Caution and flexibility: a new "behind the curve" strategy for the Fed

by Franck Dixmier | 24/01/2019

Summary

In hitting pause on monetary tightening, the Fed is clearly planning to remain cautious and flexible while staying behind the curve. This offers a favourable context for risk assets in the short term.

Key takeaways

- Fed Chair Powell's recent statements confirm a change of tone and strategy: the Fed will adopt a cautious and flexible approach to stay "behind the curve"
- The Fed clearly wants to hit pause on monetary tightening and not increase rates in March – but it is unclear whether this is just temporary or an announced end to rate hikes
- For investors, this pause from the Fed is an opportunity that offers a favourable context for risk assets in the short term
- In the medium term, rate hikes cannot be ruled out if inflation overshoots the Fed's 2% target

Earlier this month, Federal Reserve Chair Jerome Powell made public statements that were quite different from his comments after the Federal Open Market Committee's December meeting. But it was not just the tone of his speech that had changed; its content was different as well.

In his latest comments, Mr Powell made it clear that the time is over for raising rates twice in 2019 – a departure from the Fed's December message. Moreover, Mr Powell had already stated that he does not want the fed funds rate to go past neutral. Clearly, the Fed has adjusted its monetary-policy strategy and, in a cautious and flexible approach, is now remaining "behind the curve" – meaning it is deliberately not raising rates to keep up with inflation.

To arrive at these conclusions, the Fed has taken note of the new reality. On the one hand, inflation remains moderate and stable at 2%, despite a dynamic labour market and wage pressures. On the other hand, risks continue to increase:

- Economic indicators have deteriorated, with decelerating global growth and a marked slowdown occurring in China and Europe.
- In the United States, an extension of the partial government shutdown – the longest in history – could affect consumption now that US growth has clearly passed its peak.
- Political unease has not subsided. The US and China are engaged in a trade war, and US-German trade tensions could rise in February. There is also uncertainty about Brexit and European elections over the coming months.
- The markets have been tense. Financial conditions tightened with the sharp fourth-quarter fall in equities, and credit spreads and volatility also rose. It is worth noting that financial stability remains an implicit goal of central banks.

We don't expect the Fed to hike rates at its January or March meetings. The question then becomes, will this just be a pause, or will it effectively be an announced end to the Fed's rate hikes? The markets have made their predictions clear. Fed funds futures indicate that the markets see only a 30% probability of a rate hike in 2019, and rates are even expected to go down in 2020.

Yet for its part, the Fed will maintain leeway in its decision-making, meaning a rate increase in 2019 cannot be dismissed. With an unemployment rate below 4%, US growth remains above its potential, and rising wages in the face of labour-market pressures could fuel inflation. Moreover, it is interesting to note that the real fed funds rate – which accounts for the effects of inflation – is in positive territory for the first time since the financial crisis. The divergence between the message of the markets and that of the central bank has therefore diminished, but it has not disappeared.

For investors, this pause from the Fed is good news in the short term, and it creates a favourable context for risk assets. In the medium term, a hike in interest rates cannot be ruled out if inflation exceeds its target.

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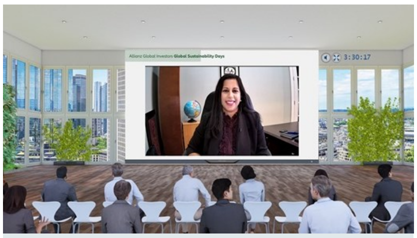

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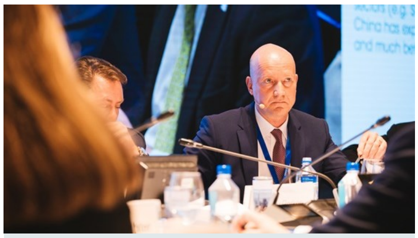

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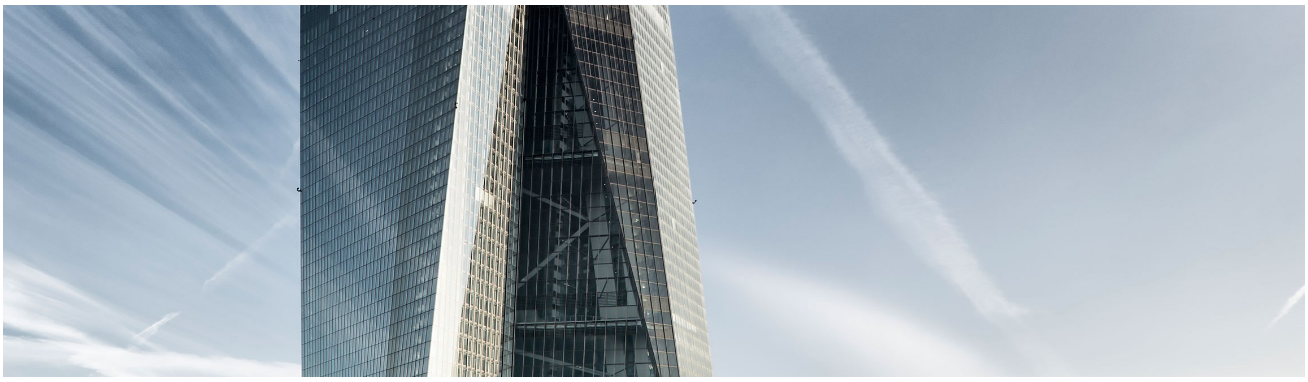

Summary

Changes in the euro zone's economy have raised expectations that the central bank will be more precise at its next meeting about what's causing the slowdown. We think the ECB will continue delaying rate hikes while also announcing a new liquidity program for banks.

Key takeaways

- Amid deteriorating economic conditions and falling inflation expectations in the euro zone, the ECB's 7 March meeting is highly anticipated by the markets
- Investors will be awaiting news on three elements: updated prospects for euro-zone growth, an analysis of the downturn's causes and duration, and possible news of another TLTRO-style liquidity facility
- Fixed-income spreads in peripheral countries (especially Italy and Spain) stand to benefit from news of another liquidity program, and from renewed expectations of a first rate hike being delayed until 2020

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