

Take-Aways from the Fed's December Minutes: Rate Hikes, Inflation and CRE/Financing Conditions



January 3, 2018

In short:

- Recall that in December, the Fed released its latest set of quarterly projections. The Board and Federal Reserve bank presidents continue to see three rate hikes in 2018; the average forecast calls for an additional three hikes in 2019 as well.
- Even so, today's minutes suggest greater ambiguity on the part of the Committee as to whether the persistent disinflationary, suggesting that the risks are tilted toward a Fed that moves more slowly in 2018 and 2019 than would otherwise be expected.

Below, please find highlights from the minutes that focus on wages, inflation, the impact of tax cuts and the future path of interest rates.

December Federal Reserve Board Economic Forecast (vs. September)

Variable	2017	2018	2019	2020	Longer Run
Change in real GDP, %	2.4 to 2.5 ≈ ↑	2.2 to 2.6 ↑	1.9 to 2.3 ↑	1.7-2.0 ≈	1.8 to 1.9 ≈
September Projection	2.2 to 2.5	2.0 to 2.3	1.7 to 2.1	1.6-2.0	1.8 to 2.0
Unemployment rate, %	4.1 ↓	3.7 to 4.0 ↓	3.6 to 4.0 ↓	3.6 to 4.2 ↓	4.4 to 4.7 ≈ ↓
September Projection	4.2 to 4.3	4.0 to 4.2	3.9 to 4.4	4.0 to 4.5	4.5 to 4.8
PCE inflation, %	1.6 to 1.7 ≈ ↑	1.7 to 1.9 ≈ ↓	2.0 ≈	2.0 to 2.1 ≈	2.0 ≈
September Projection	1.5 to 1.6	1.8 to 2.0	2.0	2.0 to 2.1	2.0
Core PCE inflation, %	1.5 ≈	1.7 to 1.9 ≈ ↓	2.0 ≈	2.0 to 2.1 ≈	n/a
September Projection	1.5 to 1.6	1.8 to 2.0	2.0	2.0 to 2.1	n/a
Fed Funds (average)	1.34% ≈	2.02% ≈	2.70% ≈ ↑	3.02% ↑	2.78% ≈
September Projection	1.33%	2.04%	2.63%	2.85%	2.78%
Fed Funds (median)	1.38% ≈	2.13% ≈	2.69% ≈	2.56% ↓	2.75% ≈
September Projection	1.38%	2.13%	2.69%	2.88%	2.75%

Source: Federal Reserve

Note: Excludes the three highest and three lowest projections for each variable in each year (except average and median Fed Funds rate figures, which include all participants.) Arrows (↑, ↓ and ≈) indicate direction of change in forecast from September 2017 to December 2017. Real GDP and inflation projections are from Q4 of the previous year to Q4 of the year indicated. PCE inflation refers to the price index for personal consumption expenditures. Projections for the unemployment rate are for the average rate during Q4 of the year indicated.

Good news for CRE and borrowers, despite “elevated” asset prices

In commercial real estate (CRE) markets, **spreads of commercial mortgage-backed securities (CMBS) yields over comparable-maturity Treasury yields remained near the lower end of the range seen since the financial crisis, and delinquency rates on loans in CMBS pools continued to decrease.** The growth of CRE loans held by the largest banks continued to slow, while CRE loan growth at smaller banks remained strong overall and even picked up a bit in October.

Financing conditions for large nonfinancial corporations continued to be accommodative on balance. Gross issuance of corporate bonds and gross equity issuance remained robust. Institutional leveraged loan issuance in November was brisk. Growth of bank-intermediated credit to nonfinancial firms, however, was tepid. On balance,

the credit quality of nonfinancial corporations was little changed over the intermeeting period and appeared to remain solid. **Financing conditions for small businesses also appeared to have remained favorable.** In municipal bond markets, gross issuance was strong and credit quality remained stable.

