

Focal Point

The Fed in 2019: more data-driven, not yet pausing

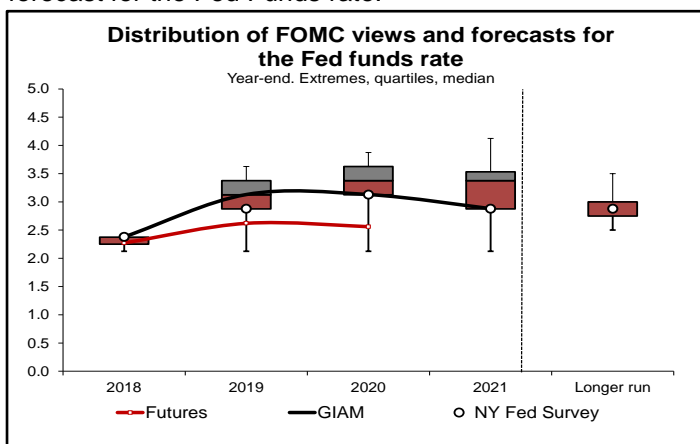
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- We expect the Fed to deliver at most four more hikes. The one at the December 19 meeting will likely be followed by two rises in the first half of next year; the last one will depend on the state of the US economy at the end of 2019.
- As the cycle matures and the impact of past rates feeds through the economy, the Fed has to switch from a predetermined course to a more careful assessment of the economic prospects. In this sense the comments by Powell and Clarida reflected more a statement of the current conditions than a change in strategy.
- The switch to a more data-driven ratemaking occurs at a time when evidence of a moderation in growth starts to emerge and the risk of an inflation overshooting dims.
- Market reacted strongly, and now are underpricing the Fed's resolve to stick to its plans. We expect a reassessment, in line with our outlook of higher US interest rates, as data show a resilient economy with inflation grinding higher.

A series of speeches by Chair Powell and other FOMC members led markets to a sharp reconsideration of the path of the Federal Funds Rate. Futures currently price in only two more hikes by the end of 2019 and no further moves thereafter. We do think that the change in communication foresees a slightly less aggressive path for normalization, reflecting a more uncertain growth outlook, but markets are underestimating the next Fed moves. In our view the Fed will continue to increase rates at most four more times. After the hike at the next meeting (on December 19), there will be two more increases in the first half of 2019, and the final one will depend on the state of the economy at the end of next year. Given our relatively upbeat view of the US economy we think that it will take place in Q4. In what follows we lay down the case for our forecast for the Fed Funds rate.

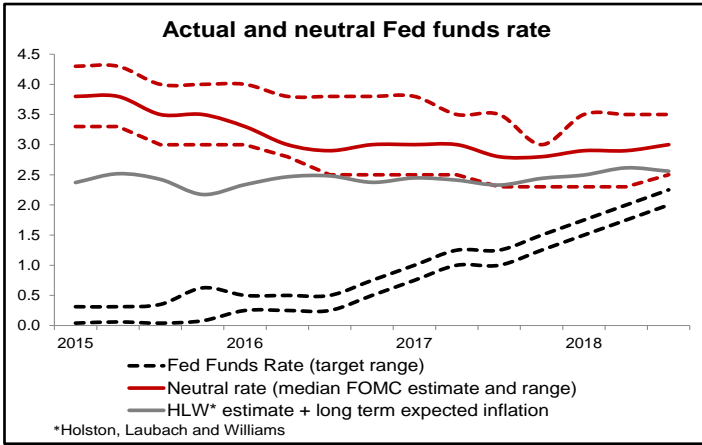


Dovish communication tilt or new strategy?

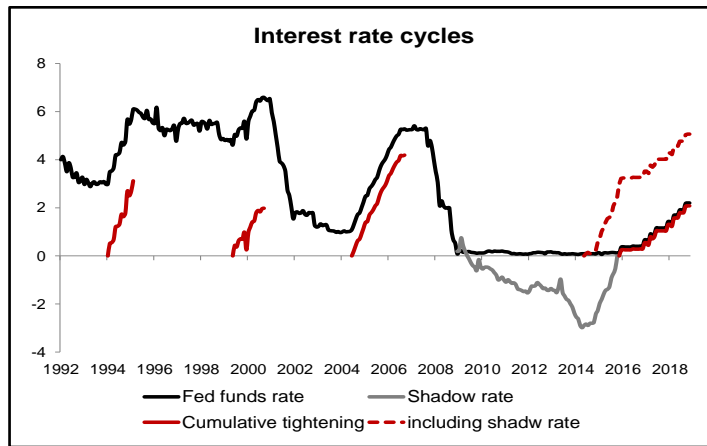
The speech delivered by Chair Powell on November 28th was a turning point in the markets' perception of the Fed's next moves. He stated that: *"Interest rates are just below the broad range of estimates of the level that would be neutral for the economy"* (also known as "R-Star"). Many of the nuances of the statement were somehow lost in translation, and markets took Powell's words as an indication of an imminent pause or end of the tightening cycle.

