STIFEL Economic Commentary

# Economic Insight

March 22, 2019

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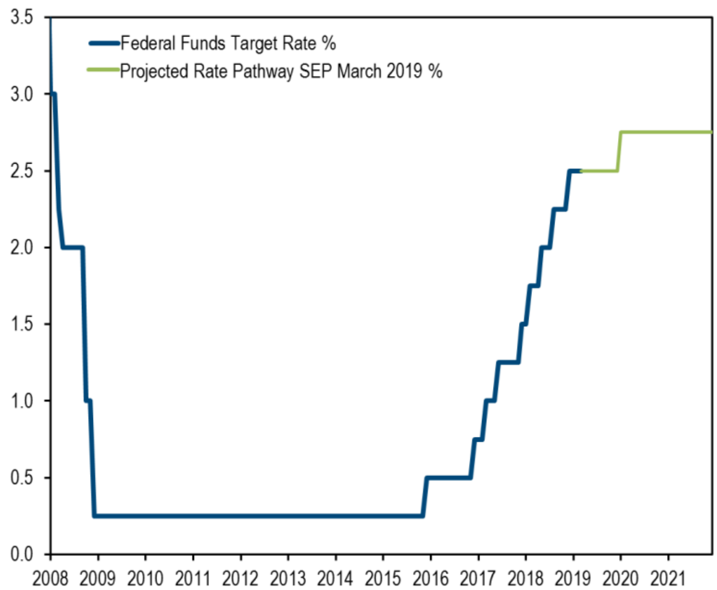
## Fed Holds Rates Steady, Signals Ongoing Patience and an End to Balance Sheet Reduction

Earlier this week, in a widely anticipated decision, the Fed opted to hold rates steady. In a somewhat unexpected move, however, the Committee eliminated an expectation for further policy action on the Fed funds rate this year, while reducing the outlook for growth and inflation. Amid rising risks of a slowdown overseas, as well as intensifying weakness in domestic economic data, the Fed appears relatively comfortable with policy action already taken over the last few years. Thus, reiterating January's "*patient*" tone, this week the Fed all but committed to an indefinite position on the sideline. Although current policy is presumably near or at a neutral level, according to Fed officials, downside risks are likely to shift the Fed to a defensive position sooner than later. At such point, the question will become how much and what type of monetary support is needed to stave off an economic contraction?




Source: Bloomberg

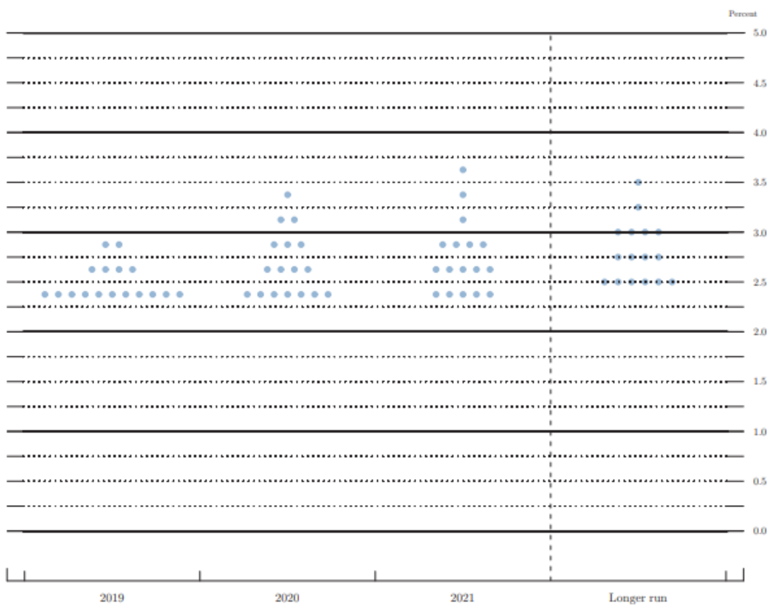
*Policy Decision*

As expected, the Federal Reserve opted to hold rates steady in its March policy announcement. Maintaining a Federal funds range of 2.25% to 2.50%, the Fed's latest decision left rates unchanged from last December. But while the Committee's decision to forgo a rate hike earlier this week was widely anticipated, there was uncertainty surrounding policymakers' expectation regarding the longer-run pathway for rates. In December the Committee's famed dot plot showed the Fed hiking rates potentially twice more in 2019 and one more time in the following two years. This month, with the onset of a more "*patient*" tone at the start of the year, the market clearly expected the Fed to temper its forecast for future policy adjustments. The degree of alteration, however, was widely debated ahead of Wednesday's announcement.

