GENERALI INVESTMENTS

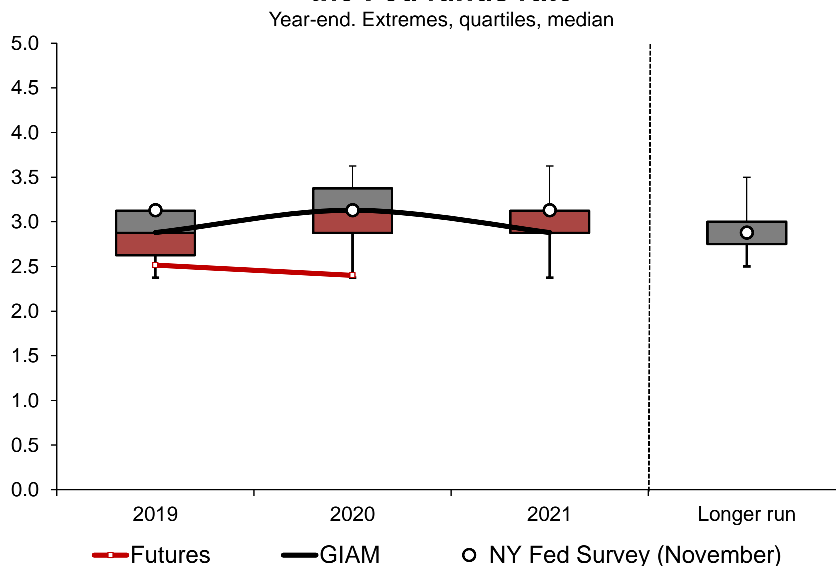
GIAM Macro & Market Research - Market Commentary

The Fed hikes rates, but signals slower pace in monetary normalization

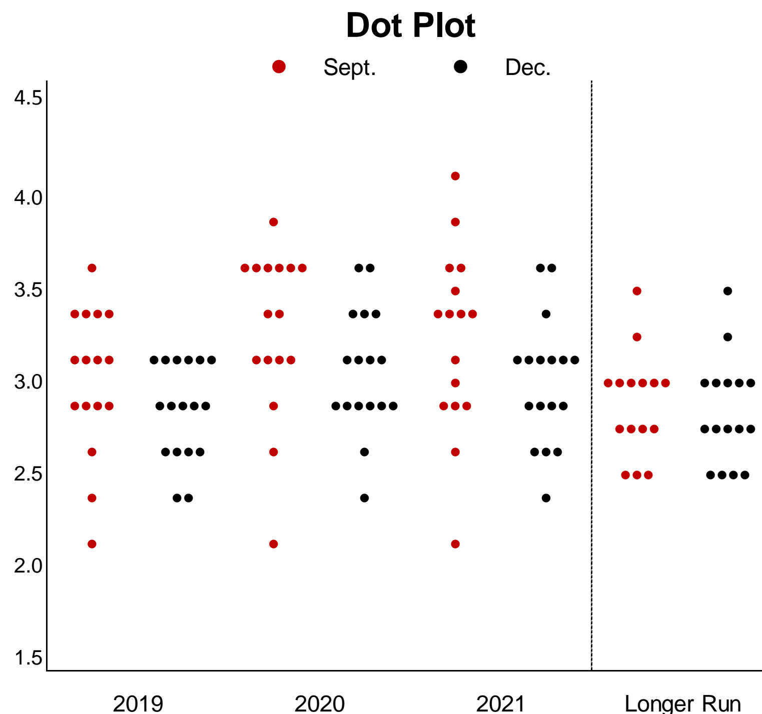
- **The widely expected increase in rates was accompanied by a reduction to two of the number of rate hikes deemed appropriate for 2019. A final increase should follow in 2020. The expected terminal rate decreased to 3.1%.**
- **The recent weak macro data flows, the softening in global growth and the tightening in financial conditions led to a mild downward revision of the growth forecast for 2019. Inflation is no longer expected to overshoot the target.**
- **In the press conference Powell continued to push its view that the Fed is now even more data dependent and the importance of projections and the dots must not be exaggerated.**

As expected the Fed deliver its fourth rate increase for 2018, lifting the range for the Fed funds rate to 2.25%-2.5%. However **it took quite a dovish turn, reducing from three to two the increases deemed appropriate for 2019.** A final increase in 2020 will bring the policy rate to a peak of 3.1% (instead of 3.4% expected in September) where it should remain in 2021.

