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March FOMC: A rate rise coupled with an upgrade to economic forecasts



Yesterday, 21st March, the Federal Open Market Committee (FOMC) unanimously voted to raise the key US short-term interest rate by a quarter-percentage point to a range between 1.5 and 1.75%. It was the sixth in a succession of hikes since the Fed began raising rates in December 2015. The Committee, with Jerome Powell at the helm for the first time, also upgraded its economic forecasts but curtailed fears of overly aggressive tightening ahead.

The market currently expects three hikes for 2018, and this remained the baseline forecast. The

Fed's dot-plot (a diagram revealing Fed officials' projections for appropriate interest rate levels for the future) showed that the base case for 2018 is still three hikes, with an additional hike being added to expectations beyond 2018. By 2020, the funds rate is now expected to reach 3.4% (versus 3.1% previously expected). However, the neutral rate (that is the rate considered to be the neutral end point in the tightening cycle) is viewed at 2.9% which, Mr. Powell said, amounts to "modestly restrictive" policy.

Though the Fed has for now kept to three hikes in its 2018 guidance, the dot-plot did reveal an extra dash of hawkishness. The number of Committee members expecting four hikes is now equal to the number expecting three and if only one more member had indicated a higher funds rate, the median would have moved upwards and the scale would have likely tipped to four rate hikes this year. Economists and commentators have been increasingly subscribing to the 'three not four' narrative with regards to rate hikes this year, with a fourth being given a probability of 38% in futures markets before the meeting. It is important to note that the Fed's guidance is not set in stone, and as Powell himself stated, Fed forecasts were simply a collection of individual views, he said, and the FOMC could easily change its mind about the economic prospects.

The pace of growth is one essential ingredient in determining the Fed's monetary policy pathway. The FOMC raised its forecast for 2018 GDP growth to 2.7% (versus predictions of 2.5% in December), and increased the growth expectation for 2019 by 0.3% to 2.4%.

However, what is also a critical factor for the Fed is inflation, which has been playing hard-to-get, leading some members to challenge why the Fed is hiking without decidedly firm numbers. The Fed's prediction for personal consumption expenditures (PCE) inflation — the Fed's preferred measure — remained unchanged at 2%. This is despite more upbeat predictions for both employment and economic growth.

It seems that Jerome Powell passed his first test in terms of central bank communication. Though he revealed upgrades to the Fed's growth and interest rate forecasts, he simultaneously avoided giving the impression that the Fed would clamp down hawkishly on the economy, implying that it would move in a very data-driven manner. As a result, the stock market was tranquil. The 10-year Treasury yield held steady below 2.9%, reaching 2.84% today. The retreat is potentially due to the unwinding of short positions in bonds that were opened prior to the meeting, betting on a rise in yields that did not materialize on the back of Powell's prudent press conference.

Overall, fundamentally speaking, the outcome of the March meeting allows for a continuation of a 'risk-on' approach and bodes well for our equity overweight. However, the market has a short attention span and already its focus has been diverted to Trump's newly unveiled plan to levy tariffs on Chinese goods, once again stoking fears of a global trade war. This may also be weighing on the 10-year Treasury yield. We await the official details and the response from

Beijing which have the potential to promote a shift into safer assets.

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