The latest version of the dot plot released along with the Fed's rate announcement ultimately showed no further Fed action in the remaining nine months of the year, just one rate hike in 2020 and nothing in 2021. Two FOMC participants still see rates pushing higher to 3.0% this year and three expect an additional 25-50bps next year on top of that, arguing higher rates are needed in order for the Fed to have enough ammunition in their proverbial tool belt to combat eventual weakness. This hawkish faction of the Committee, however, seemingly represents a minority opinion relative to the eleven members that expect rates to remain unchanged in 2019. Of course, more broadly, the dot plot, as the Chairman himself has emphasized time and time again, is just a forecast for policy and not a commitment.

Still, the change in that forecast relative to the end of last year suggests the vast majority of officials believe the current level of policy is at or near neutral. **Even with a majority of officials projecting one additional rate hike next year, it seems unlikely, if not counterintuitive, to expect policymakers would revert back to tightening after a prolonged pause for 12 months or longer. Historically, after the Fed takes to the sidelines following a series of rate increases, the next course of action is a reduction in rates.**

March 20th FOMC Dot Plot




Source: Federal Reserve

At this point, policymakers are not yet openly talking about a potential easing of policy, especially with a still-ambitious growth outlook for 2020. Nevertheless, as the economic data begin to deteriorate, the Fed is likely to adjust its tone, and quickly. Recall, the Fed did an about-face at the start of the year, shifting from a more aggressive tone in December 2018 to one of patience in January. The Fed could expectedly make a similarly abrupt adjustment in the coming months should growth and inflation disappoint.

*Health of the Economy*

Despite increased volatility in the recent data, the Fed remains relatively optimistic regarding the current state of the economy; however, revised expectations reflect a noticeable reduction in the level of output and prices anticipated over the next 12-18 months. According to the March FOMC statement, domestic growth remains *"strong,"* but has slowed from a more solid rate in the fourth quarter. Recent indications, the statement read, point to *"slower growth of household spending* *and business fixed investment"* and that overall inflation has *"declined."* On the labor market front, the Fed noted the relatively *"solid"* pace of job gains and furthermore, that the unemployment rate has *"remained low."* As Chairman Powell noted in the press conference following the rate announcement, growth is expected to remain at a positive pace in 2019, albeit noticeably reduced from last year's more robust level. Recall, the U.S. economy grew at a 2.6% pace at the end of last year, although the Atlanta Fed's GDPNow forecast for GDP in the first quarter is just 0.4%.

*"With the benefit of fiscal stimulus and other tailwinds, growth in 2018 was strong--in fact, at 3.1 percent, the strongest year in more than a decade. For some time, most forecasts have called for growth to continue in 2019 at a somewhat lower but still healthy pace."*

- Federal Reserve Chairman Jerome Powell, March 20th Press Conference

According to the Summary of Economic Projections (SEP), the Committee reduced its forecast for growth from 2.3% to 2.1% in 2019 and from 2.0% to 1.9% in 2020. The Committee's median inflation forecast was lowered from 1.9% to 1.8% and 2.1% to 2.0% in 2019 and 2020, respectively, although the Committee's core PCE forecast was unchanged at 2.0% for 2019, 2020 and beyond. While still a relatively solid expectation for growth and inflation each near 2%, policy officials have clearly indicated an expected downward bias in the directional momentum of the underlying economy. Fed officials are often overly optimistic in terms of nominal forecasts. On a relative basis, however, policymakers have acknowledged an expectation for a weakened pace of expansion in the domestic economy in the coming months. So the question is not whether or not the Committee expects growth will slow but by how much, compounding market expectations of a rate cut sooner than later.

