Evaluating US Fed Comments

Balance sheet recalibration in sight; June rate hike likely

Economics
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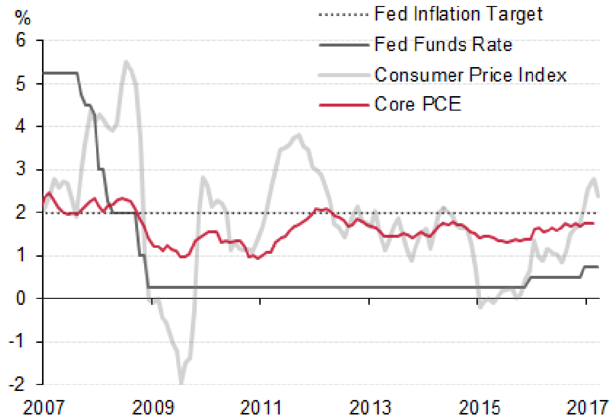
OVERVIEW

- **Federal fund rate range likely retained at 0.75-1.00%.** We believe that the Federal Open Market Committee (FOMC) is likely to maintain its Federal fund rate range at 0.75-1.00% in May. This comes after its decision in March to raise the benchmark rate by 25 basis points (bps).
- **Inflation barometer sluggish; labour market health improving.** An assessment of the Fed's key barometers suggests that while jobs market have been advancing steadily, the US economy remains a distance from its inflation target of 2.0% core PCE inflation. Some Fed officials have been quick to note that this is a target, rather than a ceiling.
- **Bond portfolio normalisation to alter tightening timeline**. The March FOMC minutes suggest that the bond portfolio may be trimmed sooner than later in 2017. While some Fed members have noted that this may be a substitute for rate hikes, interpretations vary on how far this would alter the number of rate hikes for 2017.
- **Two rate hikes for 2017 likely.** We expect one more 25bp rate hike for 2017 in June as the Fed execute its plan to normalise its balance sheet.
- **Ringgit gains on USD weaknesses.** On the deterioration of the US dollar, we expect the ringgit to strengthen somewhat though trade range bound within USD4.40-4.50 band for 1H17 as it tests the psychological MYR4.40/USD threshold. Our full year forecast remains at MYR4.35/USD.

Doves and hawks weigh on monetary policy. The Federal Open Market Committee is due to announce their next policy rate decision at the conclusion of their May 3rd meeting. Based on the Federal Fund Futures as at 17 April, there is an implied 13.3% odds that the policy rates will be raised at the conclusion of the May meeting though the implied probability for rates to move above the 0.75-1.00% bracket is 50.2% in the June meeting.

Graph 1: Fed Funds Rate & CPI (Core & Fed Target)

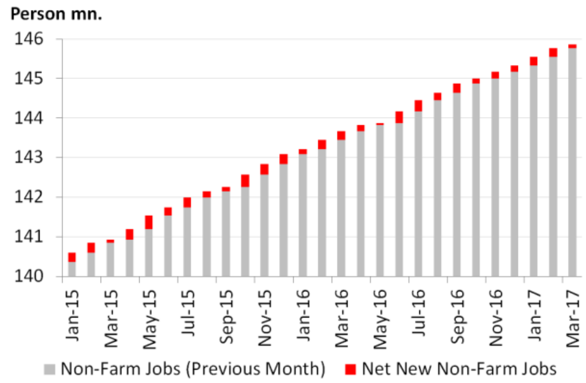


Source: Bloomberg

Slow pickup in inflation. The latest core PCE reading (as at February) shows inflation rising 1.8% YoY (Jan: 1.8%), just slightly under the Fed's full year projection for 1.9% and stubbornly under the Fed target for 2.0%. The headline PCE index, meanwhile, grew 2.1% (Jan: 1.9%). Based on the consumer price index, inflation rose 2.4% (Feb: 2.7%) while the corresponding core inflation rose by just 2.0% (Feb: 2.2%), its smallest increase since November 2015. The moderation in core inflation was partially attributed to a 6.2% decline in gasoline prices. March's retail figures further suggests that demand-based inflation may not be as strong as previously anticipated with purchases falling 0.2% in March (Feb: -0.3%, revised from +0.1%), suggesting a possible moderation in economic growth.