With regard to financial markets, some participants observed that financial conditions remained accommodative, citing a range of indicators including low interest rates, narrow credit spreads, high equity values, a lower dollar, and some evidence of easier terms for lending to risky borrowers. **In light of elevated asset valuations and low financial market volatility, a couple of participants expressed concern that the persistence of highly accommodative financial conditions could, over time, pose risks to financial stability.** Participants also noted that term premiums on longer-term nominal Treasury securities remained low. A number of factors were seen as possibly contributing to the low levels of term premiums, including large holdings of longer-term assets by major central banks, persistently low global inflation, and substantial global demand for assets with long durations.

Curve flattening is not necessarily a recession signal

Several participants thought that it would be important to continue to monitor the slope of the yield curve. **Some expressed concern that a possible future inversion of the yield curve, with short-term yields rising above those on longer-term Treasury securities, could portend an economic slowdown, noting that inversions have preceded recessions over the past several decades,** or that a protracted yield curve inversion could adversely affect the financial condition of banks and other financial institutions and pose risks to financial stability. A couple of other participants viewed the flattening of the yield curve as an expected consequence of increases in the Committee's target range for the federal funds rate, and judged that a yield curve inversion under such circumstances would not necessarily foreshadow or cause an economic downturn. It was also noted that **contacts in the financial sector generally did not express concern about the recent flattening of the term structure.**

The caution of “several” outweighs the “few” who see low inflation as being transitory

Inflation on a 12-month basis was expected to remain somewhat below 2 percent in the near term but to stabilize around the Committee's 2 percent objective over the medium term. Near-term risks to the economic outlook appeared to be roughly balanced, **but participants agreed that it would be important to continue to monitor inflation developments closely. A few participants again noted that transitory factors had likely held down inflation earlier this year. However, several participants observed that survey-based measures of inflation expectations or market-based measures of inflation compensation remained low, or that other persistent factors may be holding down inflation,** which would present challenges for the Committee in promoting a return of inflation to 2 percent over the medium term.

“Modest boost” from tax cuts, but the bill could explain the rally in equity markets *(comments made prior to the passage of the tax bill):*

Many participants expected the proposed cuts in personal taxes to provide some boost to consumer spending. A few participants noted that **expectations of tax reform may have already raised consumer spending somewhat to the extent that those expectations had spurred increases in asset valuations and household net worth.** A number of participants expressed uncertainty about the magnitude of the effects of tax reform on consumer spending.

Many participants judged that the proposed changes in business taxes, if enacted, would likely provide a modest boost to capital spending, although the magnitude of the effects was uncertain. **The resulting increase in the capital stock could contribute to positive supply-side effects, including an expansion of potential output over the next few years.** However, some business contacts and respondents to business surveys suggested that firms were cautious about expanding capital spending in response to the proposed tax changes or noted that the **increase in cash flow that would result from corporate tax cuts was more likely to be used for mergers and acquisitions or for debt reduction and stock buybacks.**

A few participants noted that a reduction in personal tax rates could potentially increase labor supply, but the magnitude of such effects was quite uncertain. *(Editor's note: do you know anyone who is more likely to re-enter the workforce now because they'll be giving away less to the government as a result of lower tax rates?)*

Wages and inflation

Overall, the pace of wage increases had generally been modest and in line with inflation and productivity growth. In some Districts, reports from business contacts or evidence from surveys pointed to a pickup in wage gains, particularly for unskilled or entry-level workers. In a couple of regions, businesses facing tight labor market conditions were said to be offering more flexible work arrangements or taking advantage of technology to use employees more efficiently, rather than raising wages. A few participants judged that the tightness in labor markets was likely to translate into an acceleration in wages; however, another observed that the absence of broad-based upward wage pressures suggested that there might be scope for further improvement in labor market conditions.

