

Federal Reserve preview: a glass half empty?

The Federal Reserve is widely expected to leave monetary policy unchanged on 29 January, but with hints of economic softness amongst the equity market euphoria we continue to see risks skewed towards lower rather than higher interest rates later in 2020



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The Fed's quiet confidence

Back in late August all the talk was of a potential recession. Business surveys were softening, the yield curve had inverted and equities were looking vulnerable. Fast forward five months and three Fed rate cuts, a phase one trade deal and the Fed re-expanding its balance sheet have helped turn the situation round and pump equity markets to new all-time highs. Inflation is broadly in line with target and the unemployment rate remains at 50+ year lows so in this environment there is no reason for the Fed to deviate from its December assessment that “the current stance... is appropriate”. The target range for Fed funds will therefore remain 1.5-1.75% after Wednesday's announcement.

With no new forecasts being released at this meeting it will be the tone of Jerome Powell's press conference and the actual vote that is likely to be of most interest for markets. The annual rotation

of voting members means that James Bullard (the dovish St Louis Fed President), Eric Rosengren (hawkish Boston Fed President) and Esther George (hawkish Kansas City Fed President) have been replaced by Richmond Fed President Thomas Barkin, The Atlanta Fed's Raphael Bostic and Mary Daly, the San Francisco Fed President. On the face of it these new voters appear to be more centrist than the three they replace and are likely to contribute to unanimous decision for no policy change.

We would also expect to hear Jerome Powell retaining his cautiously upbeat language, particularly given the positive conclusion to US-China trade talks. He is likely to reiterate that we will need to see a "material change" for the Fed to consider a policy shift. With the recent data flow suggesting the US is growing respectably, if unspectacularly, and with 4Q GDP set to have expanded by around 2% there is little sign of "material change" happening. As such this briefing is unlikely to be a catalyst for major market swings and that is the way the Fed would likely want it.

Balance sheet bonanza

One trickier area Powell will likely be questioned on is the size of the Fed's balance sheet. The Fed had been running it down via no longer reinvesting all the proceeds of maturing bonds in its QE expanded portfolio, but this process was terminated last year. Since September, when there was a dislocation in overnight funding markets that resulted in a spike in borrowing costs, we have seen a re-expansion, initially through emergency liquidity injections, before being more formally stepped up through US\$60bn of Treasury bill purchases per month. Fed officials have been at pains to inform us that this is not QE4 and instead is a "technical move" yet the market is in little doubt of what it thinks is going on.

Some Fed officials are finally seemingly acknowledging that it is at a minimum a "derivative" of QE, as stated by Dallas Fed President Robert Kaplan last week. With equity markets remaining on an upward cash fueled trajectory at a time when corporate profits as measured on a GDP basis are looking unremarkable we are somewhat nervous that this exposes the US economy to the threat of an equity market correction should an external shock emerge. Therefore we will be keen to hear what the Fed plans to do with this current programme.

Growth issues remain

We take the position that while a near-term policy change looks unlikely, we see the risks skewed towards lower rates through mid 2020. We remain cautious on the growth story, predicting a deceleration to 1.7% from 2.3% GDP growth in 2019 and with wage rises and inflation looking benign this gives the Fed room to respond to any negative surprises with another rate cut.

We see little growth upside coming from capital expenditure this year in the knowledge that capex already contracted in 2Q and 3Q with the upcoming 4Q GDP report likely highlighting another disappointing reading for the final three months of last year. While the trade deal with China lifts some of the uncertainty, we don't see it as a transformational agreement that will unleash an investment boom. Moreover, with the recent Deloitte's, CFO survey showing 97% of respondents thinking the US is either already in a downturn or will be at some point this year, this doesn't give us confidence in the view that US business leaders are about to start spending in a meaningful way. We are also cognizant of the fact that presidential elections typically make firms wary of putting money to work given the potential for significant regulatory/taxation changes.

The consumer sector has also been looking a little less rosy. While the economy has continued to

create jobs, wage growth has been disappointing and has slowed to just 2.9% having threatened to push towards 4% twelve months ago. Auto sales have been flat lining and retail sales growth appears to have topped out and we continue to hunt for a catalyst that will prompt a renewed upturn following the tax cut shot in the arm they received in late 2018. It may well be that sustained equity market gains could tempt households to spend more of their incomes rather than save while the housing market is also a source of strength right now, but we remain hesitant to call a turn in broader spending just yet.

Risks remain skewed towards lower rates

Moreover, underwhelming wage growth should help to contain price pressures in the economy and offers the Fed the flexibility to respond to new events. Geopolitical tension, such as the US-Iran flare-up at the beginning of the year, remain a threat and the coronavirus could cause increasing anxiety in case it leads to broader global economic dislocation. Add in our sense of wariness about US equity markets together with willingness from the Fed to respond to economic changes and we feel that 10Y Treasury yields are more likely biased towards a 1.5-1.8% range rather than push above 2% anytime soon.

Author

James Knightley

Chief International Economist

james.knightley@ing.com

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