Improving labour market health. In the labour market, the Labour Market Conditions index remained in positive territories, rising 0.4 in March, slightly weaker than 1.4 and 1.5 in January and February respectively. This comes as the jobs market continues to see modest gains in employment as both unemployment and rate jobless claims fell. The US added 98,000 non-farm jobs in March though lower than the 216,000 and 219,000 non-farm jobs added in January and February respectively. The closely-watched Job Openings and Labour Turnover Survey (JOLTS) saw job openings inching higher at 5,743,000 job openings (Jan: 5,625,000) while the Automatic Data Processing Inc.'s ADP National Report, showing a 263,000 increase in nonfarm private sector employment.

Graph 2: Net Non-Farm Job Creation



Source: Bloomberg

Notwithstanding lower addition in nonfarm employment, the seasonally adjusted unemployment rate also fell 4.5% in March (Feb: 4.7%) while the first time jobless claims fell to 234,000 person during the week ended 8 April, slightly down from 235,000 during the previous week and 259,000 during the last week of March. Robust labour market trend may portent future support to wage growth, a much needed ingredient in persuading Fed policymakers of firming inflation.

Policy uncertainties cloud outlook. Despite President Donald Trump's ambitious plans for overarching fiscal reforms, there are increasing signs that these plans may well be mired in legislative gridlock, at best, or strangled in the cradle. His failure to push through the repeal of Obama's Affordable Care Health ("Obamacare") amid divisions in his Republican Party and strong partisanship suggests that Trump's fiscal plan may have to struggle with the fiscal conservatives within his party (who may balk at higher expenditure) and the moderates (who may oppose excessive cuts to social assistance). His significant U-turns in recent weeks – most notably, support of NATO, declining to label China as a currency manipulator and his warming up to Fed Chair, Janet Yellen – suggests some moderation from some of his campaign stance. This, in turn, suggests that paring down expectations of his pre-election promises may be prudent.

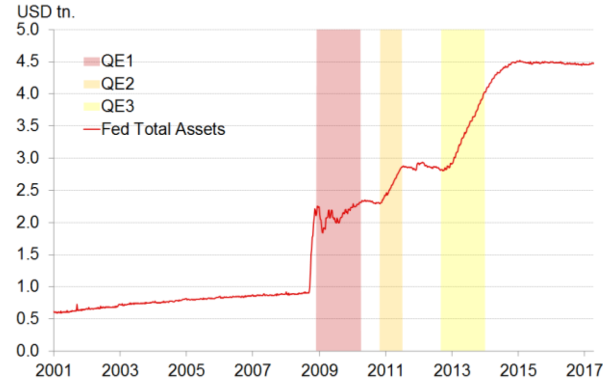
DISSECTING FED'S COMMENTS

Doves and hawks weigh on monetary policy. Fed Chair, Janet Yellen, noted that despite the Fed's decision to raise rates by 25bp, the Fed is likely to keep interest rate hikes slow notwithstanding inflation overshooting, noting that the 2% inflation goal is not a ceiling but a target. St. Louis Fed President, James Bullard stood at the more dovish end, backing one more rate hike for 2017, arguing "This is not an environment that data is screaming at the Fed that it has to move". This sentiment was likewise echoed by Minneapolis Fed President Neel Kashkari, who dissented on March's rate hike. Chicago Fed President, Charles Evans, later noted that he is "at a point where two (total Fed Fund) rate increases in 2017 seems very safe". This implies comfort among some Fed policymakers in building up an inflation buffer for overshooting the price growth target.

However, Cleveland Fed President, Loretta Mester, saw more than three interest rate hikes for 2017 as she sees a stronger economy than the median forecast. She was joined by Boston Fed President, Eric Rosengren who argued that "The base case (for 2017) would be four tightenings, reflecting the strength of the economy that I believe justifies more regular normalization of interest rates". Slightly biased on a more aggressive tightening pace, San Francisco Fed President, John Williams, saw interest rates rising "three or more" times as the US economy achieved full recovery from the recession. Other Fed policymakers, including Stanley Fischer (Fed Vice Chairman) and Robert Kaplan (Dallas), stood by the projection for three rate hikes.

