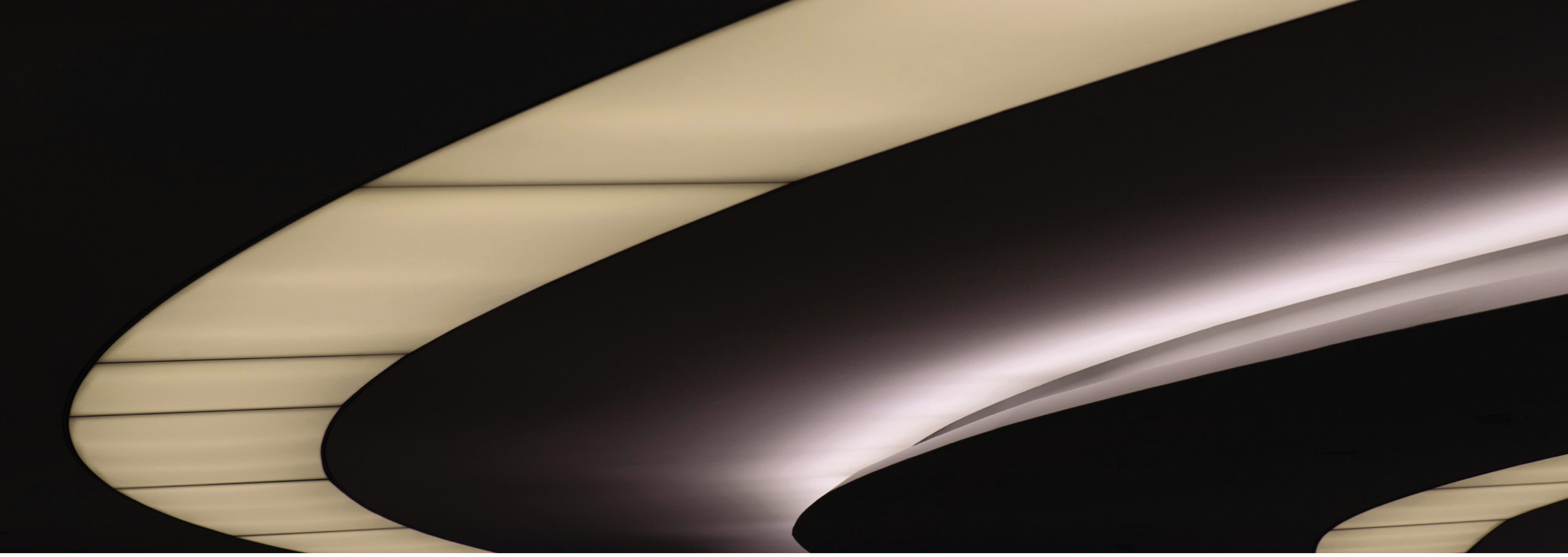

November 2018

Fed Thoughts:
A Narrow Lane

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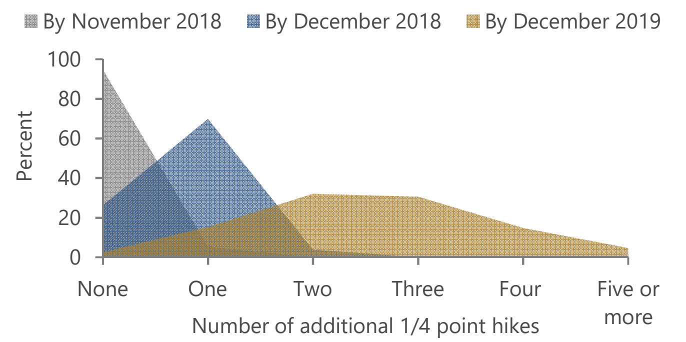
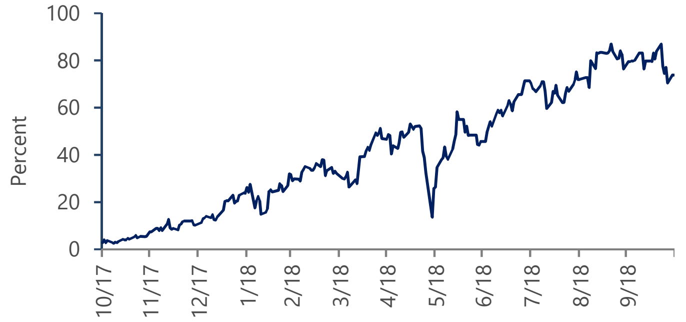
The Halloween window is shut, making it inappropriate to describe participants at the next meeting of the Federal Open Market Committee (FOMC) as mindlessly shuffling into a lifeless event. But they are. Federal (Fed) Reserve Chairman Jay Powell's favorite phrase is that he intends "to stay in his own lane," which must be reassuring to everyone along bicycle paths in his hometown of Chevy Chase, Maryland, and makes predicting the outcome of the upcoming meeting easy. The FOMC has narrowed its policy lane to one action per quarter that is advertised in advance in the statement and minutes of the prior meeting. The every-other-meeting calendar makes November an orphan, and one without a press conference to provide the stage to explain deviating from the schedule.[1]

