The concluding section discusses near-term recession risks, as well as two different scenarios for monetary policy this year.

Tighter Financial Conditions

Tighter financial conditions remain one of the primary reasons why 2016 growth will come in meaningfully below the FOMC's median economic projection made at the time of lift-off. Indeed, financial conditions have now been tightening for well over a year, and by some measures are more restrictive than at any point since 2009. The catalysts behind tighter conditions are varied, and include the drawn-out and uncertain approach of Federal Reserve policy tightening over the course of last year, mounting concerns about China's growth outlook and economic management, and rising default risks in the US high yield oil and gas sector. In the aggregate, the tighter conditions these developments have engendered will serve as a drag on consumer wealth and confidence, and constrain business investment and hiring. In addition, prior dollar strength will continue to weigh on net exports.

Financial Conditions Index



Source: Goldman Sachs

When we model the impact of last year's stock market declines, dollar strength, and credit spread widening, we find that the tightening of conditions, if sustained, could subtract around one percent from our baseline growth forecast for 2016, shrink monthly payrolls growth to around 100,000, and dampen the inflation outlook. We do not take this modelling exercise as verbatim, especially since some of the growth effects of tighter financial conditions likely already occurred last year[1]. Still, the results provide support for our conviction that US growth this year will slow to around 1.75 percent, with risks to that projection now skewed to the downside.

One way to think about the linkage between financial conditions and monetary policy is to consider that markets have already done the work for the FOMC. By gradually raising the policy rate, the Committee had sought to tighten financial conditions in order to slow the economy back towards a two percent growth rate (the median Committee participant's estimate of trend) and prevent an inflation overshoot. To the extent that tighter financial conditions will already weigh on growth and inflation this year and possibly next, the Committee will have a greatly reduced need to raise rates over the medium term. In fact, according to our model, last year's tightening of financial conditions was the equivalent of about 150 basis points of policy rate increases, in terms of the estimated macro effects.

Falling Inflation Expectations

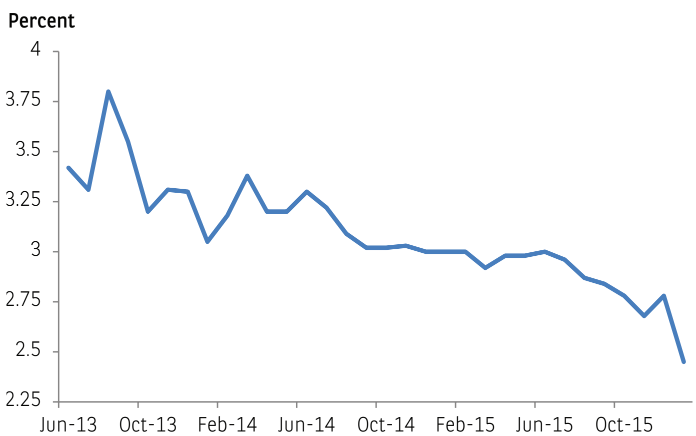
Slack-based models of inflation ascribe a critical role to inflation expectations. If realized inflation persists below the central bank's inflation objective, the central bank can still feel relatively confident that inflation will eventually rise to the objective so long as inflation expectations remain well anchored. Unfortunately for the FOMC, the news on this front has not been encouraging. Except for brief

[1] The results also do not take into account the positive macro effects associated with lower interest rates.

periods, the Federal Reserve has failed to sustain core PCE inflation at two percent over the past seven years. Over this period, both spot and forward measures of inflation compensation derived from the TIPS market have declined, and are currently hovering near historic lows. The Committee has tended to downplay the signals from the TIPS market, citing poor market liquidity and occasional flight-to-quality flows into nominal Treasuries that suppress inflation breakevens. In addition, some Committee members have argued that narrow breakevens may primarily reflect a declining inflation risk premium, instead of lower inflation expectations. However when inflation remains persistently below target, even a narrowing of the inflation risk premium is concerning, as it may signal that investors assign lower probabilities to upside inflation surprises.

Even as the Committee has downplayed the signals from the TIPS market, discouraging news from surveys is harder to ignore. The University of Michigan consumer survey reveals median expectations for inflation to average 2.4 percent per year over the next 5 to 10 years, the lowest level in the survey's 40-year history. The new Federal Reserve Bank of New York's Survey of Consumer Expectations has recently shown an even sharper decline in inflation expectations. Committee members may be tempted to focus on the level of these indicators, which seem in line with the Committee's inflation objective. However, the trend in the survey measures should be a source of concern, particularly as realized inflation has persisted below the two prevent objective over the same period. These survey measures are unlikely to reverse course over the medium term if the Committee follows through with policy tightening even as downside growth risks mount.

