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The Fed reaches the end of its policy cycle

Dovish pivot reduces recessionary risk

The Fed's dovish turnaround is welcome as it vindicates our view that the US economy is facing a significant slowdown. It remains to be seen whether the pragmatic change in policy is enough to reignite growth momentum but it reduces the risk of a policy error, which we considered to be one of the key risks for 2019. Importantly, it takes off the pressure on other central banks to tighten their monetary policy.

Source: iStock

"I don't feel that we have kind of convincingly achieved our two percent [inflation] mandate in a symmetrical way."

Jerome Powell

The Fed acknowledges weaker US growth as global momentum remains muted

We have long held the view that although the US economy is currently still enjoying solid momentum it is likely to slow down significantly from last year's pace to around trend growth this year and will probably fall into recession next year. It seems that the Fed now also acknowledges the risks that the US economy is facing and has lowered the expected change in GDP to 2.1% for 2019, slightly above the projected long-run growth rate of 1.9%. Importantly, these downward revisions come despite interest rates basically being on hold for most of this year and next. Consistently, the implied growth forecast would have been even lower were it not for the lowered rate projection and the end of the balance sheet reduction.

In line with recent statements from a number of FOMC members, the Fed is putting more weight on global economic and financial developments and their impact on the US economy.

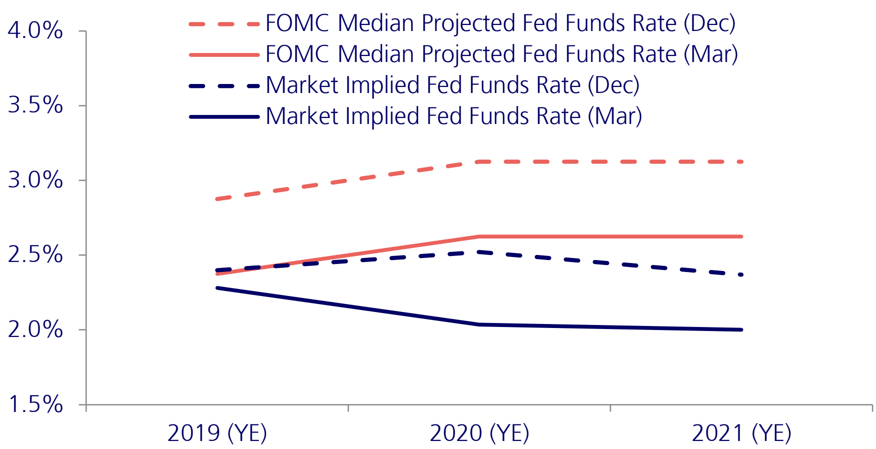
Firms and households become more cautious

Not only global but also domestic US economic data have weakened over the past few weeks and months. The ISM Manufacturing index has fallen to the lowest level since December 2016 in February, though the Non-Manufacturing part held up better.

Business optimism of small firms, the backbone of the US economy and job market, has also dropped to levels last seen at the end of 2016 when sentiment got boosted by Donald Trump's election victory and his promise to cut taxes, deregulate and bring manufacturing back to the US. Recent NFIB surveys also indicate that small businesses intend to cut back on capital expenditure plans, hiring and compensation.

Consumer sentiment has recovered from its weakness in the final quarter of last year but the gap between the perception of the current situation and future expectations

The Fed lowers its interest rate projection



Source: Bloomberg

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remains very wide, which historically does not bode well for consumer spending. Indeed, spending on big-ticket items seems to have peaked last year as can be seen in both the housing market and vehicle sales. We still think that growth in the US will slow down significantly as the economy is hitting capacity constraints.

Nevertheless, the Fed's pragmatic move away from its tightening stance will help to mitigate the slowdown. Importantly, it removes the pressure on other central banks to tighten their policy. This will help to support global growth and should have a positive impact on the US economy as well.

Tapering the tapering

In a rarely observed dovish tilt, the FOMC surprised investors by significantly lowering the projected interest rate path, reinforcing its new found pragmatism. The Fed now signals no further rate hikes this year and just one more in 2020, down from two and one, respectively, underlining its willingness to pause. Even the projected rate hike in 2020 is only a marginal expectation as seven officials expect rates to remain on hold through 2020.

Next year's rate hike would then mark the end of the current cycle, according to the Fed's projection. Interestingly, that would leave the rate at 2.625%, which is below the FOMC's estimate of the longer-run neutral rate.

In addition, the Fed announced that it will begin to slow down its balance sheet reduction in May by lowering the cap on monthly redemptions. It will completely stop the balance sheet reduction in September. According to this projection, the Fed would then have completely removed its tightening bias by October this year.

The Fed's sudden turnaround is pragmatic but its credibility may suffer

The relatively hawkish stance was never fully credible (or justified). The sudden shift within less than three months from a projected steady path of rate hikes to basically having reached the target and from the balance sheet reduction being "on autopilot" to it being ended soon is remarkable.

The Fed's turnaround and renewed focus on low inflation may not help its credibility as it has missed its target for most of the past decade. The dovish shift now comes at a time when wage growth has finally accelerated to a post-recession high, the labour market remains very tight and households' inflation expectations have actually ticked up again. We nevertheless welcome the more pragmatic approach the FOMC seems to have taken entering the new year.

It is also interesting to note that the Fed's dovish turnaround is not due to its willingness to signal a stronger commitment to a symmetric inflation target as could have been concluded from Jerome Powell's statements. In fact, expected PCE inflation for this year has been reduced to 1.8% from 1.9% and the projections for the next two years have been lowered to 2.0% from 2.1%.

The Fed's dovish stance is welcome, but it may have come too late

As stated above, we welcome the Fed's dovish shift and its willingness to pause as there is no urgency to continue tightening monetary policy and the risks for the economic outlook are to the downside, in our view. It remains to be seen whether the Fed's new stance can reignite the economy's momentum or whether it instead accelerates the expected slowdown as investors and households interpret the FOMC's sudden turnaround as a negative signal and become more cautious.

Interestingly, the stock market turned negative after a brief spike higher following the dovish surprise. Meanwhile, 10yr Treasury yields are back below 2.5%, a level last seen more than a year ago and a strong signal that bond investors are not worried about higher inflation in the future.

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