March 20th FOMC Summary of Economic Projections

Percent

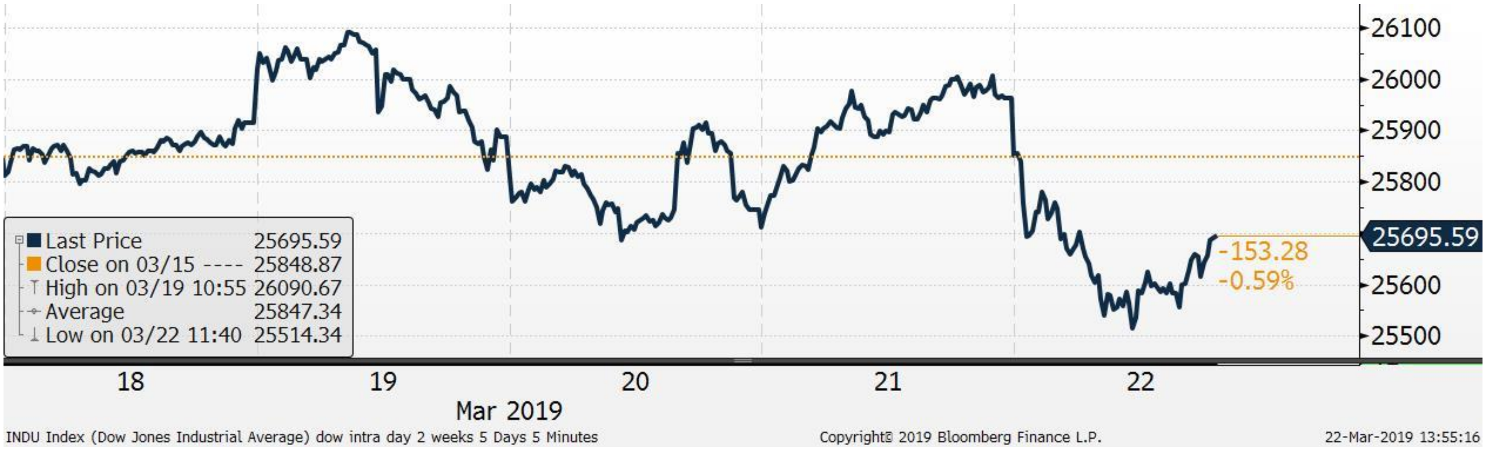
| Variable | Median[1] | | | | Central tendency[2] | | | | Range[3] | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2019 | 2020 | 2021 | Longer run | 2019 | 2020 | 2021 | Longer run | 2019 | 2020 | 2021 | Longer run |
| Change in real GDP | 2.1 | 1.9 | 1.8 | 1.9 | 1.9 – 2.2 | 1.8 – 2.0 | 1.7 – 2.0 | 1.8 – 2.0 | 1.6 – 2.4 | 1.7 – 2.2 | 1.5 – 2.2 | 1.7 – 2.2 |
| December projection | 2.3 | 2.0 | 1.8 | 1.9 | 2.3 – 2.5 | 1.8 – 2.0 | 1.5 – 2.0 | 1.8 – 2.0 | 2.0 – 2.7 | 1.5 – 2.2 | 1.4 – 2.1 | 1.7 – 2.2 |
| Unemployment rate | 3.7 | 3.8 | 3.9 | 4.3 | 3.6 – 3.8 | 3.6 – 3.9 | 3.7 – 4.1 | 4.1 – 4.5 | 3.5 – 4.0 | 3.4 – 4.1 | 3.4 – 4.2 | 4.0 – 4.6 |
| December projection | 3.5 | 3.6 | 3.8 | 4.4 | 3.5 – 3.7 | 3.5 – 3.8 | 3.6 – 3.9 | 4.2 – 4.5 | 3.4 – 4.0 | 3.4 – 4.3 | 3.4 – 4.2 | 4.0 – 4.6 |
| PCE inflation | 1.8 | 2.0 | 2.0 | 2.0 | 1.8 – 1.9 | 2.0 – 2.1 | 2.0 – 2.1 | 2.0 | 1.6 – 2.1 | 1.9 – 2.2 | 2.0 – 2.2 | 2.0 |
| December projection | 1.9 | 2.1 | 2.1 | 2.0 | 1.8 – 2.1 | 2.0 – 2.1 | 2.0 – 2.1 | 2.0 | 1.8 – 2.2 | 2.0 – 2.2 | 2.0 – 2.3 | 2.0 |
| Core PCE inflation[4] | 2.0 | 2.0 | 2.0 | | 1.9 – 2.0 | 2.0 – 2.1 | 2.0 – 2.1 | | 1.8 – 2.2 | 1.8 – 2.2 | 1.9 – 2.2 | |
| December projection | 2.0 | 2.0 | 2.0 | | 2.0 – 2.1 | 2.0 – 2.1 | 2.0 – 2.1 | | 1.9 – 2.2 | 2.0 – 2.2 | 2.0 – 2.3 | |
| Memo: Projected appropriate policy path | | | | | | | | | | | | |
| Federal funds rate | 2.4 | 2.6 | 2.6 | 2.8 | 2.4 – 2.6 | 2.4 – 2.9 | 2.4 – 2.9 | 2.5 – 3.0 | 2.4 – 2.9 | 2.4 – 3.4 | 2.4 – 3.6 | 2.5 – 3.5 |
| December projection | 2.9 | 3.1 | 3.1 | 2.8 | 2.6 – 3.1 | 2.9 – 3.4 | 2.6 – 3.1 | 2.5 – 3.0 | 2.4 – 3.1 | 2.4 – 3.6 | 2.4 – 3.6 | 2.5 – 3.5 |

