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Looking Beyond the Rate Hike

The Federal Reserve delivered two surprises on Wednesday, neither of which have had much impact on financial markets yet.

The Federal Reserve hiked the federal funds rate by 25 basis points (0.25%), moving their target corridor to 1.00-1.25%, up from 0.75-1.00%. The federal funds rate is now back above 1% for the first time in nearly a decade. But the move was a foregone conclusion. It was the central bank's plans for the federal funds rate this year and next, and its balance sheet plans, which were at odds with the market's expectations.

First, in terms of the federal funds rate, futures implied slightly more than 1 additional rate hike before the end of 2018. The Fed disagrees. The Fed's updated projections include 1 more rate hike in 2017 and 3 additional rate hikes in 2018. In short, whereas the market sees 1 more rate hike in the next 18 months, the Fed sees 4.

What explains the wide gap between market pricing and the Fed's own projections? The gap may have to do with a key dilemma policymakers face. While the unemployment rate (at 4.3% as of May) is at cycle lows, inflation as measured by the Fed's preferred inflation gauge, the core PCE, is lower now (1.5%) than it was in January (1.8%). Further, on Wednesday morning, a report for May showed that US core CPI slowed to 1.7% year-over-year versus the 1.9% consensus, corroborating the slower inflation theme. Longer-dated U.S. Treasury securities fell 7-10 basis points on the news.

Markets seemed to have decided that the inflation data might delay further rate hikes. Not likely, say policymakers, including Chair Yellen. "Conditions are in place for inflation to move up," Yellen opined at the press conference following Wednesday's meeting, pointing toward the strength in the labor market (a tighter labor market should -- eventually -- bring higher wages and more inflation). Further, recent weaker inflation readings, she said, may turn out to be noise, "driven significantly by what appear to be one-off reductions in certain categories of prices, such as wireless telephone services and prescription drugs."

We agree with Ms. Yellen. Look at the components of CPI, for example. We see that mobile phone plans shaved a surprisingly large 0.2 percentage points from headline inflation in May. Median CPI, which allows us to see through the short-term noise in inflation trends, registered at 2.3% during May.

Second, the Fed also surprised with the release of initial details for shrinking their balance sheet and indicated that the process would begin later "this year." Most market participants had expected details to be released later in the year. The unwind process will permit $6 billion of Treasury securities and $4 billion of agency debt and mortgage-backed securities (MBS) to roll off the Fed's balance sheet each month. If future economic conditions warrant shrinking the balance sheet further, every three months the initial caps will increase by $6 billion (Treasuries) and $4 billion (agency and MBS), up to a maximum of $30 billion in Treasuries and $20 billion in agency and MBS per month.

Financial markets exhibited a muted reaction to the two surprises. What do we expect for the rest of 2017? In terms of the balance sheet, barring a deterioration in the economy, September appears the likely start to balance sheet normalization. Fed Chair Yellen quoted her colleague Philadelphia Fed President Harker who suggested that the balance sheet run-off would be like "watching paint dry." All signs suggest a low probability of a taper-tantrum repeat, so the muted market reaction makes sense, although the process is likely to begin sooner than expected. And for those expecting a return to the $800 billion Fed balance sheet of yore, we suggest you do not hold your breath. Our best guess is that the future of "normal" balance sheet size will still be in the $2-3 trillion or larger range. On the other hand, if we're right about the economic backdrop, we expect the Fed to manage at least one more rate hike in either September or December, depending on how quickly the noisy inflation picture clears. The markets, clearly, disagree. Will the disagreement last?