FED WATCH: THE “NEW” NORMAL IS REALLY JUST THE “OLD” NORMAL

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The first Federal Open Market Committee (FOMC) meeting of 2019 is now in the books. While the result did not deviate from the market’s expectations on the rate front, the policy statement did provide further evidence that the Federal Reserve (Fed) is going about things in a different way than investors have been accustomed to over the last few years. Is this decision-making process the “new” normal? No, it is really just the “old” normal, or how the Fed typically conducts monetary policy when the Fed Funds Rate target is not zero.

Since the FOMC began raising rates in December 2015, and picked up the pace during the last two years, the plan was to move the Fed Funds Rate target away from zero, i.e., to normalize policy. Now, with the upper band of the policy rate target at 2.50%, or close to what is considered a neutral rate, the voting members have achieved their goal. So instead of raising rates in a somewhat gradual, but more importantly, predictable manner, further possible rate hikes will hinge upon upcoming economic data. In other words, monetary policy has become data-dependent. This is how the FOMC typically went about its business prior to the global financial crisis/great recession.

With inflation below the Fed’s 2.0% target, the policymakers can afford to be patient and, in the words of Chair Powell, “flexible” as well. Certainly, the decline in risk assets as 2018 came to a close created an environment of tighter financial conditions. The question now is whether that development had any visible, longer-lasting impact on economic growth. Certainly, the December jobs report was robust, so the good news seems to be that the economy was in relatively solid shape to absorb the blow.

So, where do things stand as the markets look ahead? Unfortunately, the waters will be muddy for a while. Due to the partial government shutdown, both the Fed and the bond market have not been receiving any fresh insights on the economy. The only exceptions have been the Bureau of Labor Statistics and private vendors. Even with the federal government now open, it will take time for the various agencies to compile and release their data. In other words, the Fed and the bond market will have to wait!

Once the government agencies are caught up, history has shown us that a data deluge could be on the horizon, as two months’ worth of reports could get released on the same day. A further complication is that Q1 real GDP will more than likely be adversely impacted to some degree by the shutdown—and Q2 should show a bounce-back. This means the Fed may not get a true sense of underlying conditions until later in the spring.

Conclusion

Our base case, much like the Fed’s, still involves a slowdown in U.S. growth, rather

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than a recession. Eventually, we feel that should lead to at least one more rate hike this year, but the timing has probably been pushed out due to the aforementioned considerations. Don't forget about the balance sheet. I'm expecting more headlines on this front as 2019 progresses. Stay tuned for more on this latter point in future blog posts!

Unless otherwise stated, all data is sourced from Bloomberg as of 1/29/19.

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DEFINITIONS

Federal Open Market Committee (FOMC) : The branch of the Federal Reserve Board that determines the direction of monetary policy.

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Monetary policy : Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

Federal Funds Rate : The rate that banks that are members of the Federal Reserve system charge on overnight loans to one another. The Federal Open Market Committee sets this rate. Also referred to as the “policy rate” of the U.S. Federal Reserve.

Normalization : The process by which a policy or action returns to its historically normal levels.

Rate Hike : refers to an increase in the policy rate set by a central bank. In the U.S., this generally refers to the Federal Funds Target Rate.

Recession : two consecutive quarters of negative GDP growth, characterized generally by a slowing economy and higher unemploymen.

Inflation : Characterized by rising price levels.

Gross domestic product (GDP) : The sum total of all goods and services produced across an economy.

Balance sheet : refers to the cash and cash equivalents part of the Current Assets on a firms balance sheet and cash available for purchasing new position.