Many indicated that they expected cyclical pressures associated with a tightening labor market to show through to higher inflation over the medium term. These participants generally judged that much of the softness in core inflation this year reflected transitory factors and that inflation would begin to rise as the influence of these factors waned. However, one of them noted that secular trends, such as technological innovation or globalization, could be affecting competition and business pricing, and muting inflationary pressures. With core inflation readings having moved down this year and remaining well below 2 percent, some participants observed that there was a possibility that inflation might stay below the objective for longer than they currently expected. Several of them expressed concern that persistently weak inflation may have led to a decline in longer-term inflation expectations; they pointed to low market-based measures of inflation compensation, declines in some survey measures of inflation expectations, or evidence from statistical models suggesting that the underlying trend in inflation had fallen in recent years. A few participants, however, noted that measures of inflation expectations had remained broadly stable this year despite the low readings on inflation and judged that this stability should support the return of inflation to the Committee's 2 percent objective.

The future remains data-driven and “realized vs. expected” developments

Regarding the determination of the appropriate timing and size of future adjustments to the target range for the federal funds rate, participants reaffirmed the need to continue to assess realized and expected economic conditions. Most participants reiterated their support for continuing a gradual approach to raising the target range, noting that this approach helped to balance risks to the outlook for economic activity and inflation.

More tightening?

Participants discussed several risks that, if realized, could necessitate a steeper path of increases in the target range; these risks included the possibility that inflation pressures could build unduly if output expanded well beyond its maximum sustainable level, perhaps owing to fiscal stimulus or accommodative financial market conditions.

A few other participants mentioned that they saw as appropriate a pace of additional policy tightening through the end of 2018 that was somewhat faster than that implied by the December SEP median forecast. They noted that financial conditions had not materially tightened since the removal of monetary policy accommodation began, that continued low interest rates risked financial instability in the future, or that the labor market was increasingly tight. A couple of participants noted the need to continue to monitor and evaluate the effects of balance sheet normalization on long-term interest rates and economic performance.

Less tightening?

Participants also discussed risks that could lead to a flatter trajectory for the federal funds rate in the medium term, including a failure of actual or expected inflation to move up to the Committee's 2 percent objective. While participants generally saw the risks to the economic outlook as roughly balanced, they agreed that inflation developments should be monitored closely. A few participants indicated that they were not comfortable with the degree of additional policy tightening through the end of 2018 implied by the median projections for the federal funds rate in the December SEP. They expressed concern that such a path of increases in the policy rate, while gradual, might prove inconsistent with a sustained return of inflation to 2 percent, or that the level of the federal funds rate might already be near its current neutral value. Due to the persistent shortfall of inflation from the Committee's 2 percent objective, or the risk that monetary policy could again become constrained by the zero lower bound, a few participants suggested that further study of potential alternative frameworks for the conduct of monetary policy such as price-level targeting or nominal GDP targeting could be useful.

From the dissenters (who will not be voting in 2018):

Mr. Evans: With inflation continuing to run substantially below 2 percent and measures of inflation expectations lower than he believed to be consistent with a symmetric 2 percent inflation objective, it was important to pause in the process of policy normalization. Leaving the target range at 1 to 1-1/4 percent for a time would better support an increase in inflation expectations, increase the likelihood that inflation will rise to 2 percent and perhaps modestly beyond, and thus provide more support for the symmetry of the Committee's inflation objective. Such a pause also would better allow the Committee time to assess the degree to which earlier soft readings on inflation were transitory or more persistent.

Mr. Kashkari: While employment growth remained strong, wage growth had not picked up and inflation remained notably below the Committee's 2 percent target. In addition, the yield curve had flattened as long-term rates had not moved higher even though the Committee raised the federal funds rate target range. He was concerned that the flattening yield curve was partly due to falling longer-term inflation expectations or a lower neutral real rate of interest. He preferred to wait for inflation to move closer to 2 percent on a sustained basis or for inflation expectations to move up before further raising the target range for the federal funds rate.

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