Economic Flash!

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Federal Reserve: Gentler, But Not THAT Gentle Yet

- Like the Postal Service, neither rain, nor snow, nor the stock market or Donald Trump kept the Fed from its appointed rate hike round, but concerns over the outlook ahead has it offering a gentler future for subsequent moves. As we expected, the Fed not only hiked a quarter point today, but it continued to talk about future rate hikes in the plural.

- Still, it added the word “some” before mentioning those further hikes, and it pared back its projection to only two hikes next year (to 2.9%) and a final hike in 2020 (to 3.1%), leaving both the 2020 and 2021 levels a quarter point lower than its last forecast, and similarly reducing its long run estimate of the neutral rate to 2.8%. Even with that, our forecast for only one final hike in 2019, and a quarter point cut in 2020, has us on the dovish side of where Powell’s team sits.

- Critics opposing a hike today, who pointed to the malaise in equity markets, or the weakness in global growth indicators, can’t say that the Fed was tone deaf to those concerns. It added a specific reference to monitoring both global economic and financial market developments in considering the US outlook. There were even two non-voting members of the FOMC that seem to have opposed today’s hike, judging by the “dot” forecast.

- But, as we had expected, the Fed put greater weight on what it’s observing in the here and now in the domestic economy, with early Q4 data still showing respectable growth and job gains after two hot quarters. The FOMC’s median 2019 real GDP forecast moved down only two ticks to 2.3% and holding at 2.0% in 2020. As our real GDP forecasts are below that track (2.1% and 1.5% respectively), we’re counting on some disappointments on the growth front to further soften the Fed’s perspectives in 2019.

- Other than the pared back view of the neutral rate and the mention given to global and financial market issues, the Fed didn’t have much new to say. The inflation forecast was a yawner, taking one tick off the core PCE rate to show it rock steady at 2.0% over the forecast horizon. There was nothing new to say about the Fed’s QE unwind.

- The was however a technical change in the overnight market, with the Fed opting to lift the rate on required and excess reserves by 20 bps, as opposed to the full 25 bps, putting it at 2.4%, or 10 bps below the 2.5% top end of the range for the fed funds rate. That’s the second time this year the Fed has used this tool in an effort to keep the effective fed funds rate from bumping up to the top end of the band, and thereby contain the pressure on money market rates coming from heavy bills issuance and the Fed's balance sheet reductions.

Market Implications

This hike wasn't fully priced into futures markets, with the recent declines in equity markets, contained inflation, and some softer global data leaving some wondering if the Fed would offer a pause to see how 2019 started off. We were confident that the generally healthy tone to US Q4 figures would keep the central bank on course, but neither we nor the market were surprised to see future rate forecasts pared back, given recent speeches by Powell and Clarida that leaned in that direction. Two year yields ticked up slightly as did the US dollar, but 10 year Treasuries moved marginally the other way.

We see the US dollar as vulnerable if, as we expect, the Fed hikes only once more next year and cuts in 2020, but the recent rally in longer term yields is unlikely to stick if risk assets find a footing in the first half of 2019.