Inflation expectations support holding rates steady – for now

by Franck Dixmier | 18/03/2019

Summary

With the Fed having largely achieved its objectives of full employment and price stability, we expect short-term rates to stay unchanged at the FOMC's next meeting. This should be good for investors, but don't rule out a rate hike by the end of the year if inflation surges, or if tariff- or Brexit-related risks recede.

Key takeaways

- Expect the FOMC to confirm its prudent approach at its March 20 meeting: it has achieved full employment and price stability, and inflation expectations remain moderate
- We believe the Fed's interest-rate policy is appropriate and rates should remain unchanged for now; in our view, this provides a strong anchor for the US yield curve
- Still, a rate hike at the end of the year cannot be ruled out, given the US economy's resilient growth and the potential for higher inflation

The Federal Open Market Committee's March 20 meeting and communications are not likely to result in any surprises; rather, we expect the Fed to confirm its new, prudent monetary-policy strategy. Federal Reserve Chair Jerome Powell largely lifted the veil on this approach during a recent interview on "60 Minutes" – a widely viewed news program on US television. During the interview, Mr. Powell clearly indicated that he finds the Fed's current interest-rate policy to be appropriate given today's low US inflation levels, and that he saw no urgency to adjust interest rates.

Indeed, the US central bank has largely achieved its objectives of full employment and price stability:

- The Fed's inflation target of around 2% has essentially been reached, with PCE (personal consumption expenditures) at 1.94%, core PCE (the Fed's preferred indicator) at 1.9% and CPI (the consumer price index) at 2.2%.
- Inflation expectations remain moderate, as confirmed by newly published three-year household inflation expectations. These fell from 3% to 2.8% – their lowest level in 18 months.
- Inflation expectations priced into two-year TIPS (Treasury inflation-protected securities) are at 1.90% – below the Fed's inflation target.

Collectively, these indicators fully support a pause in the Fed's rate-hike strategy despite year-over-year wage growth of 3.4% – the highest level since 2009.

Yet the Fed has been debating a new inflation approach for some time. This would entail managing its monetary policy according to an average inflation rate, tolerating the times when it temporarily overshoots its 2% target as a way to compensate for the times it undershoots that target. This potential change, which has yet to be confirmed by Mr. Powell, would allow the Fed to be more flexible and pragmatic, and it would likely create fewer surprises for the markets. It would also reinforce the Fed's desire to abandon automatic steering to stay "behind the curve" – an approach that entails not raising rates at a pace that keeps up with inflation.

The FOMC's upcoming meeting will also be interesting in other ways:

- The Fed will present its forecasts for growth, inflation and short-term rates, as anticipated by the members of the FOMC.
- The upcoming "dot plot" – a chart that indicates the rate-path estimates of FOMC members – should provide information on the Fed's future monetary-policy stance. We think it is likely that the Fed expects to hike rates just one or two times by 2021 – down from previous expectations for three hikes.
- In its post-meeting communications, we expect the Fed to highlight several important risks to the US economy – namely tariffs with China and Europe, and political risks such as Brexit.
- We believe the Fed will also focus on further reducing its balance sheet – a process that started in 2017, going from a peak of USD 4.5 trillion in 2015 to USD 4 trillion today.

To this last point, the minutes of the January meeting show that FOMC members unanimously supported ceasing balance-sheet reductions in 2019 to avoid making monetary conditions tighter. Mr. Powell confirmed as much in his February speech to the US House Committee on Financial Services. By not further reducing its balance sheet, the Fed will likely find it easier to manage banks' reserves to maintain short-term rates in a predefined range. However, the contents of this balance sheet remain to be seen – particularly with regard to mortgage-backed securities and bond maturities.

Investors should expect the Fed to keep short-term rates at current, neutral levels for now – levels that we believe provide a strong anchor for the US yield curve, and that reinforce longer-term rates. But investors should also expect the Fed to keep all options open in the medium term as it continues watching the economic data. Growth remains resilient and above its potential, despite the fact that the latest growth statistics are difficult to decipher because of the US government's partial shutdown. Moreover, the recently released average three-month job creation rate was 180,000. Even if this figure disappointed some market-watchers, it is compatible with continued wage growth.

Further, the global economy continues to slow, particularly in China and Europe. The Fed has previously noted these "cross currents" as a contributory factor to its current policy and will be watching global growth trends closely.

While the Fed is seeking to be more flexible than ever in how it conducts monetary policy, we cannot rule out the possibility of an interest-rate hike at the end of 2019 if inflation surges or risks recede. This is our base-case scenario. It is also a source of fragility for the US bond market, which continues to anticipate that the Fed will actually cut rates in 2020, rather than hike them.

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About the author

Franck Dixmier
Global Head of Fixed Income

Active is: Anticipating what's ahead

The ECB's monetary-easing policy is here to stay

by Franck Dixmier | 08/04/2019

Summary

Recent ECB comments suggest that the horizon for a rate hike may be moving further away, based on the central bank's uncertain growth outlook and concerns over weak inflation. The ECB is also keen to preserve banks' ability to lend to the euro-zone economy.

Key takeaways

- We expect the ECB to confirm its extremely accommodative monetary policy stance at its next meeting; the pause in normalisation could last, and short-term rates are well anchored
- The ECB is likely to emphasise its uncertain outlook for growth and concerns about weak inflation expectations as justification for its ultra-accommodative policy
- Look for the ECB to highlight that it still has room for further monetary easing, although this could fuel market uncertainty

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