Market participants have seen this movie before, which is why the November fed funds futures contract puts over 95 percent probability weight on inaction (as in the upper panel of the chart). What matters is what they say about their next meeting, scheduled on December 18 and 19.[2] We believe the Fed will queue up a quarter-point hike, to be followed by three more next year. Futures contracts suggest about a 70 percent chance of action then. The unsteady climb up in that probability (as in the lower panel) retraced from the almost-certain belief of last month, most likely due to the equity market selloff. It was not economic data, which mostly surprised to the upside and are consistent with the continuation of above-trend growth that intensifies excess demand. True, the stock market correction dented financial conditions, but they remain in accommodative territory, on net. Besides, the Fed's intent is to limit overshooting inflation.

Implied Probability of Fed Funds Changes



Implied Probability of Action in December 2018



Source: CME Fedwatch Tool, accessed October 31, 2018.

[1]Chair Powell indicated that he will hold a press conference at every meeting starting next year, so this will be the last time the FOMC stays silent about its policy.

[2]Note to self: Preposition for "The Grinch Who Stole the Expansion" meme.

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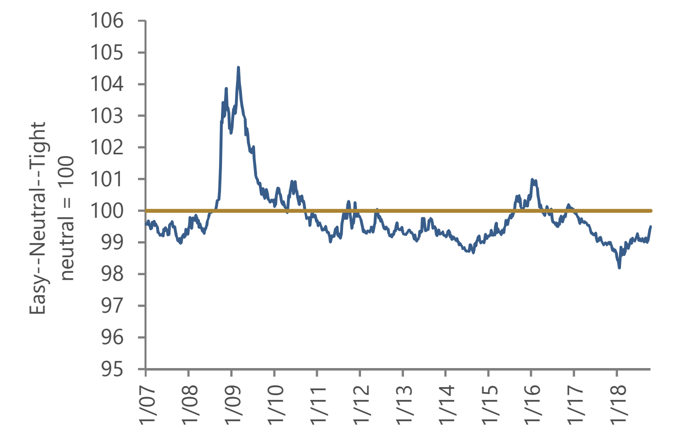
Financial Conditions Index



Source: Goldman Sachs, accessed via Bloomberg, October 31, 2018.

To accomplish this, the FOMC has to get the nominal funds rate a bit above its neutral level. An influential new member of the committee, Vice Chair of the Board Richard Clarida, offered an instructive glimpse into Fed thinking on the neutral rate in his inaugural speech (found here). He emphasized the five-year, five-year forward yield on inflation-protected securities, adjusted for liquidity and term premium effects. The idea is that the longer end of the TIPS term structure reflects the market view on the real rate in the long run. Currently just above 1 percent, the unadjusted rate seems consistent with a neutral nominal federal funds rate around 3 percent. One percentage point of tightening puts policy a shade toward the firm side, at which point, policy makers can see how the inflation picture clarifies. Futures prices are nowhere near that vicinity, but they were not close to the likely 2018 outcome at this time last year either.

Treasury Inflation-Indexed Constant Maturity Yields

Source: Federal Reserve, accessed via FRED, October 31, 2018.

Since policy action is not the subject of the November meeting, participants will likely occupy themselves with a discussion of policy implementation. The slowing of reinvestments has pulled securities in the System Open Market Account (SOMA) to under $4 trillion, consistent with reserves of about $1.9 trillion, much of which is excess on bank balance sheets. How much excess reserves banks want is another item on the long list of central bank conundrums, but it is probably safe to say reserve supply still hits at the flat portion of reserve demand. This was the subject of a recent speech by Simon Potter, the manager of the SOMA. Notable in his remarks (found here) was the emphasis placed on keeping the funds rate trading within the lower and upper limits that the FOMC announces.

