Federal Reserve: Keeping the balance

While financial markets continue to price in rate cuts, the Federal Reserve is maintaining a cautiously upbeat tone that to us signals stable monetary policy through 2019

Source: Federal Reserve

There were no real surprises from the Federal Reserve with the target range for the federal funds rate left at 2.25-2.5%. The vote was unanimous with the press release again emphasising the FOMC's willingness to be "patient" on policymaking despite President Trump's ongoing demands for an immediate rate cut.

The general tone was upbeat and it certainly didn't signal an inclination to cut policy interest rates anytime soon. Both the growth and the rate of jobs growth is described as "solid" – which is a slight upgrade on the March FOMC statement when they commented that the economy had "slowed from its solid rate". The Fed acknowledged that inflation is running below target, but mitigated this by stating inflation expectations "are little changed".

The Fed did announce a technical change to the interest rate paid on required and excess reserve balances, lowering it by 5 basis points to 2.35%. This is characterised as a way of helping to keep the effective fed funds rate within the target range since it has been pushing up towards the ceiling due to the Fed's balance sheet changes. It should not be construed in any way as a form of policy easing.

For now, though the market is of the mindset that inflation will remain low, growth will slow and the Fed will need to respond by cutting interest rates later this year.

In terms of our view on the outlook for monetary policy, GDP growth will certainly slow with an inventory run down and a rebound in imports acting as a drag over the next couple of quarters. However, a robust jobs market and firm confidence readings can help partially offset the fading support from the fiscal stimulus. Improving financial conditions – lower borrowing costs, rising equities, a stable dollar – should also support growth. We still expect the economy to expand 2.5% this year.

As for inflation, we think the market is being a little too relaxed regarding the prospect of a pick-up. Rising labour costs in the form of both wages and other benefits could be passed onto consumers while higher energy price will feed through into other components. Gasoline prices have jumped 30% from $2.23/gallon in mid-January to $2.88 today and this will soon start to be felt in transport fares and distribution costs.

Given the decent growth story, the improvement in financial conditions and the prospect of rising inflation we see little reason for the Federal Reserve to cut interest rates.

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