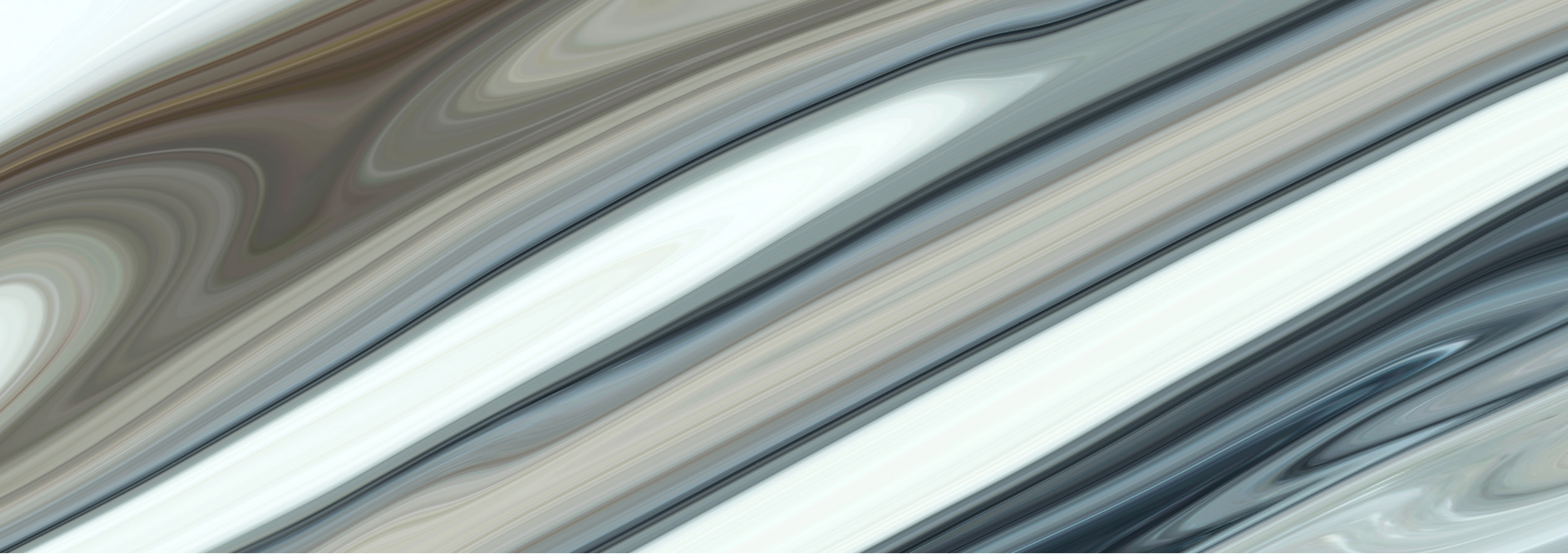

January 2018

Fed Thoughts:

Interregnum

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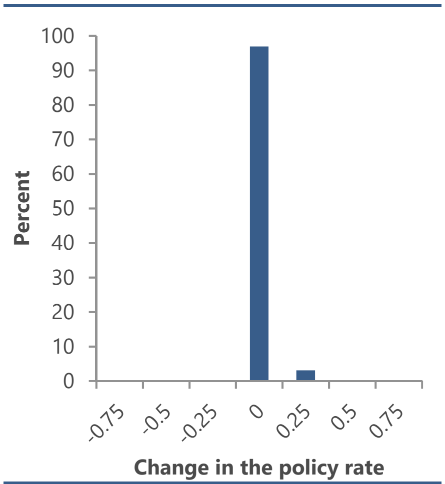
We almost forgot that the Federal Open Market Committee meets on January 30th-31st. That is understandable, as the chance of any significant news from the Federal Reserve at the conclusion of the meeting is remote. According to the latest federal funds futures quotes, the probability of a change in the policy rate this month is about 3 percent, which is basically rounding error in financial markets. We have arrived at this conclusion for a few reasons.

Action Expected at the FOMC Meeting Implied by Futures Contracts



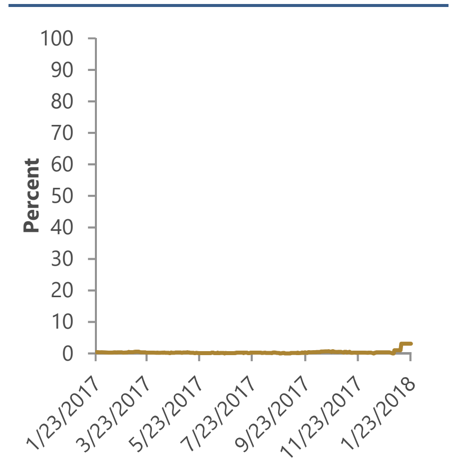
Source: CME Group at http://www.cmegroup.com/trading/interest-rates/countdown-to-fomc.html, accessed as January 28, 2018

First, Fed officials view surprising investors as anathematic. In 2017, a strong foreshadowing of action appeared in the minutes of the meeting prior to the four actions of the year (three on the policy rate and one on the balance sheet). If that was not sufficient warning, officials worked hints into their public remarks and probably guided some journalists to the appropriate conclusion.