Trimming of balance sheet on the cards. Recent comments by Fed policymakers suggest that the Feds may consider trimming its USD4.5t bond portfolio as soon as this year. The New York Fed projects a modest bond portfolio normalisation to approximately USD2.8t by the end of 2021. The minutes of the March FOMC meeting suggests that many of the Fed policymakers favour shrinking the balance sheet in 2017, parallel to cutting interest rates. At the same time, some of the Fed policymakers suggest that the normalisation of the bond portfolio may work as a substitute for short term rate hikes given its similar impact in tightening monetary policy – Philadelphia Fed President, Patrick Harker cautioned that this would be balanced "off the path of the fed fund rate". New York Fed President, William Dudley commented, "Presumably, at the time that you make the decision on the balance sheet you might want to forego the decision on short-term rates just to make sure that the balance sheet doesn't turn out to be a bigger decision than you thought you were making", lending credence to the idea of a "little pause" in the Fed's plan to hike rates.

Graph 3: Federal Reserve Total Assets



Source: Bloomberg

Policy uncertainties as a wildcard. The uncertainties surrounding the Trump's planned expansionary fiscal push adds another unknown variable into the Fed's policymaking. With some wind taken off the sails of the reflation trade amid partisan politics and Trump's failure to mobilise both moderate and fiscal conservatives among the Republican camp, it is uncertain if a more cautious approach to Fed's tightening monetary policy in the event that Trump's fiscal push results in a sharp correction in the reflation trade which was observed post elections. On the flip side, a modest advancement of Trump's fiscal agenda may warrant a faster than expected step-up of Fed's monetary tightening.

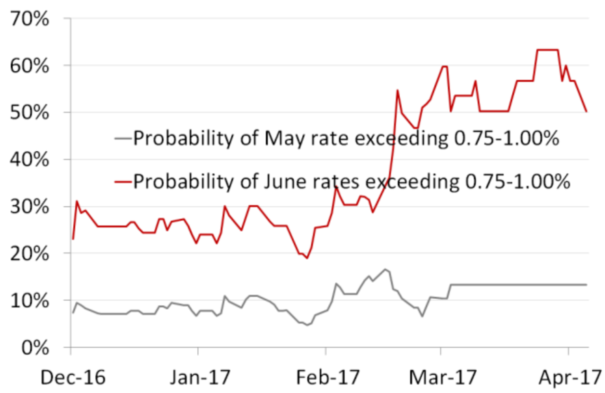
Thus far, policymakers have broadly claimed that interest rates will be predicated in the prevailing economic situation rather than "impending policy", we continue to believe that the ongoing developments on the fiscal sphere – whether sentiment or policy-driven – will hold significant sway on the Fed's barometers, hence ultimately influencing interest rate decision.

OUTLOOK

May rates likely to stand pat. The Fed will likely take a breather in May as it digests further economic and financial data before deciding on a rate hike in May, along with obtaining further clarity on Trump's fiscal plan. Fed Evans suggests that June is likely to be the earliest decision point for the Fed in considering a further rate hike.

Strong case for two rate hikes. While comments from the Fed suggests that many of the policymakers are leaning towards the median estimate of three rate hike, we believe that there is a compelling case for just two rate hikes for 2017, with the next hike occurring in June, combined with a gradual reduction of the bond portfolio. At present, while improvements in labour market suggests that there are some room for optimism in pushing for

Graph 4: Probability of May & June Rate Hike



Source: Bloomberg

the Fed's suggested three rate hikes, we believe that it would be prudent for the Fed to err on the side of dovishness (at least on the interest rate front), as the Fed seeks to normalise its bond portfolio. Furthermore, despite lower unemployment rate, the labour force participation rate remained below its pre-crisis level at around 63% as at March, only slightly higher than 62.7% during December 2016 and below the 66% point during 2008.

