

Macro Keys

Probabilities of rising inflation & more Fed tightening

Economics & Macro Strategy

Global

Global Macro Team

Core Inflation key to 2016 Fed policy

Will the Federal Reserve's 25 basis point Federal funds rate hike be followed by similar steps in 2016? Our answer is "yes", and we still expect four further 25 basis point hikes to bring the Federal funds rate to 1 3/8% by the end of next year. (See Figure 1.)

Why? We believe the economy will perform in line with what the Fed expects. Specifically, the central tendency 2016 forecast ranges for Federal Open Market Committee (FOMC) members are for a 4.6% to 4.8% unemployment rate and for core (nonfood, nonenergy) inflation of the personal consumption expenditures (PCE) chain price index in a 1.5% to 1.7% range. We forecast a 4.6% yearend unemployment rate and core PCE inflation of 1.7%.

How likely is the Fed to see unemployment and inflation as they expect? A year ago in December of 2014 the FOMC members' central tendency forecast was for a 5.0%-5.2% unemployment rate versus the latest 5.0% reading for November. However, **while the FOMC was able to foresee the unemployment rate outcome in 2016, it has been over-estimating the rate of core PCE inflation.** Over the year ending in October it was just 1.3% versus the 1.7%-2.0% FOMC forecast range reported in December of 2014.

Will the Fed continue under-estimating core PCE inflation? Our forecast for a 40 basis point acceleration during 2016 in core PCE inflation reflects less slack in the US economy and less core inflation drag from the weaker dollar, which is not apt to further weaken as much in 2016 as it did in 2015. Specifically, we employ a forecasting model in which core PCE inflation depends on the gap between actual and potential output, households' inflation expectations, dollar changes and productivity growth.

How likely is core inflation to pick up as much as UBS and the FOMC expect? Such a probability is key to the probabilities of further Federal funds rate tightening. To address this question, we have developed multivariate statistical models to estimate the probability that core PCE inflation will be at least at the bottom of the Fed's 1.5% to 1.7% expected range for 2016. (Note: These models include the same variables in the above described regression model.) In these models, core PCE inflation odds rise with a narrower output gap between actual and potential output but fall with a rising dollar. (See Figure 2.) In turn, Fed tightening odds rise with improvement in the output gap but fall with a higher dollar. (See Figure 3.) If the trade weighted dollar is unchanged from recent levels, these models suggest an over 90% probability of enough core inflation to trigger further Fed tightening. However, such odds fall by around 40 basis points with a further 10% (2.5% per quarter) dollar rise.

For further details, see our December 17 Q-Series® report titled "Will the Core PCE Balloon Inflate Enough to Lift Rates and Equity Baskets Through 2016?". <https://neo.ubs.com/shared/d1lBgRA90LUv>

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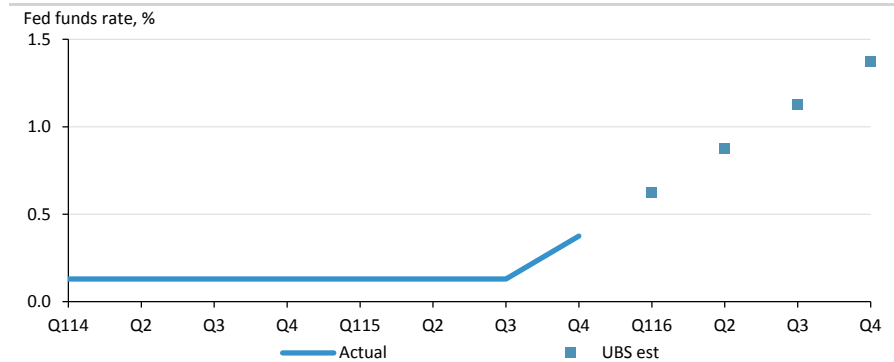
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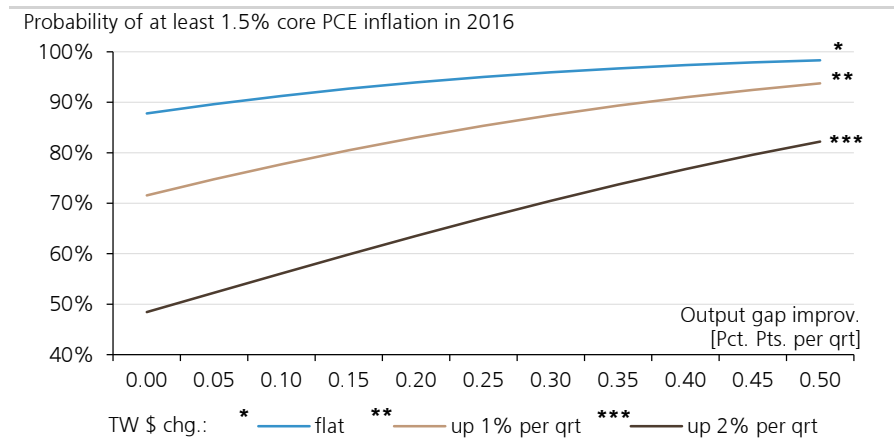
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Figure 1: Federal funds rate tightening path



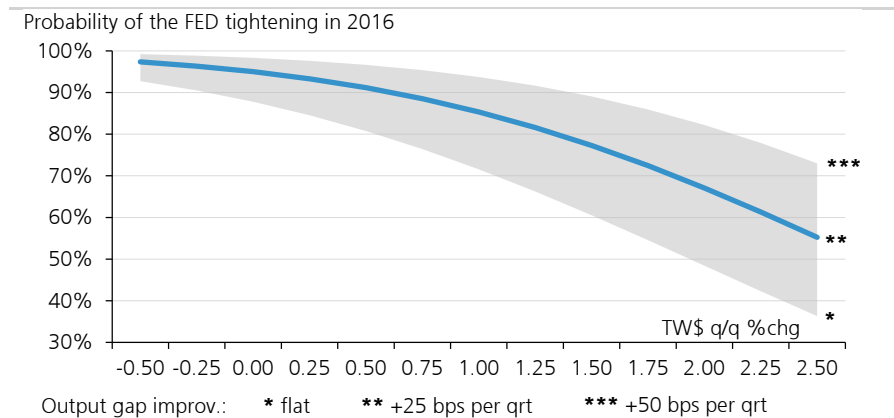
Source: Federal Reserve Board and UBS

Figure 2: Core PCE inflation odds rise with a narrower output gap between actual and potential output but fall with a rising dollar.



Source: UBS

Figure 3: Fed tightening odds fall with a rising dollar. How much depends on the behavior of the output gap between actual and potential GDP.



Source: UBS

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