Actually, the situation described by Powell and other board members (especially vice president Clarida) was known since the September. The upper bound of the Fed Funds rate corridor (currently at 2.0%-2.25%) has almost reached the lower bound (around 2.5%) of the FOMC views for R-star and the level of one of the most conservative academic estimates, developed by Holston, Laubach and New York Fed President John Williams.

Therefore, and consistently with the Fed strategy and what has been said by many FOMC members since October, R-star is no longer a prime reference and the latest phase of monetary tightening will be largely driven by the actual data releases and their deviation from expectations.



The markets' (over)reaction may have also been triggered by the consideration that, if one takes into account the effect of the unwinding of QE (translated into Fed Funds rate-equivalents by an estimate based on bond yields called the "shadow rate", see chart below) the extent of the monetary tightening appears to be unprecedented. However, it has to be compared with the unprecedented loosening following the 2008 crisis. Looking at just the behavior of the Fed Fund rate the current cycle does not look overly steep or big.



Getting data dependent when data soften

The perception of a dovish shift in the Fed stance was also helped by a few data releases signaling slower growth in some component of domestic activity more sensitive to tighter interest rates, such as home sales and durable goods consumption, and also to worries about global trade like manufacturing orders.

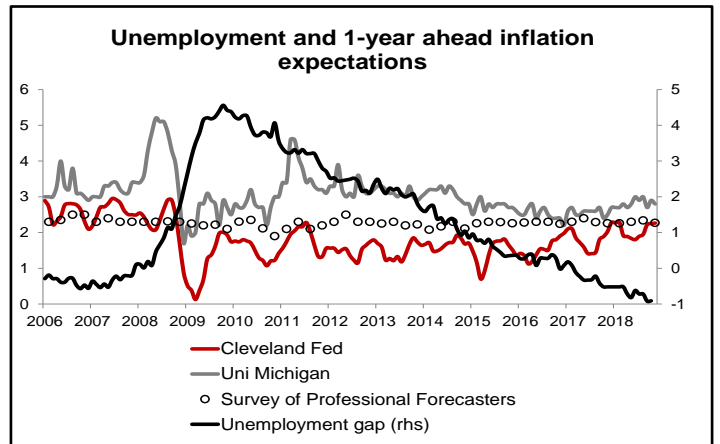
However, a correction is different from an imminent recession and the US economy is expected to deliver an above 2% growth in 2019. Moreover, and more importantly, it will also feature a positive output gap well into 2020, with the unemployment rate bottoming out at around 3.5% (it was 3.7% in November). This will allow core inflation to grind higher, slightly overshooting the Fed's target, by the end of next year.

Moreover, despite a very tight labor market, inflation expectations appear to stick to the 2% inflation target set by the Fed, a fact that Chair Powell has started to stress more forcefully since downplaying the role of R-star as a guide for rate-setting. This should minimize the risk of an over-

shooting, allowing for a continuation of the gradual rate hikes.

As a consequence, given the still solid fundamentals and a reduced risk of an abrupt downturn of the economy, we expect markets to reprice on the upside, which is one of the reasons why we forecasts the yield on 10-year Treasuries rising to above 3.20% by the end of next year.

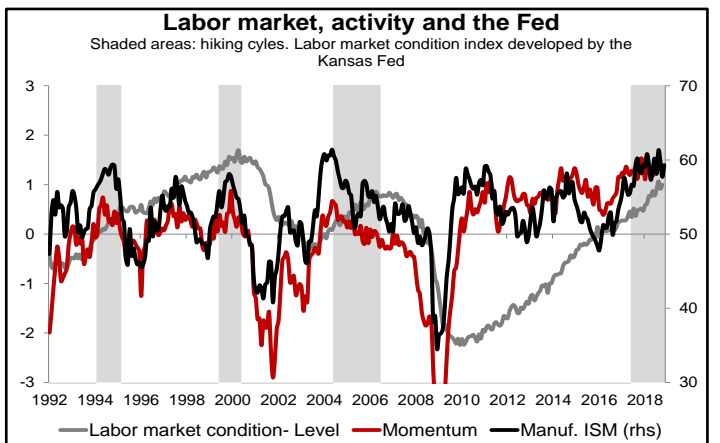
Of course, embracing full data dependency at a late stage of the business cycle means that the Fed will proceed more carefully. At the same time, (upside and downside) surprises in the data will have a higher weight on the future course of rates, introducing a dose of unpredictability that may add to late-cycle market volatility.



What can make the Fed pause/stop?

