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FOMC Minutes

Only 'a few' seem ready to hike in March

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Important disclosures and certifications are contained from page 19 of this report

Only a few FOMC members seem ready to hike in March

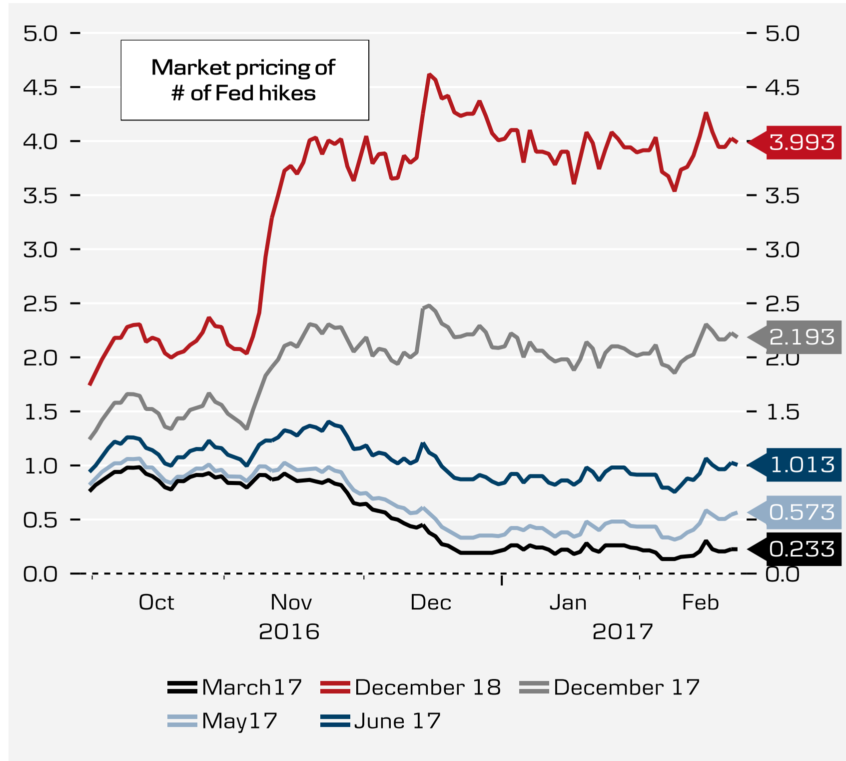
- **As expected, we did not get much new from the FOMC minutes,** as many FOMC members have already expressed their views since the meeting, not least Fed Chair Janet Yellen in connection with her semi-annual hearing in Congress.
- **The FOMC members think the economy continues to improve but that Trumponomics make the outlook more uncertain.** 'Uncertain' was mentioned 14 times in the minutes (versus 15 in December despite the hike and just five in November).
- **Although *'many participants'* expect a hike *'fairly soon'*, only *'a few participants'* expect a hike *'at an upcoming meeting'.*** This supports our view that a March hike is unlikely. The Fed can afford to stay patient for now due to the strong USD, which puts downward pressure on import prices, and PCE core inflation, which continues to run below 2% target.
- **We still expect the Fed to hike twice this year (in June and December) with risk skewed towards a third hike**. If economic indicators continue to be strong and we get more information on Trumponomics, we cannot rule out a May hike.
- **As the Fed has communicated it wants to offset more expansionary fiscal policy, the Fed may increase its hiking pace in the second half of the year, when we are likely to know much more about 'Trumponomics'.** Given the complicated process of passing through the necessary legislation in Congress, we do not expect any changes to economic policy before the end of Q2 17 at the earliest.
- **We will listen carefully to President Donald Trump's speech to a joint session in Congress on Tuesday 28 February, as we may get some more information about his economic plans.**

Markets price in two hikes both this year and next year

The first full Fed hike is priced in June

- **Markets have priced in two hikes this year**, which seems fair at the moment, as we need to get more details about 'Trumponomics' before the markets can price in further hikes.
- The first full hike is priced in June but there is a 57% probability of a hike in May according to market pricing.
- **We expect three to four hikes next year, as the Fed has indicated clearly that it wants to offset Trump's more expansionary fiscal policy**, although much could still happen before 2018.
- **However, the number of Fed hikes next year also depends on changes to the Fed's current reinvestment strategy** (see overleaf).
- **Markets have priced in an additional two hikes in 2018**, so there is still room for higher rates, in our view.
- **The Fed signalled three hikes in both 2017 and 2018 at the December meeting.**

Markets price in four hikes by year-end 2018



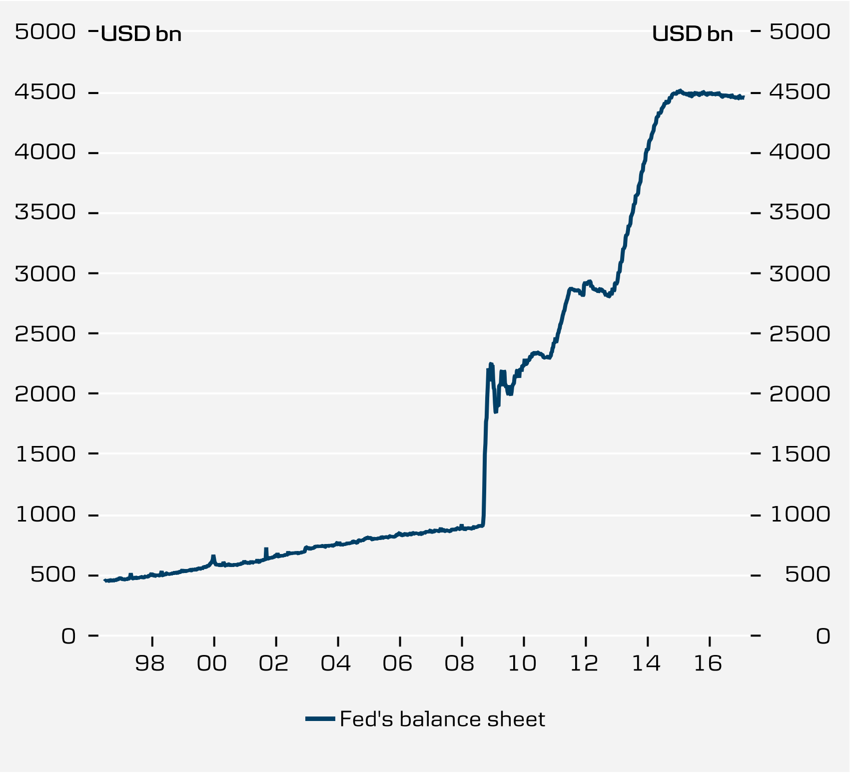
Source: Bloomberg, Federal Reserve, Danske Bank Markets