Source: Federal Reserve

*A Market Read*

From a market perspective, at least on the surface, the latest policy announcement appeared to be the best-case scenario. On the one hand, the Fed clearly indicated plans to remain on hold, indefinitely sidelined from any further policy firming. While on the other hand, the Committee reaffirmed a forecast of still-solid growth over the medium-term and more broadly, a continuation of the expansion in the domestic economy. Equities initially rallied in the aftermath of the Fed announcement, up 28 points before closing in the red, down 141.71 points.

Dow Jones Industrial Average

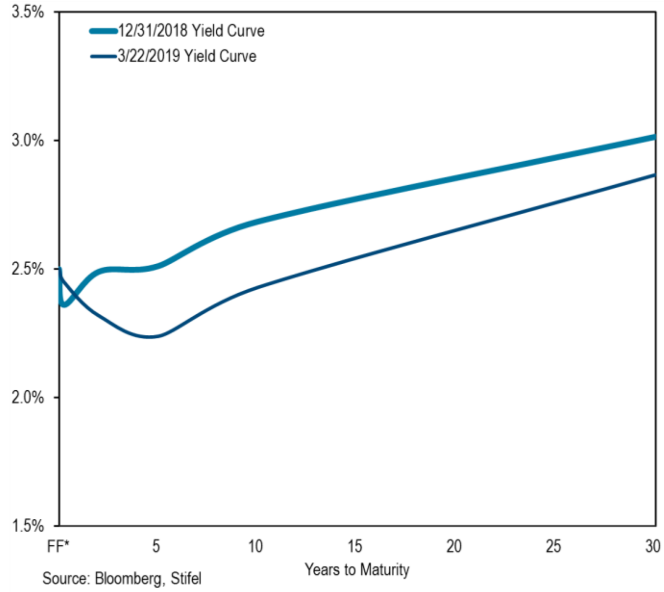



Source: Bloomberg

Historically, the Federal Reserve has failed to navigate a soft landing. In previous cycles, all too often policymakers advocated for additional rate hikes, continuing to tighten beyond neutral until weakness was clearly evident in the data. At that point, however, it was often too late and the economy was contracting, forcing the Fed to engage in a series of rate cuts to combat the ensuing weakness. **Unlike Feds in the past, the Powell-led Fed appears willing to preemptively back off from further policy firming even amid still *"strong"* growth, allowing the recovery to remain somewhat steady, at least for the time being. By acknowledging early indications of weakness, the Fed has essentially granted the domestic economy a grace period ahead of presumed weakness lurking around the corner.** While the adjustment in Fed policy is unlikely to stave off an eventual contraction, patience will allow the economy to coast into weakness as opposed to abruptly falling off a cliff.

