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US Economy & Markets. Outlook

On Fed funds rate and balance sheet normalization

The Fed will start the balance-sheet runoff in October. This timeline allows the Fed to continue their tightening cycle, but may delay a third rate hike long enough to assess if recent weakness in core inflation is actually just transitory. The Fed's balance sheet now stands just shy of 25% of US GDP (well below the relative size of the ECB and BoJ balance sheet). The Fed will start with a cap on monthly runoff of \$10bn that rises by \$10bn every quarter until reaching a \$50bn monthly cap in October 2018. We estimate the process should end in 2021 with a terminal balance sheet size of roughly \$3 trillion (13% of GDP).

On the Fed rates' field, the Federal Reserve said that it still sees the federal funds rate at 1.4 percent by the end of 2017, (admittedly, in our last Investment Committee we were still not convinced for a third rate hike in December), and the U.S. central bank maintained its 2018 projection of three hikes, saying it sees the benchmark rate at 2.1 percent. The Fed, however, slightly lowered its 2019 outlook for the federal funds rate from its June projection. It now expects the benchmark rate to be 2.7 percent by the end of 2019, instead of the 2.9 percent it previously projected, meaning two more hikes in 2019. The decision for Fed funds rate and begin the balance-sheet runoff in October was unanimous.

Storm-related disruptions and rebuilding will affect economic activity in the near term but…

Macro: near- term risks appear roughly balance

Growth outlook: The Fed stated that "storm-related disruptions and rebuilding will affect economic activity in the near term, but past experience suggests that the storms are unlikely to materially alter the course of the national economy over the medium term". The economy expanded at a 2.1 percent annual rate in the first half. "The labor market has continued to strengthen" and economic activity "has been rising moderately so far this year," the Fed statement said. The FOMC repeated language saying "near- term risks to the economic outlook appear roughly balanced."

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We have detected how recent retail sales came in below expectations, declining 0.2% MoM in August, and in YoY terms, nominal retail sales growth declined to 3.2%, well below its January peak of 5.6%. Further more, recent readings increase the likelihood of a meaningful drag on August economic activity from Hurricane Harvey, and given the possibility of sustained weakness in September due to Hurricane Irma, we now expect an even larger drag on growth in the third quarter. As a consequence we are slightly reducing our tracking estimate for annual GDP to ~2%. Nothing to worry about, especially considering that the Fed maintains a strong outlook for the activity for the rest of the year.

Inflation outlook: While the storms will temporarily boost inflation thanks to higher prices for gasoline and other items, “apart from that effect, inflation on a 12-month basis is expected to remain somewhat below 2 percent in the near term but to stabilize around the committee's 2 percent objective over the medium term,” the Fed said.

Politics & Reform agenda

Trump is on a bipartisan tear of late. Elated by what he viewed as glowing press after his debt ceiling deal with Democratic leaders “Chuck and Nancy” last week, Trump wants to replicate that thrill of victory, which he believes Republicans have failed to deliver since his inauguration. Trump has complained in private that it’s difficult to have any sort of relationship with Senate Republican’s Majority Leader Mitch McConnell. By contrast, Trump can relate to Democratic leaders Chuck Schumer and Nancy Pelosi, who talk more in non-Washington terms that he understands, according to people familiar with their meetings. No one knows how long his bipartisan kick will last or how successful he’ll be. Closely connected to the debt ceiling is the outlook for fiscal policy in the US, notably the prospect for meaningful tax relief. The President was eager to collect tax proposals that could bring Democratic support

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The prospect for a major tax overhaul has not increased despite Trump’s “readiness’ to aim for a bipartisan approach (compromise) to pass any bill in his agenda. On balance, however, meaningful tax relief still seems to be on the cards, even if it will fall short of the ambitious initial proposals. Any potential shortfall in the tax relief that will likely be granted to US taxpayers next year versus forecast assumptions made will need to be set against any extra government spending.

Financial Markets

Equities (S&P): CAUTIOUS (EXPENSIVE). We slightly revise upward the central point of our reasonable range for the S&P. The new central point is ~2,400. Exit point at ~2,500.

Bonds: CAUTIOUS (EXPENSIVE). UST10 target (entry point) 2.65%.

Credit: CDX IG: FAIR VALUE Target at 55bp. OW: Fins, Tech and Autos. UW: Retail and Healthcare.

Credit CDX HY: FAIR VALUE Target 323. OW: Fin, Tech, Media. UW: Materials, Energy and Retailers.

Fx – USD Index (Fundamental approach): Favorable Outlook.