First Trust ECONOMIC RESEARCH REPORT

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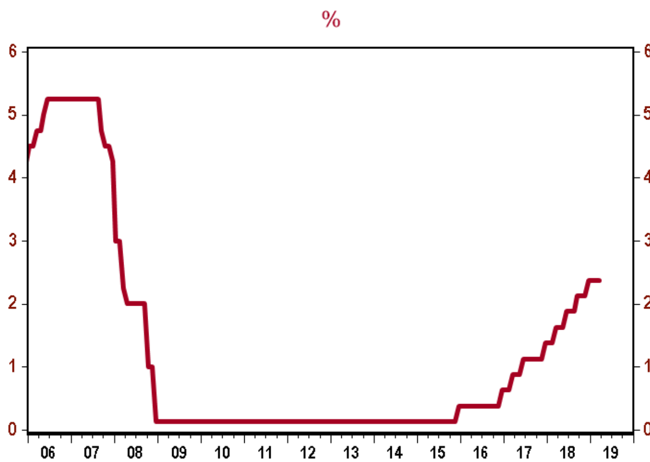
The Fed Emphasizes Patience

The Federal Reserve just made their most dovish shift in outlook since the aftermath of the financial crisis. The FOMC statement, economic projections, and "dot plot" (the expected path of rate hikes) all tilted dovish. In addition, the Fed has decided to maintain a significant portion of the bloated balance sheet it gathered during and after the crisis. In other words, their stated path of "renormalization" will leave the balance sheet well above normal levels.



Back in December, the median projection from the Fed was two rate hikes in 2019 and one more in 2020; now it's zero rate hikes this year and one in 2020. This shift reflects undue (in our opinion) pessimism about the economy. The Fed downgraded its forecast for real GDP growth to 2.1% this year from a prior estimate of 2.3%, while also revising lower their growth outlook for next year. As a result, the Fed now thinks unemployment will bottom at 3.7%, not 3.5%, and expects less inflation, with it's preferred measure (PCE prices) up 1.8% this year and 2.0% per year for 2020-21. That's a 0.1 percentage point reduction in inflation expectations for each of these years.

The statement, too, reverberated pessimism, noting a slowdown in economic growth, consumer spending, and business investment in the first quarter. It also acknowledged that overall inflation has slipped due to lower energy prices. We think the Fed is too pessimistic and that the US economy should grow in the 2.5 to 3.0% range in 2019, as it keeps absorbing the benefits of tax cuts and deregulation. We see the same slowdown the Fed sees for the first quarter, but think it's just statistical noise based largely on suspiciously weak consumer spending figures from the government that are inconsistent with other data.

The most disappointing news was that the Fed has decided to abruptly taper and end the renormalization of the balance sheet. Right now, the Fed is reducing it's balance sheet by up to $50 billion per month, consisting of $30 billion in Treasury securities and $20 billion in mortgage securities. Starting in May, the Treasury portion will be cut in half to $15 billion per month, while mortgage securities will continue rolling off at their current pace. Then, starting in October, the Fed will no longer reduce its Treasury position at all, but will instead take up to $20 billion per month in maturing mortgage securities and roll them into Treasury debt.

We think the Fed is unnecessarily concerned about inverting the yield curve, and wants to leave a "buffer zone" between the yield on the 10-year Treasury note and the federal funds rate. As a result, we're unlikely to see another rate hike until the 10-year yield hits 3.00%.

At the press conference, Chairman Powell went out of his way on multiple occasions to emphasize that the Fed would be "patient." We think this patience is a mistake, creating a feedback loop that holds the 10-year Treasury yield down, and giving the Fed a contrived reason to curtail rate hikes and renormalization too early.

Before today's meeting, the futures market in federal funds was suggesting a 27% chance of a rate cut in 2019 and a 0.6% chance of a rate hike. Now the market has the odds of a cut at around 38%, while pricing in zero chance of a rate hike.

We think those odds are totally off base. Not even one of the dots from the 17 members of the Fed shows a rate cut this year. None. By contrast, six members still expect at least one rate hike before year-end. If the economy outperforms the Fed's relatively dismal forecast, the odds of a cut will fall, the odds of a hike will soar, and the 10-year yield will recover, giving the Fed room for a hike by year end.

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Text of the Federal Reserve's Statement:

Information received since the Federal Open Market Committee met in January indicates that the labor market remains strong but that growth of economic activity has slowed from its solid rate in the fourth quarter. Payroll employment was little changed in February, but job gains have been solid, on average, in recent months, and the unemployment rate has remained low. Recent indicators point to slower growth of household spending and business fixed investment in the first quarter. On a 12-month basis, overall inflation has declined, largely as a result of lower energy prices; inflation for items other than food and energy remains near 2 percent. On balance, market-based measures of inflation compensation have remained low in recent months, and survey-based measures of longer-term inflation expectations are little changed.

Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. In support of these goals, the Committee decided to maintain the target range for the federal funds rate at 2-1/4 to 2-1/2 percent. The Committee continues to view sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2 percent objective as the most likely outcomes. In light of global economic and financial developments and muted inflation pressures, the Committee will be patient as it determines what future adjustments to the target range for the federal funds rate may be appropriate to support these outcomes.

In determining the timing and size of future adjustments to the target range for the federal funds rate, the Committee will assess realized and expected economic conditions relative to its maximum employment objective and its symmetric 2 percent inflation objective. This assessment will take into account a wide range of information, including measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial and international developments.

Voting for the FOMC monetary policy action were: Jerome H. Powell, Chairman; John C. Williams, Vice Chairman; Michelle W. Bowman; Lael Brainard; James Bullard; Richard H. Clarida; Charles L. Evans; Esther L. George; Randal K. Quarles; and Eric S. Rosengren.

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