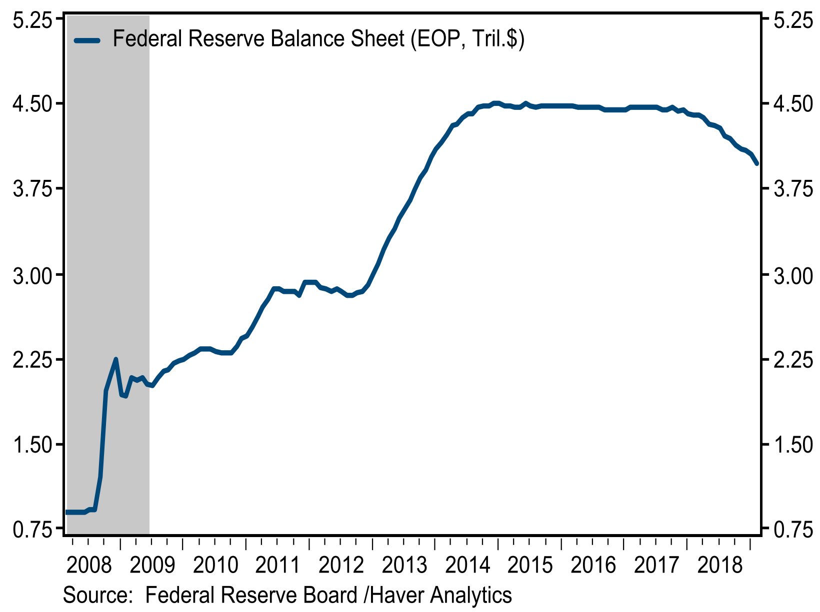
Of course, reading between the lines, it is clear the Fed sees mounting downside risks to the economy – both global and domestic. Thus, as the directional momentum in growth trends negative, the conversation among Committee members is likely to shift quickly from achieving neutral policy to implementing a defensive policy strategy. In other words, the conversation will shift from whether the Fed can slide through one additional rate hike at some point in the future to when the first rate cut will come into play. At this point, no one at the Fed is openly talking about or seemingly considering a rate cut, however, as the weakness becomes more prevalent, the Fed will be forced to shift gears and take action sooner than later.

Bonds rallied following Wednesday's Fed rate announcement. Initially, the 10-year fell 8bps and the 5-year declined 10bps, and rates have continued to fall since. So while the Fed may feel comfortable that policy is within the neutral range, the market appears to be indicating the Committee has already overtightened at the current low level of rates. With Fed funds at 2.50%, relative to 5-year and 10-year yields at 2.24% and 2.43%, respectively, according to *Bloomberg*, the Committee may already need at least one, if not two rate cuts to realign with the market, independent of providing stimulative support to activity. In the last two cycles, to soften the impact of an economic contraction, the Fed has cut rates near 500bps. With a reduced arsenal of just 200bps this time around, the Committee is likely to increasingly rely on nontraditional monetary policy support, such as balance sheet expansion.




*Balance Sheet*

Aside from rate policy, the Fed also indicated an intention of right-sizing the balance sheet by September, provided of course the *"economy and money market conditions evolved as expected."* Beginning to taper the taper in May, the Fed will slow the monthly reduction of its Treasury holdings from up to $30 billion to up to $15 billion. On the MBS side, the current $20 billion cap will remain in place for the time being. In October, however, proceeds as high as $20 billion per month would be reinvested in Treasuries, while runoffs in excess of $20 billion will be reinvested in agency-backed MBS.




While many anticipated the Fed to complete balance sheet roll off by the end of the year, few expected rightsizing to occur much sooner or with such early details of the processes revealed. Of course, with the proceeds of Treasury securities reinvested directly with the Treasury in proportion to the size of coupon auctions as opposed to bills as many had expected, there remains the question of what the Fed will buy when runoff is completed? Nevertheless, the market seemingly views the

Fed's new balance sheet management program as Treasury friendly, despite the lingering uncertainty of purchases once quantitative tightening ends.

*Take Away*

Reiterating a *"patient"* stance, the Committee held rates steady at the latest FOMC meeting and eliminated any expectation of additional rate hikes in the remaining nine months of the year. Going forward, the Fed remains optimistic regarding the current state of the economy but has acknowledged the mounting downside risks to both the global and domestic economy. While the Fed did not indicate any conversation of rate cuts or other monetary policy stimulus in the near-term, should the data deteriorate at a faster pace than expected, the Fed will no doubt shift from neutral to defensive policy. Given the still relatively low level of rates, however, the Fed has limited room to combat eventual weakness with a reduction in the Federal funds rate alone which will put an increased focus on nontraditional policy metrics such as reflating the balance sheet after nearly two years[1] of quantitative tightening.

-Lindsey Piegza, Ph.D., Chief Economist

[1] Assuming an end date of September 2019, quantitative tightening began in October 2017.

**Glossary**

EOP – End of Period
FOMC – Federal Open Market Committee
GDP – Gross Domestic Product
MBS – Mortgage-Backed Securities
PCE – Personal Consumption Expenditures
SEP – Summary of Economic Projections

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