May FOMC: It's all about the inflation - or lack thereof

- As expected, May FOMC resulted in no change to the Federal Funds Rate; the interest rate on overnight excess reserves was trimmed by 5bps in a technical operation

- FOMC statement emphasizes a lack of inflation, but the press conference was more equivocal

- We don’t believe inflation is a threat at the moment and the pause will endure for a while

“We don’t see a strong case for moving in either direction.” This was the key message on interest rates from the FOMC decision and Chair Powell’s press conference today.

Citing subdued inflation and solid growth, the Fed tried to drive home its message that rate hikes are on hold for as far as the eye can see, or at least until the data change one way or the other.

It should have been a pretty straightforward and non-controversial message, although the Chair got bogged down in multiple references to whether or not low inflation was transitory or stable.

The statement was initially perceived to be dovish by the markets. (Specifically, it referenced falling inflation and weak Capital and Household Spending, as we covered in our GDP comments last week). DXY fell on the print and bonds rallied.

The prepared remarks at the press conference were more cautious on the inflation picture. The Chair took great pains to emphasize that weak inflation was transitory and would be
expected to rise toward target as we get deeper into the year. While he was speaking, the dollar did a round trip.

In the Q&A he was pressed more than once as to why Core PCE has continuously undershot the Fed’s 2% target. Powell further softened his message on prices. In particular, he offhandedly mentioned that the Dallas Fed’s Trimmed Mean PCE, which removes the items with large price rises and declines, had recently come in bang on 2%.

This more equivocal discussion of inflation in the press conference mitigated somewhat the statement’s message. Furthermore, ever since January, when the Fed began its dovish pivot, the rationale has consistently been the lack of inflation, allowing the Fed to pause rate hikes. Strange then that during today’s discussion the inflation question was a little more muddled.

We don’t buy it. The absence of inflation has characterized what otherwise looks like a late-cycle environment and one of the reasons we had been early to join the dovish camp.

Looking at the data, we don’t see much of an inflation threat. The two charts below demonstrate this.

Figure 1 is a plot of 10 different inflation series produced by the government as well as various regional Federal Reserve Banks (including the Dallas Fed’s Trimmed Mean PCE). Most of them are barely above their post-2015 averages (when the rate-hiking cycle started), and some are lower.

**FIGURE 1: Various inflation measures, March 2019 vs post-2015 Average**

![Figure 1: Various inflation measures, March 2019 vs post-2015 Average](source: BNY Mellon Markets, Bloomberg)

Figure 2 shows a factor analysis of these 10 series, reporting the common factor they all
share. In this sense, the inflation factor is the underlying feature present in all of the series taken together, plotted against core PCE, the Fed’s preferred inflation metric. While the inflation factor has risen since a wobble in 2017, it’s been steady for most of 2018, right through the end of Q1 2019.

FIGURE 2: Inflation Factor* and PCE

![Graph showing Inflation Factor and PCE over time](source: BNY Mellon Markets, Bloomberg)

We don’t believe that inflation is a threat to the rate outlook at the moment, and that the Fed was right to call a halt to the hiking cycle. As the Chair said, if inflation does show signs of waking up, the Fed has reserved its right to resume the cycle.

This is not in the cards in the short run.

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