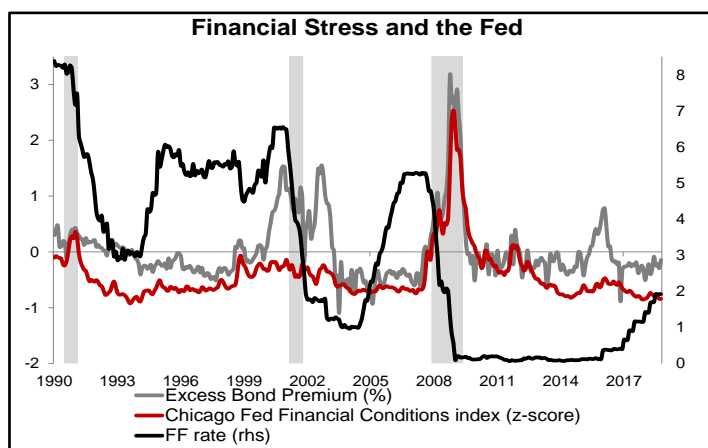
Given the importance of data it may be tempting to look for early warning indicators of a turn of the cycle which will bring hiking to an end and of tensions financial markets turmoil forcing a pause.

Consider the business cycle first. The Fed looks not just at the unemployment rate, but a host of signals from the labor market. The Kansas City Fed condensed several series on the labor market into an indicator of its general health (level) and one on how it is evolving (momentum). The chart below shows that in the past the Fed has normally stopped hiking rates when the momentum indicator dropped to below its long term average, just before the peak of the level one. Moreover, a protracted fall of the ISM manufacturing index to levels in the low 50s usually preceded the end of the hiking.



Looking at the latest numbers, the labor market appears to still have room for strengthening and, despite some volatility due to trade tensions and a strong dollar, the ISM remains not too far from its cyclical high. Again, this appears inconsistent with the perspective of at most two further rate hikes currently priced in by market rates.

Turning to financial stress, the Fed clearly reacts to bouts of volatility, often triggered by large political shocks. For example it cut rates in autumn 1998 in reaction to the Asia/Russia financial crisis or anticipated the easing in late 2002 as fears for the second Iraqi war mounted. By the same token, in 2016 it halted the increase in rates given the concerns about China and the world economy. Those periods were marked by a tightening in overall financial conditions, showing up very significantly in the bond market, which has a bigger influence on economic activity than, for example, the stock market. The chart below plots the Excess Bond Premium (EBP), a measure developed by the Fed to gauge investors' appetite for corporate bonds. The end of the past two tightening cycles coincided with elevated values of this premium. The current situation appears somewhat different. While the plunge in the stock market has led to tighter conditions, those in the corporate bond market are currently well within the historical norm. And, while we expect some further corporate spread widening, these are unlikely to trigger a marked tightening.



Avoiding a hard landing after 2020

Next year, market participants will start to consider what will happen after the Fed stop raising rates. More specifically, in the past the peak in the Fed Funds rate was followed within a few months by the beginning of a recession. The last two episodes were mostly unleashed by financial imbalances and therefore the relationship with the Fed policies looks more one of correlation than causation. However the risk of casing a recession may push the Fed to consider a lower terminal value for the Fed funds rate.

Despite the end of the fiscal stimulus and more onerous financial conditions, we expect GDP expand at a respectable 1.5% in 2020. At that time the risk of a recession will clearly be significantly higher, but we think that there are two factors that increase the likelihood of a soft landing.

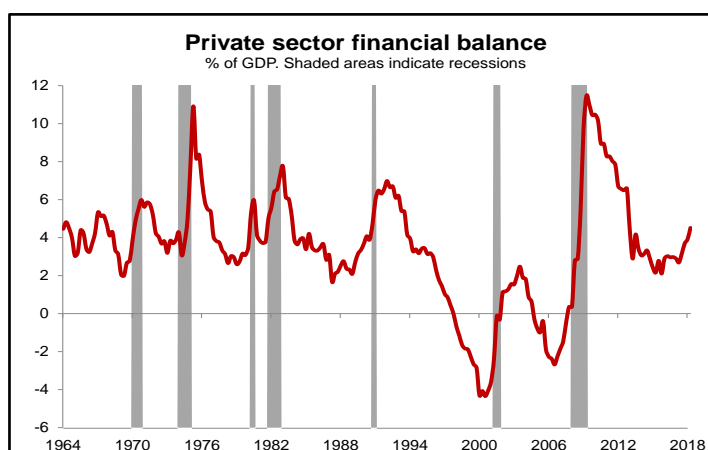
First of all, despite the marked increase in corporate debt and some pockets of distress (especially leveraged loans and commercial property), private sector financial balanc-

es are in line with their long term average, unlike in 2000 or 2007.

Secondly, the gradualism in the increase of the Fed Funds rate has allowed the private sector to “digest” it smoothly, reducing the risk of a sharp and disruptive deleveraging.

Conclusion

The Fed is currently shifting from a rather predetermined to a less predictable, data-dependent approach to rate decisions in 2019. This may keep market volatility at more elevated levels. The strong negative market reaction was the result of the shift in communication happening at the same time as data releases pointing to softer growth. Fundamentals and a relatively benign baseline outlook for the next two years allow the Fed to continue hiking rate, albeit at a less predictable pace. We reckon that therefore markets will reprice the path for the Fed Funds rate, adding to our forecasts of higher bond yields in 2019.



Imprint

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