The Fed will soon begin to discuss reinvestment strategy

'Quantitative tightening' is becoming a market theme

- The FOMC minutes reveal that *'participants…generally agreed'* that they should begin to discuss *'the economic conditions that could warrant changes'* in the current reinvestment strategy *'at upcoming meetings'*. **In other words, 'quantitative tightening' is beginning to become a market theme.**
- **It seems that the Fed thinks it can avoid raising the Fed funds target range too much by shrinking its balance sheet, as it believes it would lead to higher long-term yields.** This would have a negative impact on financial conditions and growth, according to the Fed.
- In the FOMC statement from the meeting, it was repeated that the Fed will continue to reinvest until the normalisation of the Fed funds rate is *'well under way'*.
- **In our base case of two to three Fed hikes this year, we expect the Fed to continue reinvesting matured securities this year** (see also *US monetary policy normalisation tool box stocked and ready for second rate hike*, 12 December 2016).
- **However, the Fed may begin to reduce its balance sheet in the first half of next year,** when the Fed funds rate may be around 1.50% (which is half of the Fed's estimated neutral rate at 3.00%).

Fed wants to shrink its balance sheet



Source: Federal Reserve

President Trump set to nominate three Fed governors in coming months

Tarullo is stepping down

- **President Donald Trump now has to nominate three Fed governors in coming months, as Daniel Tarullo has announced he will step down on 5 April**. While Trump has expressed different views on monetary policy, we think it is most likely that he will appoint hawkish governors.

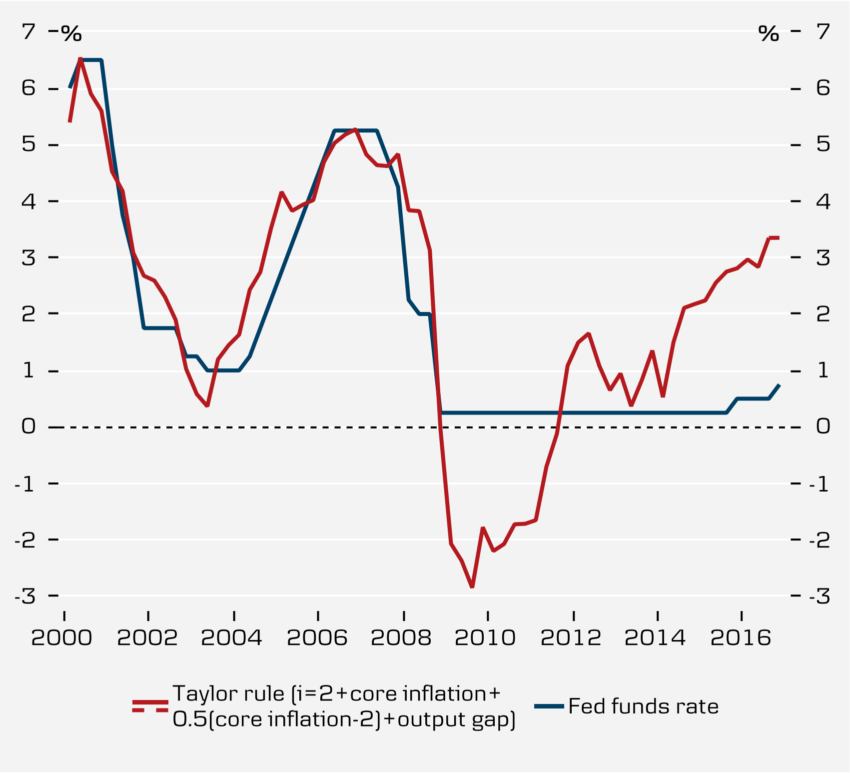
- Fed Chair Yellen's and Vice Chair Stanley Fischer's terms expire in 2018 and Trump has indicated he would be likely to replace them. ~In our view, one of Trump's nominees for the three vacant seats is likely to be the next Fed Chair.

- **Trump is likely to nominate a total of five new governors over the next two years, as Yellen and Fischer are expected to leave the Fed if they are not reappointed.**

- **The Fed may become more rule-based in coming years due to Trump's nominations.** A simple Taylor rule based on PCE core inflation and output gap suggests the Fed funds rate should be 3.0% currently. It is more difficult to predict the impact on overall US yields, as it also depends on the impact on inflation expectations.

- **For more details see** *Research US: Trump to nominate three Fed governors as Tarullo resigns*, **13 February.**

More rule-based Fed in coming years?



Source: Federal Reserve, CBO, BLS, Danske Bank

What to look for this year

	December hike	Triggers for Fed hikes in 2017
US growth	√ Picked up in H2 16 after weak H1 16	Growth to continue above trend; more expansionary fiscal policy from Trump
Unemployment rate	√ Has begun to fall again	Move lower, absorb remaining slack in labour market
Wage growth	√ Higher wage growth due to a tighter labour market	Wage growth needs to move higher to ensure a sustained increase in core inflation
PCE core inflation	√ Moved slightly higher this year	Still below 2% target, needs to move higher
Inflation expectations	√ Moved slightly higher	Still below historical average, higher expectations are very welcome
Financial markets	√ Calm markets; financial conditions have tightened in recent months but still not as tight as early 2016	Financial markets to stay calm; financial conditions not allowed to tighten too much, too quickly
Global economy	√ Synchronised recovery signal across regions	Global recovery to continue; no major slowdown in China