Median Three-Year Ahead Expected Inflation Rate



Source: Survey of Consumer Expectations, © 2013-15 Federal Reserve Bank of New York (FRBNY)

Slowing Service Sector Momentum

The US manufacturing sector came under increasing strain over the course of 2015 due to the effects of a stronger dollar and weak global demand. The FOMC has been confident that the contraction in manufacturing would have only a modest impact on overall growth and employment given the relatively small weight that manufacturing plays in the US economy. While this has generally been the case, lately there are signs that the more dominant service sector is beginning to cool as well, possibly due to spillovers from the weakness in manufacturing, as well as weak global demand. For three straight months now, the headline index reading for the non-manufacturing ISM survey has declined. And while at 53.9 it remains above the key 50 level signaling expansion, the rate of decline over the past six months of many of its component indices has been faster than at any point since the Great Recession.

ISM Non-Manufacturing Survey, Overall and Select Components

	Overall Survey	Activity	New Orders	New Export Orders	Employ-ment	Prices
Level:	53.5	53.9	56.5	45.5	52.1	46.4
6-Month Decline:	-6.1	-9.5	-6.1	-11	-7.1	-5.9
Largest 6-month Decline since:	Mar '09	Feb '09	July '11	Mar '09	Feb '14	Jan '15

Source: Bloomberg

Tighter Lending Standards

Trends in bank lending standards could also serve as a headwind to growth. According to the Federal Reserve's Senior Loan Officers Survey, over the past two quarters an increasing net percent of domestic banks have tightened credit standards for commercial and industrial (C&I) loans to large and medium-size firms. This measure moved up to similar levels ahead of the previous two recessions. It also moved higher in late 2011 as financial market stresses related to Europe's sovereign debt and banking crisis intensified. This tightening in credit standards proved to be short-lived, as more restrictive financial conditions and the shock to consumer and investor confidence led to a range of policy responses, including the Federal Reserve's Maturity Extension Program. Still, the larger point is that a tightening in bank lending standards for C&I loans tends to be associated, at the very least, with a meaningful loss of growth momentum. In the 2011 episode, real GDP growth slowed to a 1.6 percent annual rate, from 2.5 percent the previous year.

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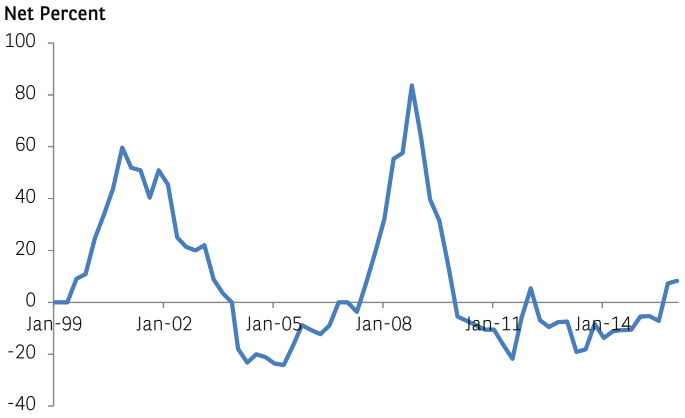
Domestic Banks Tightening C&I Loan Standards to Large and Medium-Sized Firms

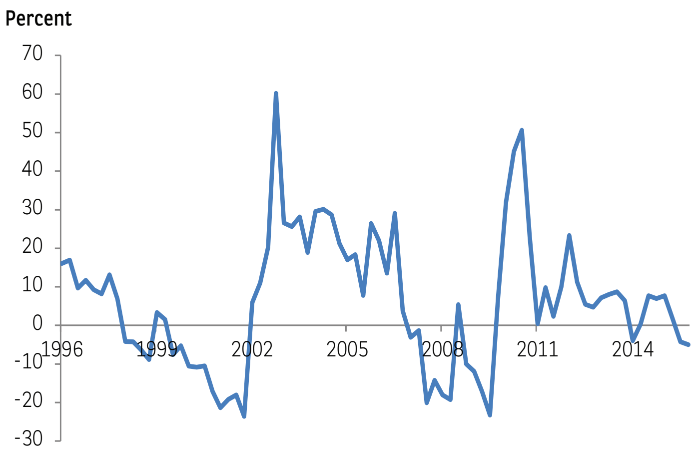


Source: Board of Governors of the Federal Reserve System

Declining Corporate Profit Growth

Finally, we estimate that corporate profit growth declined by around five percent year-over-year in the fourth quarter of 2015, after a 4.3 percent year-over-year decline the previous quarter. The decline in corporate profits has been due to a combination of very low productivity and rising unit labor costs, against a backdrop of weaker global demand. There may be limited scope for profit growth to turn positive this year, given upward pressure on labor compensation, a lackluster outlook for productivity growth, and an increasingly challenging global growth outlook. Should business margins continue to compress, companies may respond by slowing the pace of hiring and investment, resulting in an additional headwind to growth going forward.