We expect two rates in 2019 too, a third one will strongly depend on the residual strength of the economy at the end of 2019/beginning of 2020. We still consider it as the most likely event and now place it in 2020, but **with a probability of no more than 60%.** Unlike the Fed, **we expect rates to be cut by 25 bps in 2021**, in line with a marked deceleration in growth



Compared with the September meeting, the dots for 2019 and the following years appeared more clustered to the center, **reflecting a stronger consensus on the appropriate policy path.** The long term view changed only marginally (from 3.0% to 2.8%), due to the shift of only one dot.



The projections painted a faster deceleration in growth for next year (reflecting the tailwinds signaled recently by data) and a quicker recovery in unemployment rate in 2021. The moderate pace of inflation, as **the core rate is no longer expected to overshoot the 2% target,** in the face of a tighter labor market was somehow rationalized by a small reduction in the equilibrium unemployment rate.

	2018	**2019**	**2020**	**2021**	**Longer run**
Change in real GDP	**3.0**	**2.3**	2.0	1.8	**1.9**
September projections	3.1	2.5	2.0	1.8	1.8
Unemployment rate	3.7	3.5	**3.6**	**3.8**	**4.4**
September projections	3.7	3.5	3.5	3.7	4.5
PCE inflation	**1.9**	**1.9**	2.1	2.1	2.0
September projections	2.1	2.0	2.1	2.1	2.0
Core PCE inflation	**1.9**	**2.0**	**2.0**	**2.0**	
September projections	2.0	2.1	2.1	2.1	
Appropriate path for rates					
Federal funds rate	2.4	**2.9**	**3.1**	**3.1**	**2.8**
September projections	2.4	3.1	3.4	3.4	3.0

Changes from the September projections highlighted in bold

The change in tone and outlook was strongly reflected in the press statement. The FOMC took notice of the slowdown in capex and a mention of the risks related to global economic conditions was put back in. Somehow unexpectedly, **forward guidance was not completely scrapped, as "some further gradual increases" in rates are still "judged" consistent with sustained growth**.

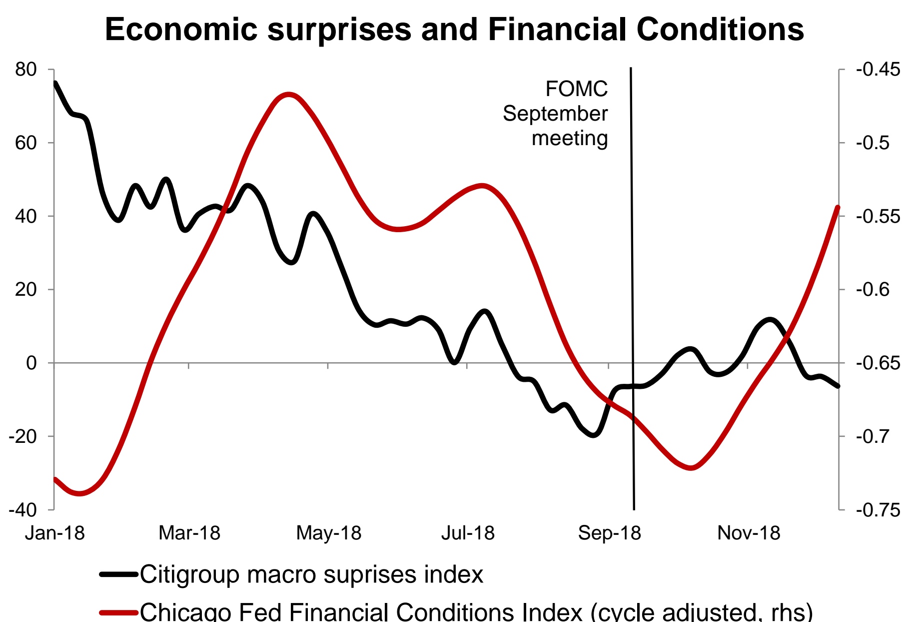
As always, the Fed thinking was illustrated in depth during the press conference:

The growth outlook: FOMC members **have not fundamentally changed the outlook, but now acknowledge a change in the growth trajectory towards a more moderate pace**. Projected growth for 2019 remains strong.