Source: Danske Bank Markets

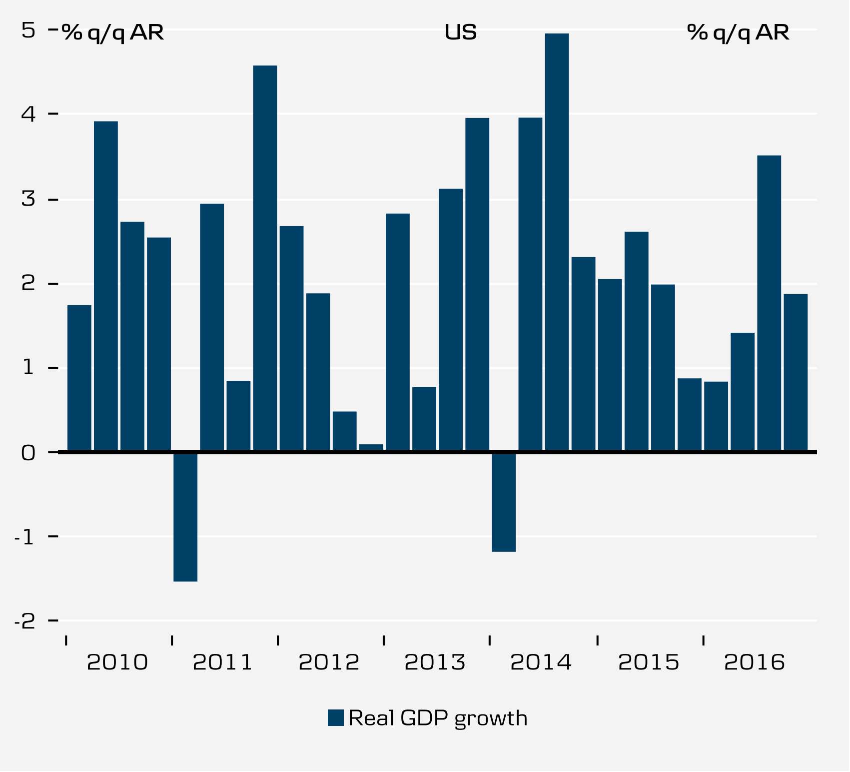
More US research

- *Research China: Don't rule out a US-China trade war just yet*, 21 February.
- *Research US: Trump to nominate three Fed governors as Tarullo resigns*, 13 February.
- *Strategy: Trump Trade – Part II?*, 17 February.
- *FX Edge: US Treasury Q1 cash deluge to ease USD support near-term*, 19 January.
- *US monetary policy normalisation tool box stocked and ready for second rate hike*, 12 December 2016.

Macro charts

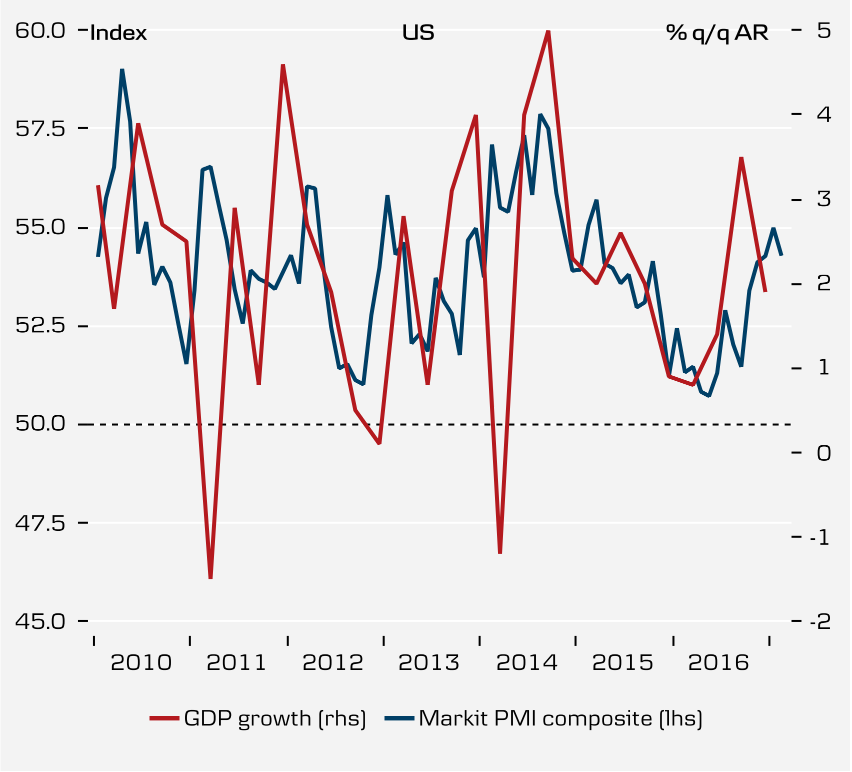
Growth rebounded in H2 16 after a slowdown in H1 16

Growth picked up in H2 16



Source: BEA

Growth has continued at an above-trend pace in Q1



Source: BEA, Markit Economics, Danske Bank Markets

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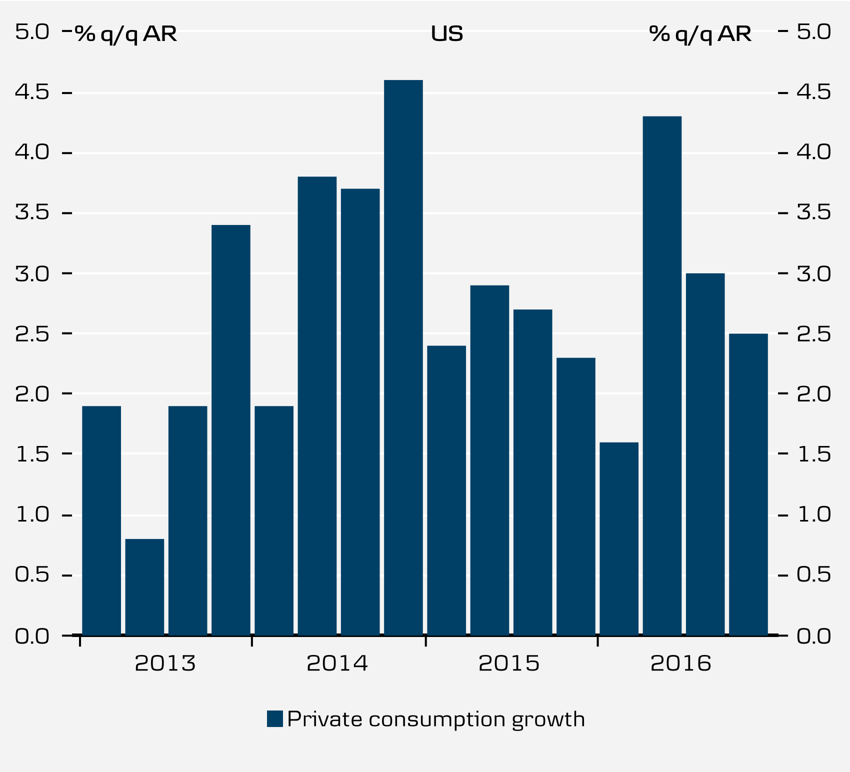
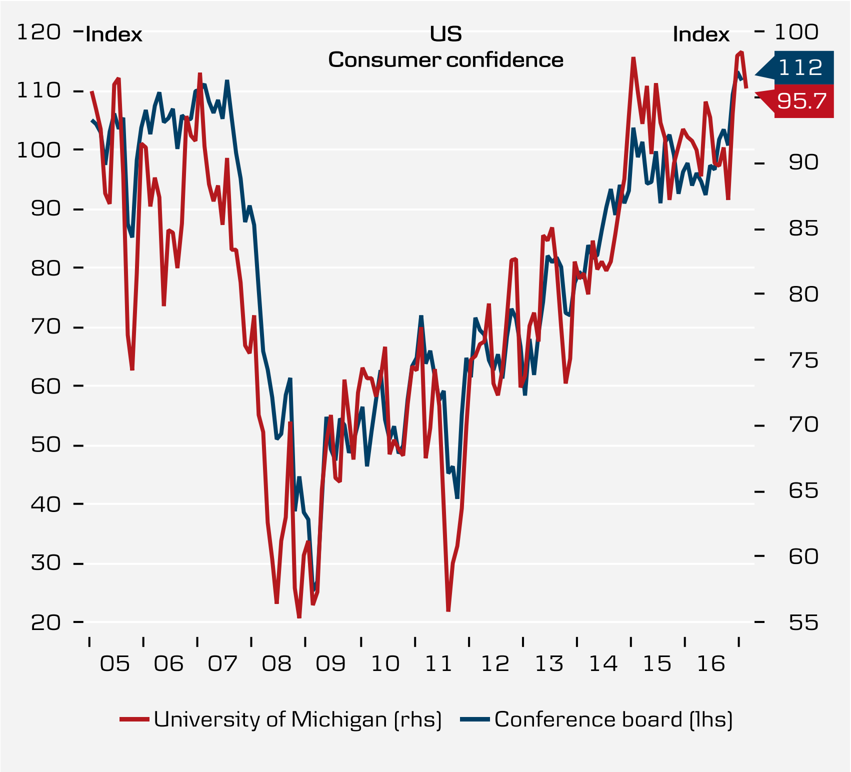
Private consumption the main growth engine