Pre-Tax Corporate Profit Growth (YoY)



Source: US. Bureau of Economic Analysis; FFTW estimate (Q4 2015)

Recession Risks and Policy Outlook

Given the above factors, many investors have argued that financial markets are sending clear signals of an imminent recession. However, unimpressive growth at around the economy's potential rate is the most likely outcome this year, for a number of reasons. First, for the majority of households, home price appreciation is a more important driver of household wealth than the stock market. Barring a much more significant decline in stock prices and a broader shock to confidence, continued home price gains will support spending. In addition, while there are signs that banks are tightening lending standards for C&I loans and commercial real estate, by all indications consumer credit standards have continued to ease, including for mortgages. These factors, along with a healthy labor market, rising real incomes and low gasoline prices, should continue to support consumption. In addition, policy-makers globally have begun to signal a greater willingness to ease monetary policy further, or in the case of the FOMC, delay additional tightening.

Given this assessment of slowing growth and factors pointing to increased downside risks to the outlook, the FOMC will find it difficult to follow a sustained, gradual pace of interest rate increases over the next year. Still, given building evidence of slowly firming wages and inflation, some additional policy tightening is likely even if the growth outlook is weaker than it was at the time of lift-off. This year, the most likely course is for just two rate increases, bringing the rate on IOER to 100 basis points by the end of the year. As for the specific path for rates, should the current stabilization in financial conditions endure, and if incoming data continue to point to a rebound in consumer spending after a poor end to 2015, the FOMC may next raise rates at the June meeting. But in this event, financial conditions would likely resume tightening and investor concern over recession risks would again build, ultimately leading the Committee to delay a second rate increase until December.

A somewhat more likely scenario is that the Committee takes an extended pause in the tightening cycle until the fall, in order to evaluate the extent of the slowdown in growth and risks to achieving the inflation objective. A cautious approach to additional rate increases is also warranted given that the FOMC remains concerned about the increasingly unattractive cost-benefit tradeoffs of the policy options available should additional easing eventually prove necessary. In this regard, political risks associated with taking IOER into negative territory were made clear during Chair Yellen's Congressional testimony[2]. Domestic criticism that the Bank of Japan has faced for its own move into negative deposit rates also serves as a useful case study of the potential costs of taking rates below zero, as has increased market concerns over the impact of a negative IOER rate on bank interest margins.

[2] Admittedly, much of the concern expressed about IOER as a policy tool during Chair Yellen's Congressional testimony focused on "subsidizing" banks by paying out IOER, as opposed to charging a negative rate. Still, in a recessionary environment that might necessitate a move to a negative IOER rate, Congress would become very concerned that banks would pass this cost along to retail depositors. In an already contentious political climate for the Federal Reserve, the Committee may be quite unwilling to take on this additional political battle. This argues for an even more cautious approach in the current policy setting in order to mitigate recession risks and the political challenges that could follow should a negative IOER rate prove necessary.

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BIOGRAPHY

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Steven is a Senior Investment Strategist at BNP Paribas Investment Partners. In this role, he is responsible for developing thematic views on the market, economic and policy outlook in the US and other major economies. Steven joined our company in 2013 and is based in New York.

Prior to his current role, Steven was a Director for the Central Banks and Official Institutions team at FFTW, a subsidiary of BNP Paribas Investment Partners. Steven also held various positions at the Federal Reserve Bank of New York, most recently as Director of Market Analysis, where he worked on both market and policy analysis. Prior to that, Steven worked in other roles within the Markets Group, including, Director of Foreign Exchange and Investments, where he had oversight for the Fed's and Treasury's foreign exchange portfolios. During the financial crisis, he worked on the design and implementation of a number of liquidity facilities, such as swap lines with other central banks. Steven also spent two years at the Bank for International Settlements as a member of the Basel Committee Secretariat.

Steven has over 17 years of investment experience. He holds a BA in Government and Russian studies from Wesleyan University, an MA in International Relations from The Paul H. Nitze School of Advanced International Studies at The Johns Hopkins University, and an MBA (executive program) from Columbia Business School.

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