US: Fed sticks to its guns

The Fed left monetary policy unchanged and has little inclination to shift its position in the near-term. Nonetheless, growth risks remain skewed to the downside with a rate cut remaining our call for 2020

Source: Shutterstock

Steady as she goes...

The Federal Reserve has voted unanimously to leave the fed funds target rate unchanged at 1.5-1.75%. Given the solid if unspectacular growth backdrop, benign inflation readings and firm asset prices this was the only realistic outcome.

In terms of the statement itself there was just one minor tweak. Household spending, which had been described as rising at "a strong pace" in December has been downgraded to "rising at a moderate pace". Despite this, the statement reiterates that in the Fed's view, policy is "appropriate" to support sustained economic expansion and keep inflation in line with the 2% goal.

The annual rotation of voting members also didn't deliver any surprises. The dovish leaning James Bullard and Charles Evans and the hawkish Esther George and Eric Rosengren have been replaced by the more cautiously hawkish Loretta Mester and Patrick Harker, the fairly neutral Robert Kaplan and leading dove, Neel Kashkari, but none broke from the center ground on this occasion.

It should be noted that the Fed did raise the interest rate paid on required and excess reserves by

5bp to 1.6%, but this is purely a technical issue and doesn't have a direct read-through for the monetary policy stance. As the Fed says in a supplementary notice, this is "intended to foster trading in the federal funds market at rates well within the FOMC's target range". The Fed will also continue its repo operations at least through April – a policy that was implemented to provide some calm after September's dislocation in overnight funding markets that resulted in a spike in borrowing costs. Again this is technical and not a signal for future potential policy shifts.

The Fed is happy to hold...

After a market/data wobble in late summer, officials feel that the three 25bp rate cuts implemented in the second half of last year, coupled with the phase one trade deal between the US and China, have stabilized the situation. Only a "material change" in the outlook is going to make them alter their assessment that policy is on hold for the foreseeable future.

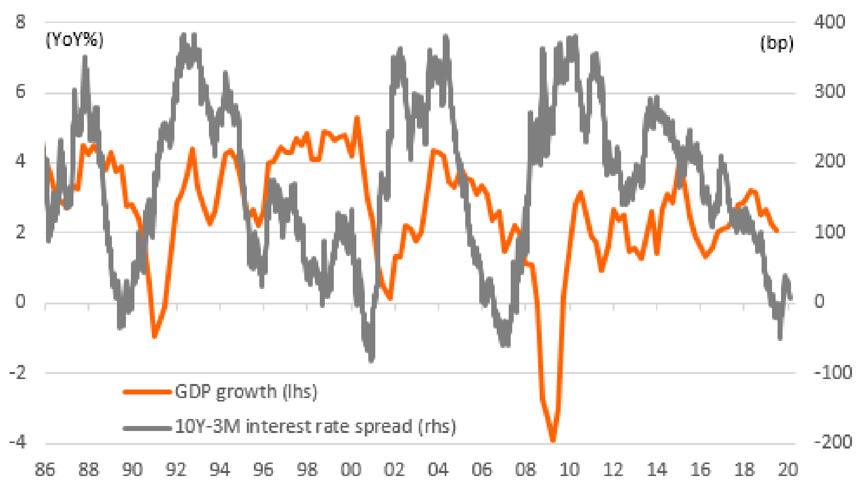
Their "dot plot" of individual member forecast from December signals that the most likely next course of action is a rate hike, but not until early 2021. This ties directly in with the Fed's notorious caution about implementing policy changes close to Presidential elections.

We, however, continue to see the balance of risks favouring a rate cut before the summer is out – a view that has gained greater credence given worries about the potential global economic costs of the coronavirus outbreak.

... but the balance of risks points to lower rates

We were already sub-consensus on US growth, seeing little upside for investment spending given cautious corporate boardrooms and the uncertainty generated by the Presidential election. Strong consumer sentiment is unlikely to translate into any significant pick-up in spending given the slowdown in wage and income growth. Then there is the Boeing situation and the cessation of 737-Max production, which could have significant knock on effects for economic activity.

Yield curve inversion highlights market fears for growth



Source: Macrobond, ING

The threat that the coronavirus outbreak poses in an environment of already subdued global growth underlines the potential for medium-term US economic weakness. So far, the market and economic impact appears limited with the travel and airline industries the most impacted. Nonetheless, the US yield curve, which is flirting with inversion once again, highlights broader market fears that the virus and its human and economic threat could spread. The more that it does the more likely it starts to alter consumer and corporate behavior, thereby prompting policy action to mitigate the dangers.

Author

James Knightley
Chief International Economist, US
james.knightley@ing.com