Solid private consumption growth



Source: BEA

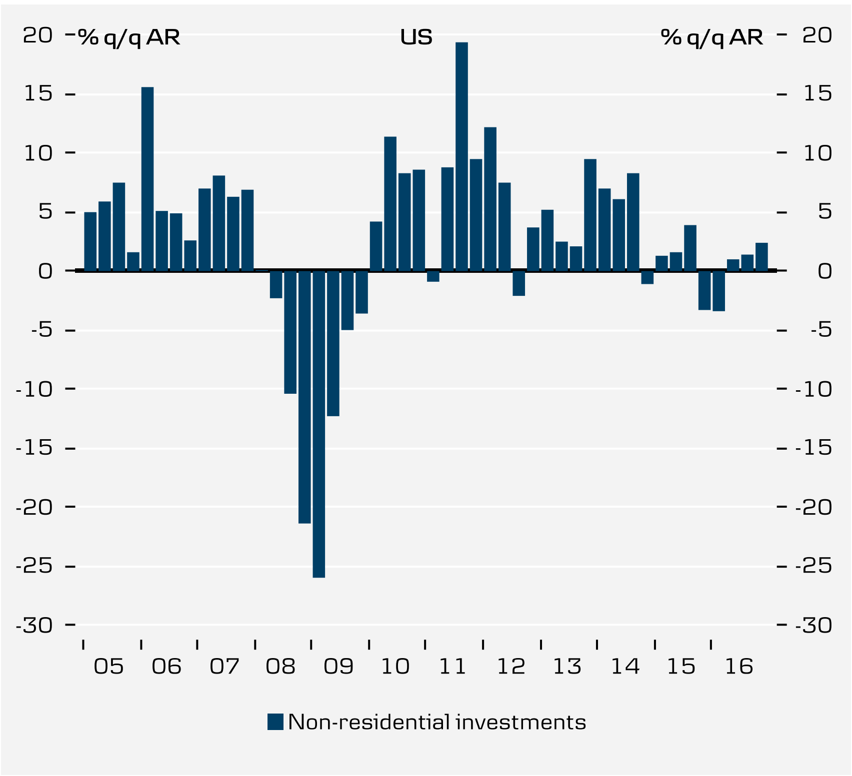
High consumer confidence supports consumption



Source: University of Michigan, Conference Board

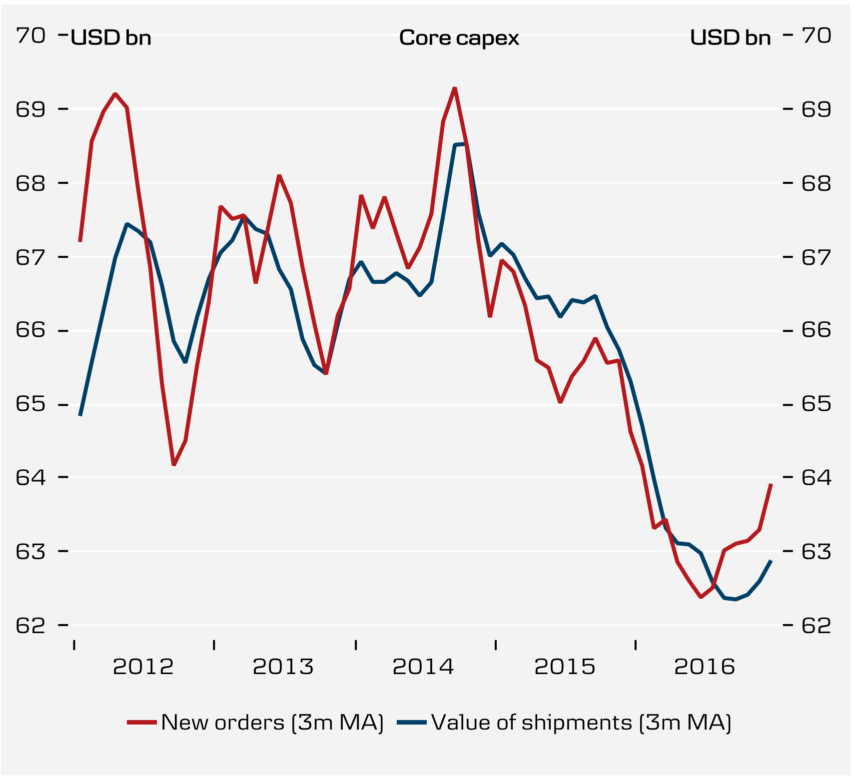
Have investments bottomed out? We think so