Second, in the modern era of four press conferences a year, FOMC participants have reserved action for those occasions when the chair could explain it to reporters. The other four meetings have become unloved orphans—such as the upcoming one. Indeed, the market-implied probability of action at the first meeting of the year has been approximately zero for the past year, in that the pricing of the December 2017 and January 2018 fed funds futures contracts have been virtually identical. That is, the corpse of the January meeting has no pulse.

Fed officials likely see predictability as a virtue, as it limits an untoward market reaction to action. The irony, of course, is the same people, repeat the mantra that "All decisions are data dependent and made meeting by meeting." In reality, those data-dependent decisions are made several meetings in advance so that they are certain to have laid sufficient foam on the market runway.

Probability of a change in the funds rate at the January FOMC meeting

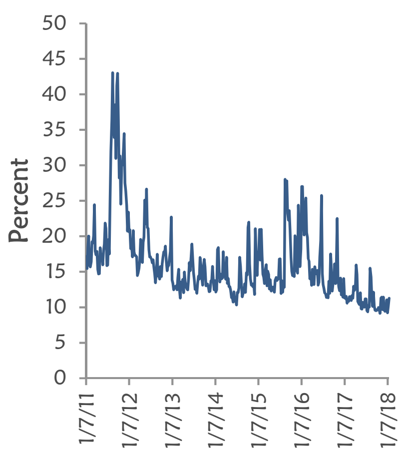


Note: Average of the absolute difference of implied probabilities across different strikes of the December and January fed funds futures contracts and probability on current target rate post December 14, 2017. Source: CME Group at http://www.cmegroup.com/trading/interest-rates/countdown-to-fomc.html, accessed January 24, 2018.

Virtue may turn into a vice if events move sharply. In that regard, the Fed's reaction to a surprise is most likely asymmetric in two dimensions. For one, they are much more willing to disappoint markets (not act when an action is priced in) than surprise markets (act when an action is not priced in). For another, having only recently lived through the worst economic downturn since the Great Depression and harboring doubts about the scope for stimulus given the low current level of rates, Fed officials are likely to move more nimbly to downside economic shocks than to upside ones. The surprise from this is that there is any surprise at the low levels of market volatility. In the event, there is no apparent imprint on the implied volatility of the S&P 500 equity price index from tariffs, tweets, nor tussles about funding the federal government.

This relative certainty contributes to the Fed's current conundrum (technically, Conundrum 2.0 in Fed history). Thus far, the funds rate target has been hiked five times. Judging by the latest Summary of Economic Projections, FOMC participants must believe that they are about halfway done with this tightening cycle. However, financial conditions have eased notably, on net, over this period, suggesting that the FOMC has a bit of work to do.

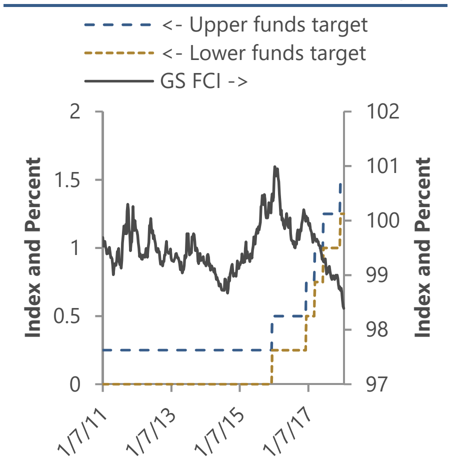
Implied volatility on the S&P 500 index (VIX)



Source: CBOE, accessed via Bloomberg, January 24, 2018.

But not at this meeting. This brings us to the third and final reason for not planning to hold our breath at 1:59 EST on Wednesday, January 31st. The Federal Reserve is a polite and patient place, almost to the point of being persnickety. There will be two people with "Chair" in their title at the meeting, one planning to retire on February 3rd and the other her just-confirmed successor. Chair Yellen will run the meeting and graciously accept the complements of her colleagues. Chair-designee Powell will be just Governor Jay, one of the eight other members of the Committee.

Federal Reserve Stance of Policy



Source: Federal Reserve and Goldman Sachs, accessed via Bloomberg, January 28, 2018.

Both will want to convey continuity. Last year, the Fed acted at its four press-conference meetings, with the policy rate hiked at three meetings and the announcement of a plan to reduce its balance sheet at the fourth. We think that the Fed will follow the same script this year, raising its policy rate four times by 25 basis points and following through with its plan to trim its balance sheet gradually and transparently. If so, they will agree among themselves to act at the March meeting. We will hear that sentiment in subsequent speeches and Chair Powell's semiannual testimony on monetary policy and read it in the minutes in three weeks. But that comes in the fullness of time, not Wednesday afternoon.

Against the backdrop of these actions in 2018, easy financial conditions, the ongoing paring of regulatory burdens, and the stimulus imparted from the newly passed tax legislation support spending and produce above-trend economic growth. With resource slack shrinking and the earlier decline in commodity prices receding in the rearview mirror, US consumer price should rise. That said, inflation has mostly run softer than expected over the past several months, and the pickup is likely to be gradual. A lower-for-longer path of the funds rate should prevent inflation from seriously breaching the Fed's 2-percent goal. True, market participants are not there yet, placing about 80 percent of the chips on futures rates below a fed target of 2-1/4 to 2-1/2 percent at year end. But the Fed has time to talk that into market prices and will do so if our macroeconomic forecast eventuates.

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