A more prudent stance will be supported by suggestions that core PCE inflation remains below the Fed target of 2.0%. While a faster interest rate rise will be consistent with the Fed's stated goal of normalising its ultra-loose monetary policy even prior to achieving the inflation target, more Fed policymakers have come to acknowledge that the 2.0% figure is a target, rather than a ceiling. The lacklustre March retail figure suggests that a more aggressive interest rate hike risks strangling recovery momentum.

Risks to a faster rate hike. The prevailing economic climate will be increasingly nebulous with Trump uncertainty and the introduction of bond portfolio normalisation as an immediate policy option. Our prediction for just two rate hikes (along with modest bond portfolio normalisation) is grounded in a relatively soft inflation rate amid continued labour market recovery. Assuming an uptick in inflation indicators, amid stable labour market growth, there may be a case for further tightening to at least three rate hikes in 2017. A further consideration includes the success (or failure) of Trump's agenda amid legislative gridlock. Indeed, the odds of a June rate hike is far from certain – the Fed Fund implied probability suggests that the odds of a June rate hike is just above 59%.

Table 1: Economic Projections of Federal Reserve Board members

	2016	2017	2018	2019	Longer Run
Real GDP (YoY%) *(December Projections)*	1.9 *1.9*	2.1 *2.1*	2.1 *2.0*	1.9 *1.9*	1.8 *1.8*
Unemployment Rate (%) *(December Projections)*	4.7 *4.7*	4.5 *4.5*	4.5 *4.5*	4.5 *4.5*	4.7 *4.8*
PCE Inflation (YoY%) *(December Projections)*	1.5 *1.5*	1.9 *1.9*	2.0 *2.0*	2.0 *2.0*	2.0 *2.0*
Core PCE Inflation (YoY%) *(December Projections)*	1.7 *1.7*	1.9 *1.8*	2.0 *2.0*	2.0 *2.0*	NA *NA*
Federal Fund Rate (%) *(December Projection)*	0.6 *0.6*	1.4 *1.4*	2.1 *2.1*	3.0 *2.9*	3.0 *3.0*

Source: Federal Reserve, Kenanga Research

OPR to stay pat; inflation in focus. Meanwhile, given improving growth prospects, rising inflationary trend (albeit on cost-push factors), and to a lesser extent, a relatively more stable flow of portfolio capital, we believe that the odds for Bank Negara Malaysia to cut the overnight policy rate has greatly receded. At the same time, however, we do not see a compelling justification for a rate rise despite the expectation that the CPI would surpass 4.0% this year from last year's average of 2.1%. This is especially so, given relatively stable demand and general price trends. However, we do note that this may be a starting point for a mild tightening bias especially when demand-induced inflation starts kicking in when aggregate demand strengthens though the probability remains low.

Ringgit outlook unchanged. With President Trump suggesting that the US Dollar may be too strong, we believe that there may be some room for the dollar to further weaken somewhat in the coming months. This, in turn, may lend some strength to the ringgit in the coming months, translating into some upside for the ringgit, possibly testing the psychological MYR4.40/USD resistance level for the ringgit. For now, our USDMYR forecast remains at 4.35 for the full year though we believe that the ringgit is likely to trade range bound between 4.40-4.50 for 1H17, with the possibility of appreciating beyond the USD4.40 mark.

Table 2: FOMC Meeting Schedule for 2017 / KIBB Outlook

No.	Date		KIBB Research Outlook	Fed Decision
1st	31 Jan-01 Feb	☑	No change	No change
2nd	14 Mar-15 Mar	☑	Fed Fund Rate increased 25 bp	Fed Fund Rate increased 25 bp
3rd	2 May-3 May	☐	No change	
4th	13 Jun-14 Jun	☐	Fed Fund Rate increased 25 bp	
5th	25 Jul-26 Jul	☐	No change	
6th	19 Sep-20 Sep	☐	No change	
6th	31 Oct-01 Nov	☐	No change	
6th	12 Dec-13 Dec	☐	No change	

Source: Federal Reserve System, Kenanga Research

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