Non-residential investments have been weak



Source: BEA

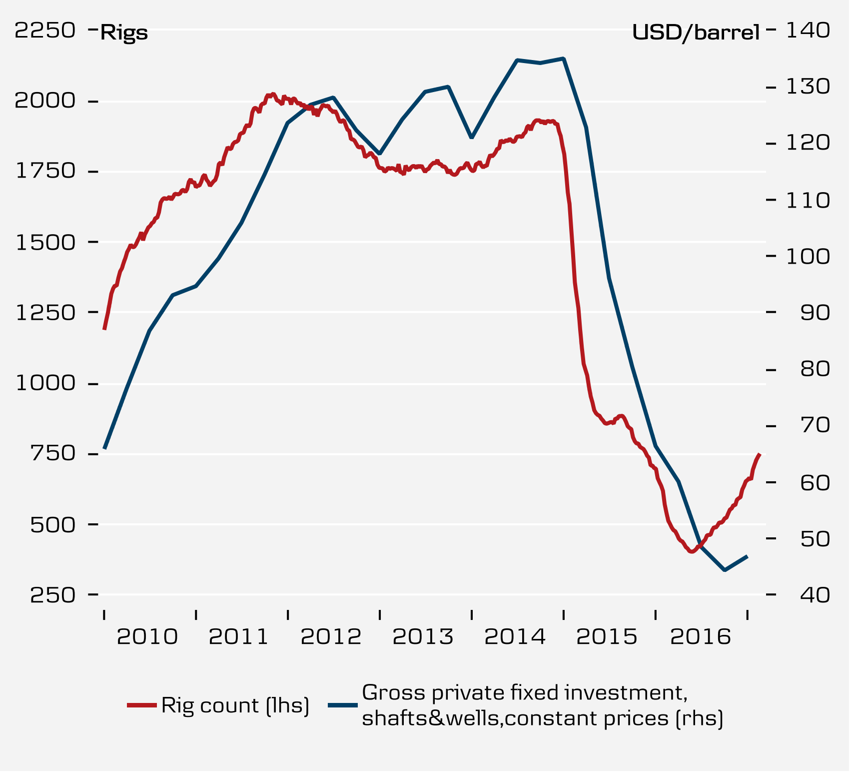
Core capex have bottomed out



Source: US Census Bureau

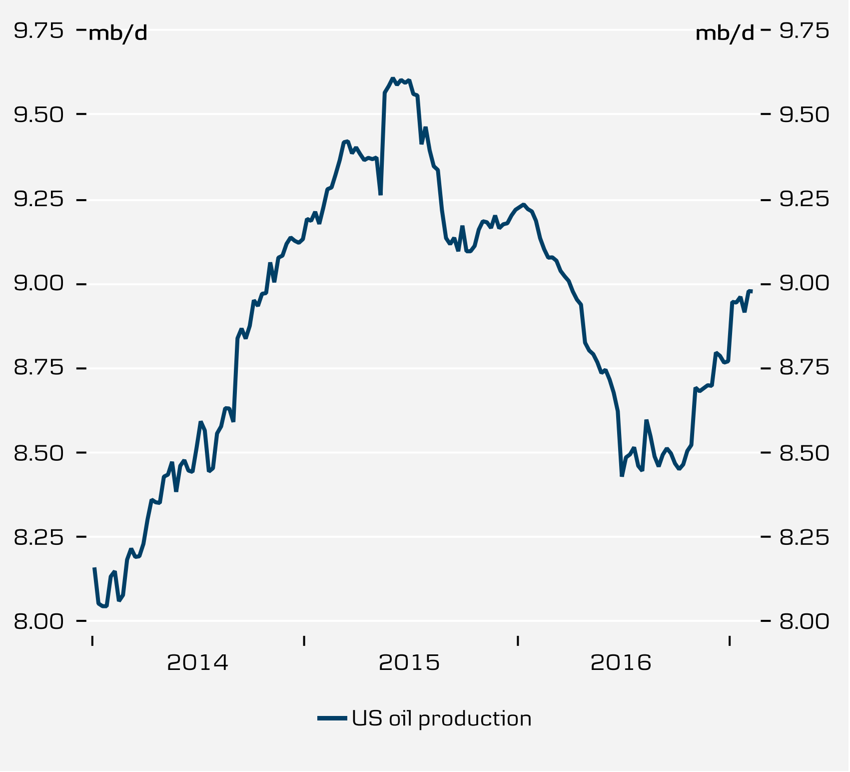
Headwind from lower oil investments is fading

