FED WATCH: SOME LIKE IT HOT

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05/01/2019

Certainly, no one can dispute that the shift in the Federal Reserve's (Fed) monetary policy outlook has been the most noteworthy development that has occurred in the money and bond markets thus far in 2019. The problem is that this shift has only created an extra layer of uncertainty in the rate outlook. Ah, remember the good ol' days (last year) when the Fed telegraphed their moves? Well, that's all changed now. So, while the debate for 2019 and 2020 seems to have gravitated toward when the Fed will actually cut rates, I offer a different take. What if the FOMC goes on a "policy sabbatical" of sorts, and just leaves well enough alone? In other words, just sits back and lets the economy "run hot."

The results of this week's FOMC meeting plays into my line of reasoning. Indeed, the policy makers continue to see the economy as being in reasonably good shape, but the deceleration in core inflation holds the key to my argument. There is no urgency to cut rates—or raise them for that matter. Thus, why mess with a good thing? Don't forget, the Fed will be ending its quantitative tightening of the balance sheet at the end of September.

Against this backdrop, it falls on Chair Powell & Co. to try to shift the market's mindset away from rate cuts. Let's face it, the rate hike focus was discarded months ago. However, heading into the May 1 FOMC meeting, the Fed Funds Futures market was, once again, pricing in a rate cut for this year and two additional easing moves for 2020. I don't think the Fed is quite there in its own policy outlook. So, the disconnect continues.

It would seem that despite the much better-than-expected headline reading for Q1 real GDP (+3.2%), the market has shifted its outlook away from a meaningful growth slowdown/potential recession to more of an inflation situation. Sure, inventories and trade provided the boost for Q1 growth and can easily be reversed in the coming months, but it appears as if *inflation* is the market's new obsession. The latest data continues to show the Fed's preferred core measure, personal consumption expenditures deflator, still residing visibly below the 2% target at 1.6%.

Conclusion

If I'm right and the Fed is in an elongated pause mode, the Treasury market is going to have to come to terms with the potential for economic growth running a bit hotter than originally expected. How would, say, the UST 10-year yield respond to this new policy environment? Probably just by continuing on its merry, range-bound way, until the time comes when investors suddenly wake up one day and wonder, Is the Fed now behind the curve?

Unless otherwise stated, all data source is Bloomberg, as of 4/29/19.

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DEFINITIONS

Inflation : Characterized by rising price levels.

Quantitative Tightening : Quantitative easing is a process whereby a central bank targets lowering longer-term interest rates by purchasing bonds and other securities to stimulate the economy. Quantitative tightening is the reverse process whereby securities are either sold or the proceeds of maturing securities are not reinvested with the goal of tightening economic conditions to prevent the economy from overheating.

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.

Fed fund futures : A financial instrument that let's market participants determine the future value of the Federal Funds Rate.

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

Personal Consumption Expenditure (PCE) Price Index : measure of price changes in consumer goods and services in the U.S. economy.

10- Year Treasury : a debt obligation of the U.S. government with an original maturity of ten years.