Federal Reserve: Dovish Fed signals end to tightening

No policy change from the Fed, but the dot plot diagram shows FOMC members have gone signalling two possible hikes to no hikes in 2019. Should we be worried?

Source: Federal Reserve

VERY patient

As widely expected the Federal Reserve unanimously left monetary policy unchanged with the fed funds target range maintained at 2.25-2.50%. The Fed noted the ongoing "strong" labour market, but also highlighted that growth has "slowed from its solid rate" in Q4. The statement also repeats the argument that with "muted inflation" the Fed will be "patient" with regard to future moves in interest rates.

The accompanying forecasts and "dot diagram" indicate that the Fed will be very, very patient. Having signalled back in December that it was thinking they could raise rates twice this year they are now projecting no rate changes in 2019 at all. In a further adjustment, they will be tapering their balance sheet roll off to US$15bn per month of treasuries from US$30bn with the process being halted by the end of September.

Unsurprisingly the dollar has reacted negatively to this and treasury yields have fallen too. We had expected officials to take one of their projected hikes out of the diagram for this year, but removing both is a surprise. It seems pretty aggressive given officials have been repeatedly telling us that the US economy is "strong". Indeed, they have only cut their 4Q19 GDP growth forecast from 2.3% to 2.1% and left their core inflation forecast at 2%.

Creeping concerns

Such a move will only boost the market conviction that the next Federal Reserve move will be an interest rate cut. Concerns over economic headwinds such as trade protectionism, the government shutdown, weak figures from Europe and China (which Jerome Powell emphasised in the press conference) and the lagged effects of higher interest rates and the strong dollar all do justify caution. The recent weak run of US activity data has also been disappointing while core inflation has undershot expectations. However, today's sharp shift from the Fed may risk exacerbating any business and household concern about the outlook.

Should we be worried?

We had been thinking that a September rate hike from the federal reserve remained on the table given our belief that the US growth story was underpinned by a strong jobs market and rising worker pay and the expectation that in the coming months we will get a positive resolution to the US-China trade dispute. Indeed we continue to think the US economy can expand in excess of 2% this year with Jerome Powell also talking of "very strong" economic fundamentals. We additionally expect core inflation to grind higher to above 2.5%. However, this does not appear to be enough for officials and we will seemingly need to see even stronger figures to get the Fed to react.

Calling the top

Given such clear direction from officials and the continued emphasis on "patient", it looks as though we will have to take that September hike out of our forecast. For now, the Federal Reserve is still signalling a bias to tighten policy given the rate hike pencilled into 2020. But with a presidential election later in the year and President Trump keen to gain political capital out of challenging the Fed on any rate hikes, we are sceptical that would happen.

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