Oil investments set to rebound



Source: BEA, Baker Hughes

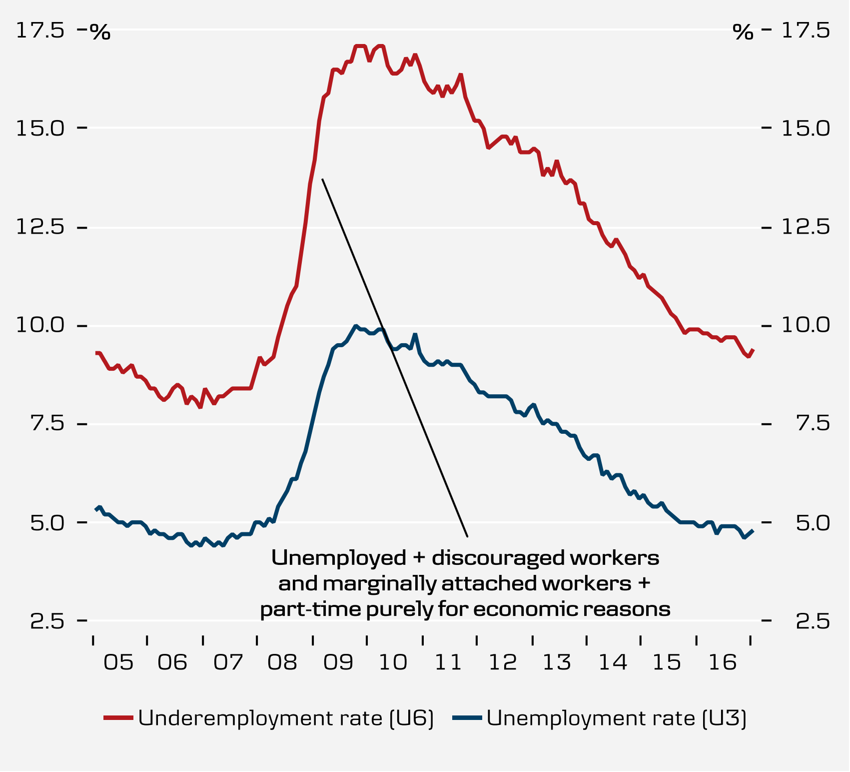
US oil production has rebounded



Source: EIA

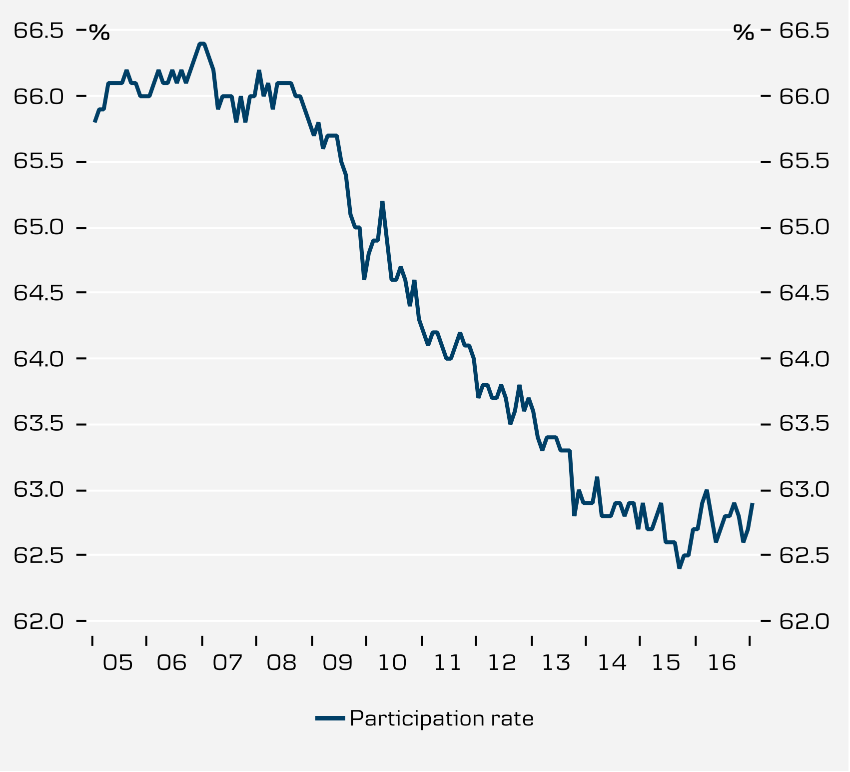
Still a bit more slack left in the labour market

Room for lower unemployment rates



Source: BLS

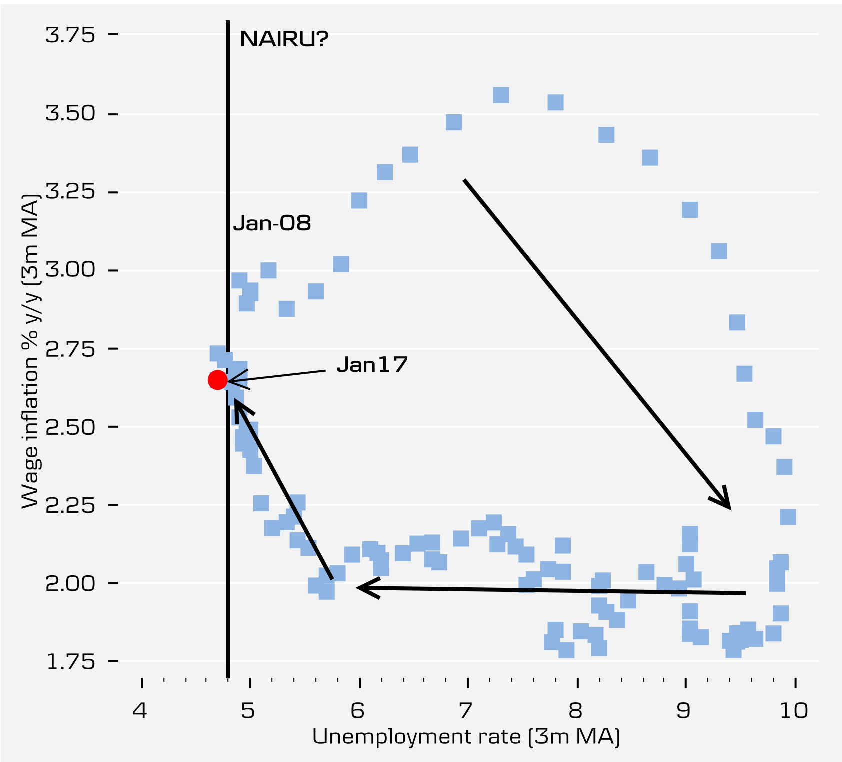
Participation rate has stabilised



Source: BLS

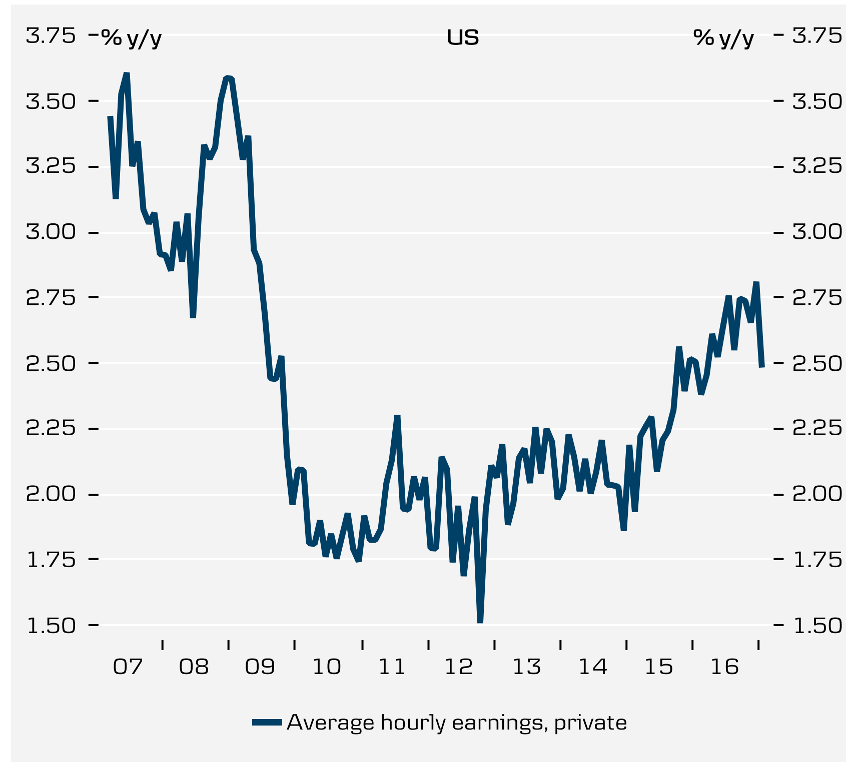
Fed sees the world through the Phillips curve

