Federal Reserve: Dovish But Divided

- The Federal Reserve struck a dovish tone, but also seem more divided than almost ever before in terms of where interest rates should go over the next 18 months, judging by its dot plot projections. There’s now almost a 50/50 split between those wanting to see rates unchanged by year-end versus those now looking for a 50bp reduction.

- However, there’s no way of knowing what those wanting lower interest rates were expecting regarding tariffs and trade relations, or which of those FOMC members are voters (apart from today’s dissenter, Bullard). So while the dovish tilt in terms of today’s statement and dot plots has seemingly justified market expectations for two cuts before year-end, and actually seen bond yields move lower still, they don’t necessarily justify the extent of interest rate reductions now priced in before the end of 2020 or make a cut at the very next meeting the slam dunk markets now think.

- The Fed’s statement and economic projections didn’t show too much change in terms of the base case outlook, apart from a near-term downgrade of the assessment for core inflation. However, they stated that the “uncertainties” around this base case have “increased”. In the press conference Chairman Powell noted that, as well as the obvious concern regarding tariffs, there was also greater concern regarding global growth than there was at the time of the prior meeting. As such, they reiterated previous communication from Chairman Powell that they will “act as appropriate” to sustain the expansion. One member (Bullard) voted against leaving rates unchanged today, and for an immediate 25bp cut.

- The largest and most unexpected changes came not from the statement, but from the dot plots of FOMC member projections. While the median forecast for the end of 2019 was for rates to be unchanged relative to current levels, there was almost a 50/50 split between those expecting lower rates versus unchanged. Even more surprising to us, seven of the eight members expecting lower rates saw them being 50bp lower than current levels. And the median projection for 2020 shows rates 25bp lower than current levels, versus expectations for one hike in the March projections.

- However, we don’t know what those members were assuming in terms of US-China trade relations, and as such if those projections could change if there’s any significant new information coming out of the G20 conference over the weekend. While Chairman Powell stated that there wasn’t “much” support for a cut today, with more data and information needed, he also stated that even those
members suggesting that rates shouldn’t be lower by year-end would admit the case for a cut has “strengthened” As such, we’re sticking with our call for the first rate cut to come in Q4, although there’s clearly a risk of an earlier move, particularly if there’s any further disappointments in terms of data or trade policy.

- Where we are a little more comfortable is in our view that markets have priced in too many interest rate cuts before the end of 2020 and beyond. The Fed’s 2021 dot plot showed rates going back to unchanged versus current levels. And even though the median projection for the long-term neutral rate came down (now 2.5% vs 2.8% previously), that’s still slightly above the current rate. As such, the four cuts now priced into markets by the end of next year, and the declines in long-term bond yields today, seem somewhat inconsistent with the Fed’s admittedly more dovish projections.