Market Commentary

March 2019

The Fed Gets Patient – In a Hurry

At the January 30th Federal Reserve (Fed) meeting, Chairman Jay Powell promised patience and flexibility in all policy matters. Saying the Fed blew right past "patient" at the March 20th meeting and went straight to full-blown dovish would be a stretch, but Chairman Powell and the Fed exceeded investor expectations with a statement and press conference fully reversing the communication gaffes and hawkish outlook of late 2018.

Key points from the March 20th statement and Chairman Powell's press conference include:

- The federal funds target range remains unchanged at 2.25% to 2.50%
- The Fed Dot Plot forecasts zero 2019 rate hikes and one rate hike in 2020
- The Fed median estimate for the long-run neutral funds rate is 2.75%
- Significant adjustments were made to Balance Sheet Normalization (Quantitative Tightening):
    - Quantitative tightening (QT) will conclude at the end of September 2019
    - The reduction in the holdings of U.S. Treasuries will slow to $15 billion from $30 billion beginning in May 2019
    - Beginning in October 2019, reductions in agency debt and agency mortgage-backed securities (MBS) will continue to be subject to a $20 billion per month cap, with the principal payments reinvested in U.S. Treasuries
    - Re-investment in U.S. Treasuries will roughly match the maturity composition of Treasuries outstanding
- Despite the statement's mild downgrade to economic conditions, Chairman Powell described the Fed's outlook as positive and underpinned by strong economic fundamentals

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A Few Thoughts

While the Fed's moves were hailed as dovish, it should not be lost on investors that Chairman Powell's forecast is for stable rates, not for rate cuts. And I must say, Chairman Powell appeared quite comfortable during his press conference and at ease with the policy adjustments made on the rate outlook and the balance sheet. This time around, the Chairman's messaging was clear that while the economy may be slowing from 2018 levels, the overall economic outlook remains positive and being patient is the best way to maintain current growth, employment and inflation conditions. As a reminder: not cutting rates is part of being patient.

Ending quantitative tightening seems right to me. Excess reserves on the Fed's balance sheet are approaching the minimum levels needed to keep the banking system running smoothly under the current market and regulatory environment. It's worth noting while the Fed has reduced securities held outright on its balance sheet by over $450 billion since QT began in October 2017, the S&P 500 and NASDAQ indices are up over 12% and 18%, respectively, on a straight price change basis over the same time frame. The Fed should consider that a win. I know I would.

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I sincerely doubt there is tremendous conviction within the Fed supporting the forecasted 2020 rate hike. More likely, the Fed is trying to avoid a complete reversal of previous guidance, hopefully tamping down concerns the Fed sees greater recession risk than is being let on. Ultimately, the Fed is boxed into forecasting the next policy move to be a rate hike rather than a rate cut. After all, if the Fed views the longer-run neutral federal funds rate as 2.75% and the current fed funds target is around 2.40%, signaling a rate cut or even steady policy over the next 21 months feels like a vote of no confidence in the U.S. economy and contradictory to the Chairman's positive outlook.

Previously, U.S. Bancorp Asset Management was forecasting one additional rate hike in late-2019, based on our opinion the Fed believed policy rates were below neutral and aspired to get there when more benign market conditions were met (financial market stability, sustainable growth, steeper yield curve, target inflation). We believed – and still believe – those conditions will be met in the back half of 2019, but the Fed's complete capitulation has us changing our outlook to no rate hikes this year. While fed funds futures are approaching an almost 50% probability of a rate cut within the next twelve months, we are more optimistic on the economy and, if pressed, our bias is the next rate move would be higher rather than lower. Who is right can be sorted out over the next few months, as we see interest rates being range-bound in the coming quarter with low risk of a meaningful rally or sell-off in 1- to 5-year yields.

How about a quick rant?

I detest the argument the Fed needs to tighten monetary policy now (higher rates, shorter maturities on the balance sheet, etc.) to store ammunition for the next downturn. Here's a plan: don't push the economy into recession in the first place. Most of the forecasts for a U.S. recession seem to revolve around the extended length of the current expansion and how the U.S. is simply overdue for an economic downturn. How defeatist. Just ask Australia – their last recession* was in 1991. Absent some misguided political or policy development – which admittedly is hardly a zero-probability event – the economy should be able to continue its current modest growth path for the foreseeable future. If anything, slower growth may just give the expansion even longer legs, by limiting the development of destabilizing sector bubbles and keeping financial markets from getting over their collective skis.

*Defined as two consecutive quarters of negative economic growth

Sources:

Bloomberg
Federal Reserve Press Releases, January 20, 2019 and March 20, 2019
Federal Reserve Statistical Release, Factor Affecting Reserve Balances, September 28, 2017 and March 14, 2019
FOMC Projection Materials, December 19, 2018
FOMC Projection Materials, March 20, 2019

[See next page for important disclosure information.]

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