Tighter labour market => higher wage growth



Source: BLS

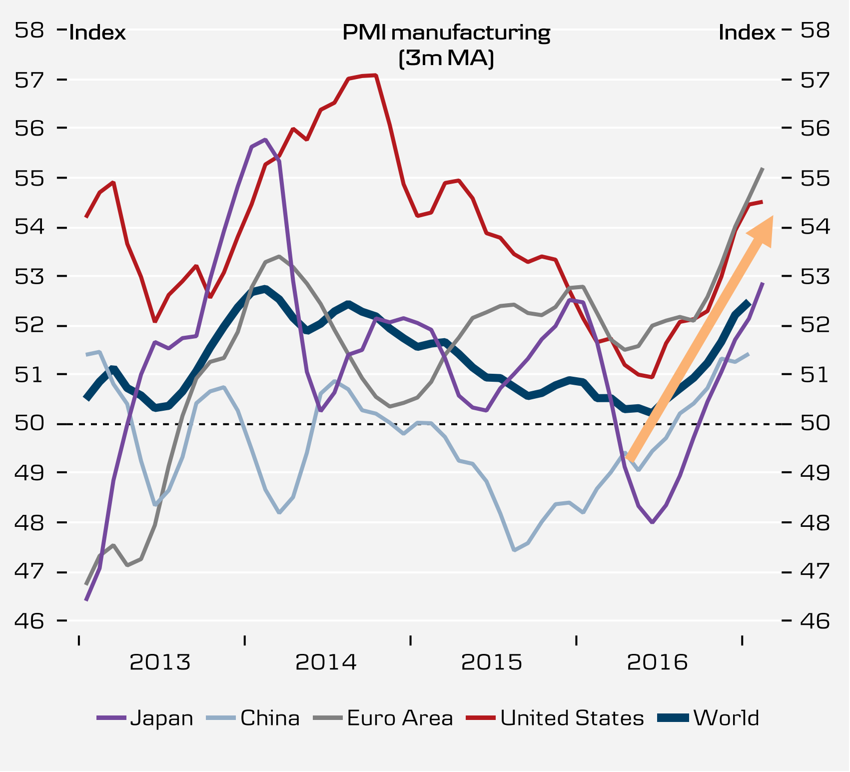
Wage growth still needs to move even higher



Source: BLS

Global business cycle has turned – synchronised recovery signal across regions

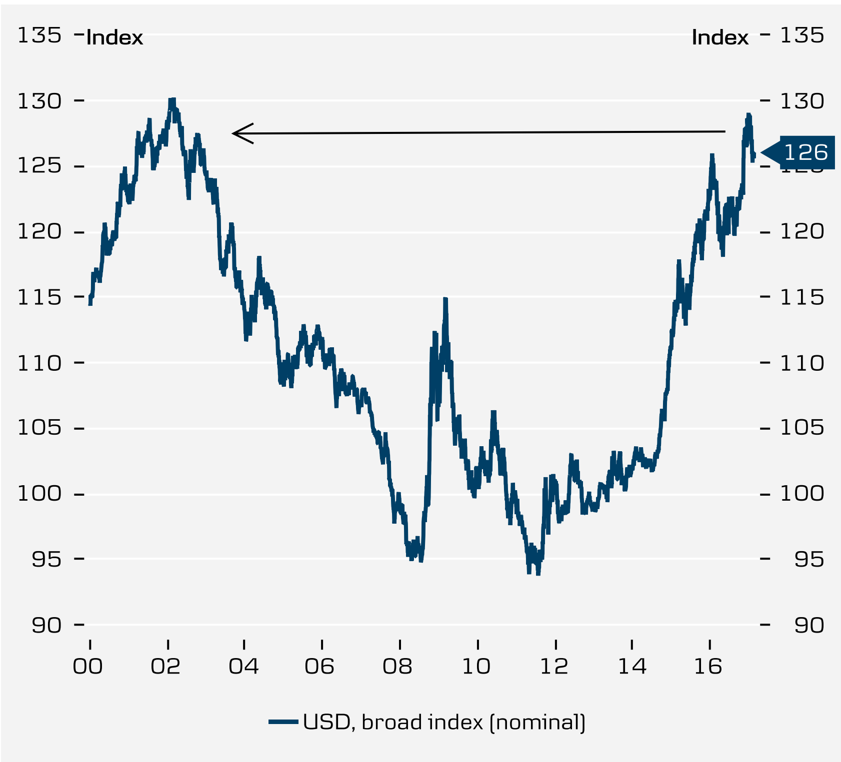
PMIs are trending up across countries



Source: Markit Economics

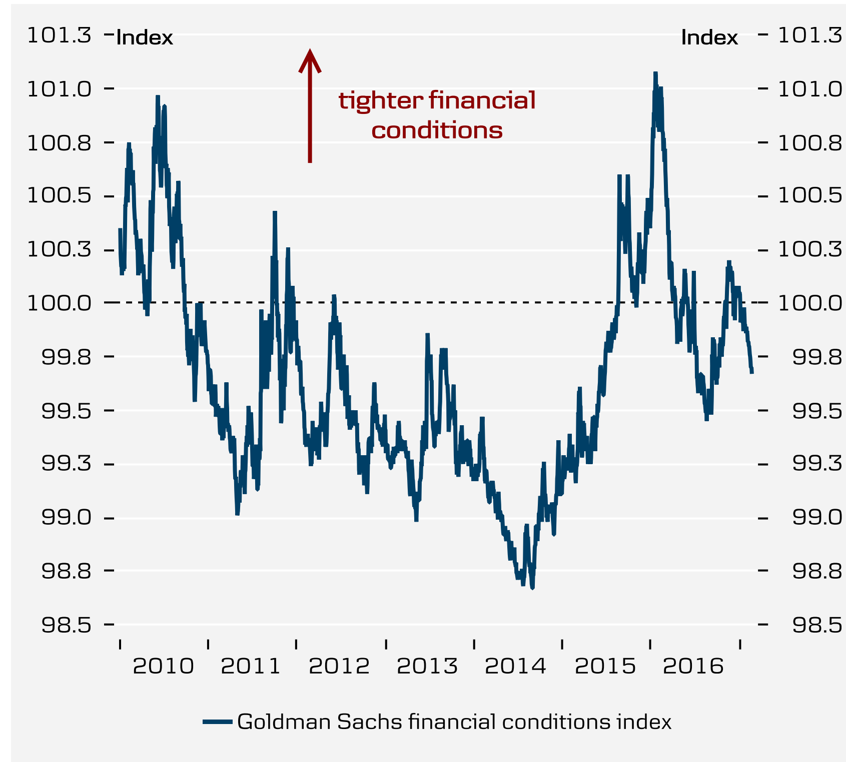
Financial conditions are not very tight yet