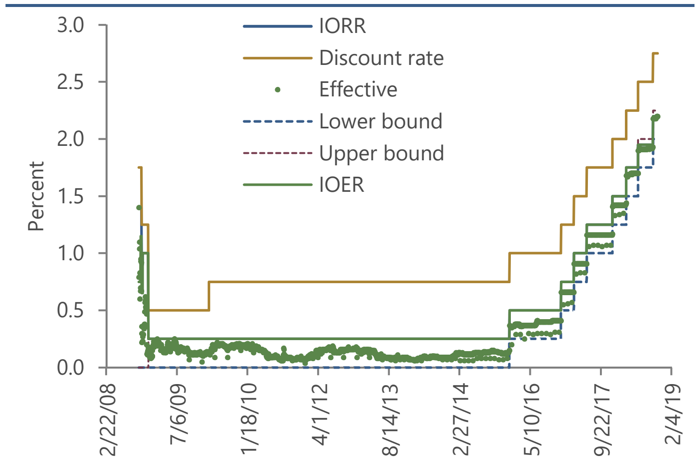
Federal Reserve Balance Sheet

$millions	**10-24-2018**		
Securities held outright	3,973,580	Federal Reserve notes	1,642,665
Treasury	2,294,215	Reverse repurchases	225,937
Agency	2,409		
MBS	1,676,956	Treasury deposits	360,681
		Bank deposits	1,898,519
Other assets	199,490		
		Other liabilities	6,174
Total assets	4,173,070	Total liabilities	4,133,976
		Capital	39,094

Source: Federal Reserve H4.1, accessed October 24, 2018

Along the flat portion of reserve demand, this outcome is achieved by setting the correct configuration among the administered rates on the Fed's chessboard. The relevant ones here are the rates paid on excess reserves (IOER) and on reverse repurchases. Some chess pieces have to move soon because for the past few months the effective funds rate (the average funds rate in private trading) has traded close to the upper end of the range. When faced with this earlier in the year, the approach officials took was to put a 5 basis point wedge between the IOER rate and the upper bound. That is, at their June meeting, the Fed raised the funds rate targets 25 basis points and the IOER rate 20 basis points.[3] This was explained here: "Setting the interest rate paid on required and excess reserve balances 5 basis points below the top of the range for the federal funds rate is intended to foster trading in the federal funds market at rates well within the FOMC's target range." Basically, banks that see less attraction to Fed deposits are more likely to unload their excess in the fed funds market.

Flora and Fauna of Federal Funds Rates

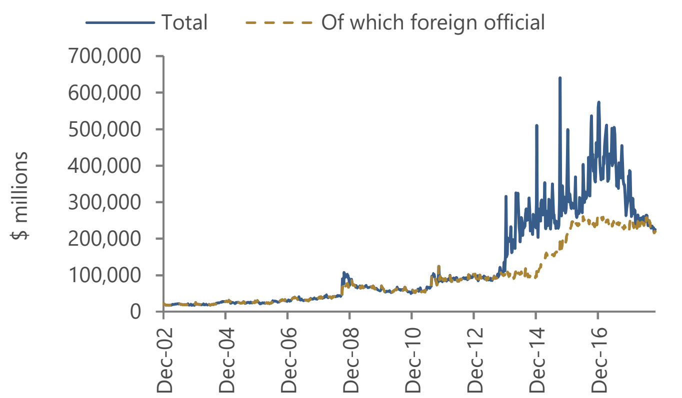


Source: Federal Reserve, accessed via FRED, October 31, 2018.

[3]The collective noun "The Fed" is important here because the FOMC sets the funds rate targets and the Board of Governors sets the IOER rate.

There is a limit to how many times they can do this, however, before the IOER rate sits too close to the rate paid at the reverse repurchase facility (currently 20 basis points below the lower bound). Too narrow a spread might entice greater and more variable use of the facility, which the FOMC wants to serve only in a secondary role. For much of this year, the preponderance of reverses on the Fed's books have been to foreign official institutions, not the private sector (as in the chart).

Federal Reserve Reverse-Repurchase Agreements



Source: Financial Accounts of the US, Federal Reserve, September 2018.

The Fed will presumably wait until December to repeat this move because it would risk muddying their message to announce an outright rate cut (in the IOER rate) during a hiking cycle. To make matters worse, the president might tweet out "Way to go, Jay. It is about time you cut rates."

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