The labor market: **Wages are expected to increase but, s this need not be inflationary**, as happened in the second half of the 90. Several indicators point to a tight marked, backing up anecdotal evidence of labor shortage. **The fact that participation rate of prime age males is still below pre crisis level may indicate residual slack.**

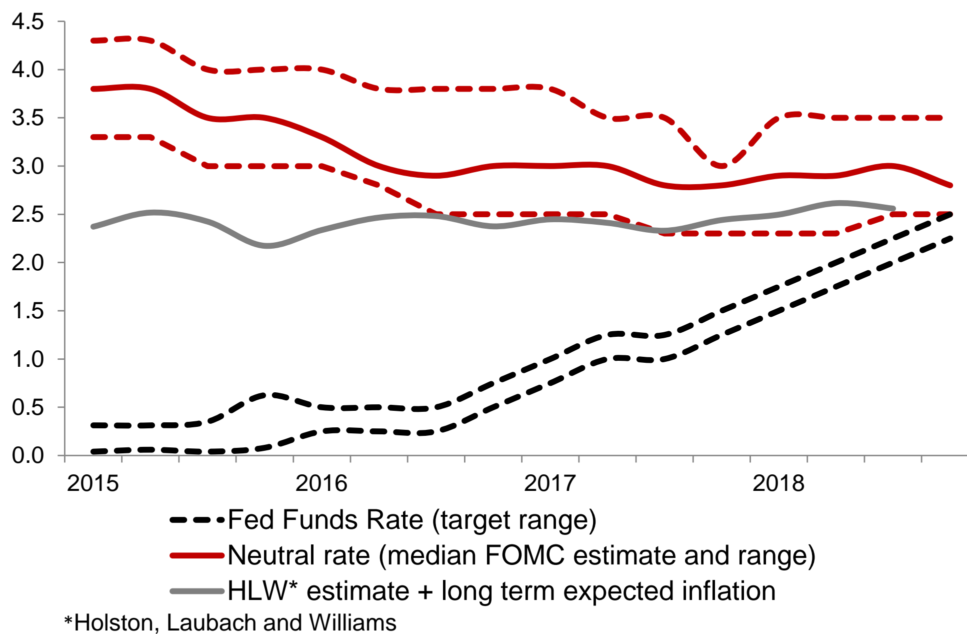
Inflation: the core rate ended the year a touch below expectations. **It is not a desired outcome but allows the Fed to be patient in setting rates.** The fact inflation peaking at 2% this seems at odds with a further tightening in rates was underlined in a few questions.

Financial conditions: the tightening in a broad range of financial market indicators since the September meeting was repeatedly stressed as one of the key factor behind the adjustments in the projections and the path for rates. However, Powell signaled that **the Fed will react strongly only to material and sustained changes in financial conditions.** By the same token, only a prolonged weakness in the long term Treasury yields can be considered as a signal of worsening growth expectations.



The global outlook and trade tensions: the global slowdown and the risks attached to it clearly played a bigger role than in the past in shaping the FOMC decisions. **Powell appears particularly alert to the impact of trade tension on confidence**.

R-Star: references to the equilibrium interest rates were rather frequent, especially given the efforts made to downplay its role. Powell stated again that the upper bound of the Fed funds rate is now within the range of FOMC estimates. **Further moves will bring it to around neutral, but at that time it will matter even less for policy decisions.**



Data dependence: **Powell illustrated how the evolution of growth expectations during 2018 was reflected in changes to the outlook for rates, to show that the Fed is already data dependent**. The pause the Fed took in 2016 and the quarterly increases in 2017 were also quoted. It then stressed that the dots will continue to adjust to data and that the pace of hikes and the final level are not predetermined. **As far as the timing of the next moves is concerned, the Fed will "let data speak".**

Communication: form 2019, there will be a press conference after each of the 8 FOMC meetings. It will permit a clearer communication, but the fact that **the Fed will have more opportunities to raise rates** may generate uncertainty. Powell signaled communication will be adapted, so that important policy shifts will not catch markets by surprise.

Balance sheet normalization: The decision to put the runoff on autopilot and proceed smoothly with it, leaving the Fed funds rate as the main policy tool is serving its purpose and there are no reasons to change it. **Powell dismissed the view that the increase in the cost of short term funding is related with the undoing of QE**.

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