US: Prolonging the pause...

Fed Chair Jerome Powell has repeated comments that economic 'cross-currents' require a 'patient' approach to monetary policy. But unlike the market, we believe the risks remain skewed to higher interest rates eventually

Fed Chair, Jerome Powell

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Prolonging the pause?

The Federal Reserve chair Jerome Powell's monetary policy testimony to the Senate Banking Committee sees him emphasise the commitment to a more 'patient', 'data dependent' approach to monetary policy that the Fed has adopted since the January FOMC meeting.

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By way of justification, he argued that "in the last couple of months, some data has softened". Certainly, the latest retail sales numbers were poor and mean that 4Q GDP growth may have slipped below 2% - we get that data release on Thursday. As for the outlook, Powell repeated comments from last month that “we have seen some crosscurrents and conflicting signals”. In this regard, he cites financial market volatility and tighter financial conditions together with weaker growth, particularly in Europe and China.

Given these risks and 'muted' inflation pressures, Jerome Powell reiterated that the Fed has adopted a 'patient' approach with monetary policy being 'data dependent'. Today’s narrative suggests the Fed will be in no hurry to adjust its neutral policy stance, indicating that we could be in for a prolonged period of policy stability.

But there are positives...

However, Powell does offer some positives, admitting that the economic drag from the government shutdown is "expected to be fairly modest and to largely unwind over the next several months”. Moreover, the jobs market remains a clear positive with “ample availability of job opportunities” boosting labour force participation and wages. Overall, economic conditions are regarded as 'healthy', and the outlook is 'favourable'.

Chair Powell also addressed the size of the Fed's balance sheet following hints in the minutes to the January FOMC meeting that it could conclude the shrinking process earlier than initially thought. They are in the process of evaluating what they should do, dependent on economic and financial developments, but underlined that “in the longer run, the size of the balance sheet will be determined by the demand for Federal Reserve liabilities such as currency and bank reserves.”

Which way will they go?

In terms of the outlook for interest rates, markets believe that the Fed’s neutral stance will eventually give way to policy easing. Fed funds futures contracts are pricing in a 25bp rate cut by the summer of 2021, but we continue to believe that the next move is more likely to be an interest rate increase. After all, the economy is running pretty strongly with little spare capacity, and this is generating rising wage pressures in the labour market, which should keep consumer confidence and spending supported.

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If positive sentiment on US-China trade relations can be turned into something more concrete, this can be a real boon for the global economy. It can lift business confidence and encourage more investment spending in the US economy at a time when supply constraints are increasingly materialising.

Broader inflation pressures are set to build too with gasoline prices now responding to higher oil prices while the pick-up in worker pay and benefits is likely to nudge consumer price inflation upwards too.

This is admittedly a glass half full narrative. But if we do get decent economic performance as we expect, in an environment of rising inflation pressures and decreasing trade concerns, we believe the Federal Reserve will overcome its current reticence and hike rates 25bp during the summer.

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