Strong USD a concern for the Fed



Source: Federal Reserve

Financial conditions have eased recently



Source: Goldman Sachs

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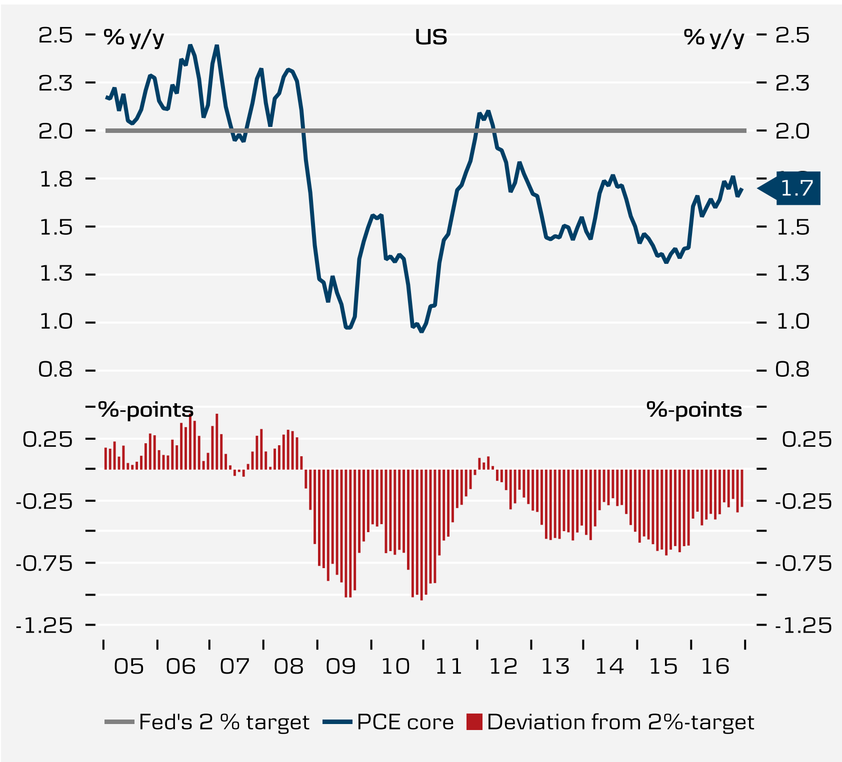
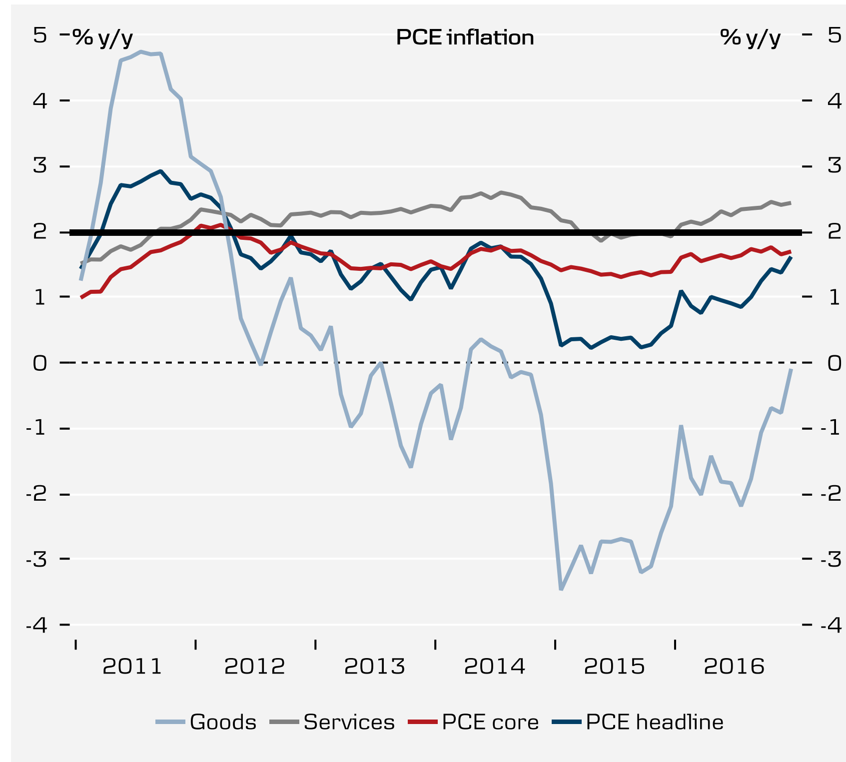
Actual PCE core inflation still below 2% target

Fed wants to see actual core inflation move higher



Source: BEA

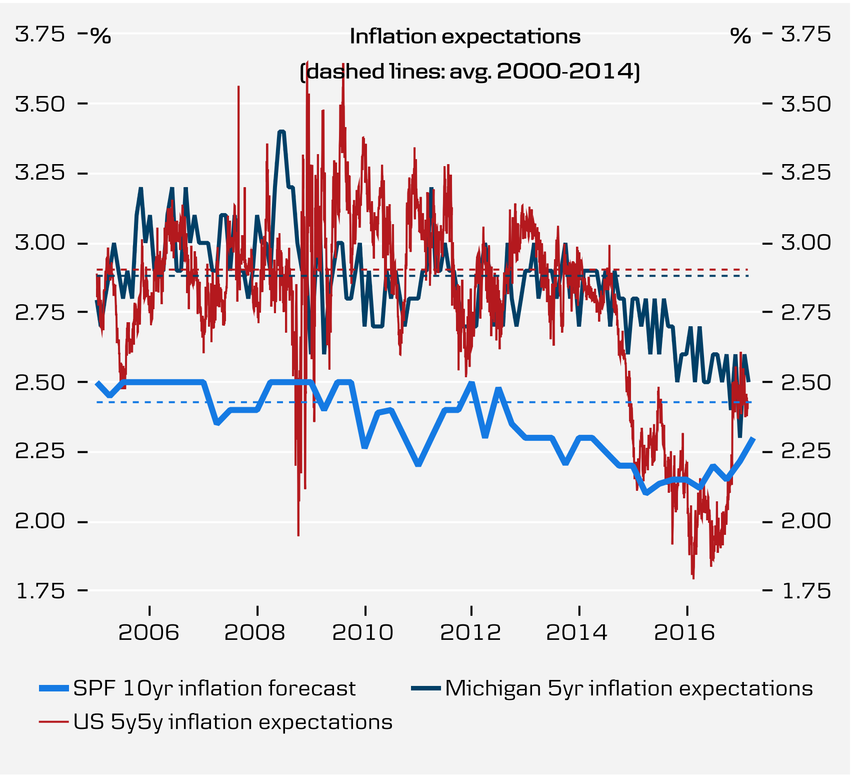
Goods deflation fading



Source: BEA

Inflation expectations have rebounded but are still low

Inflation expectations still below historical averages



Source: SPF, University of Michigan, Bloomberg

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None.

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