LPL RESEARCH

WEEKLY ECONOMIC COMMENTARY

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THE FED'S POLICY U-TURN

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KEY TAKEAWAYS

Policymakers have now committed to patience when deciding on future interest rate changes.

The Fed's decision was based on global "crosscurrents," and the U.S. economy remains solid.

We expect a pause in the near term, but we forecast one or two more hikes before a soft exit.

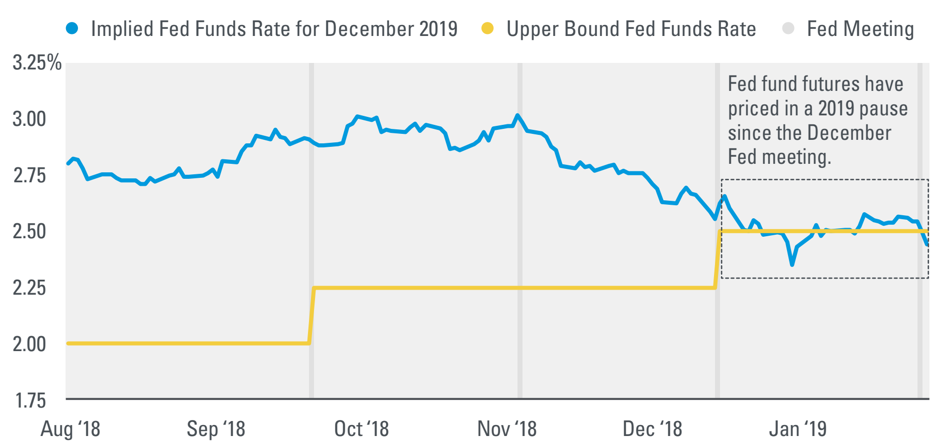
The Federal Reserve (Fed) just delivered a widely expected but important monetary policy decision. On January 30, policymakers decided to leave interest rates unchanged. More significantly, they removed language from the Fed's policy statement that "some further gradual (rate) increases" would be consistent with economic conditions and added language that they would be "patient" when determining future rate adjustments. Markets cheered the significant shift in tone: The S&P 500 Index rose 1.6%, its biggest gain on a Fed day since December 2014, and the first time it has gained on the last day of the policy meeting since Jerome Powell took over as Fed chair.

The Fed's new stance is a swift reversal from its rate expectations as recently as four months ago. In September, policymakers' projections showed the Fed was likely to hike rates three times in 2019. Now, the Fed could be finished hiking rates, at least through the end of 2019 [Figure 1].

WHY THE CHANGE?

In the post-meeting press conference, Powell noted that the Fed based its decision on "crosscurrents and conflicting signals," including slowing growth in China and Europe, trade risk, elevated uncertainty, and deteriorating sentiment. Because of these crosswinds, the Fed has chosen a wait-and-see approach,

1 FED FUND FUTURES CALL FOR LONG-TERM FED PAUSE



Source: LPL Research, Federal Reserve, Bloomberg 01/31/19
The implied fed funds rate is a weighted average of fed fund futures' rate probabilities for the December 2019 Fed meeting.

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and will likely hold off on policy moves until there is greater clarity on global economic conditions. While the Fed's official dual mandate is maximizing employment and promoting stable inflation, we have long said its unofficial third mandate has been global stability. Last week's decision and messaging were a nod to this unofficial mandate, especially considering global issues and uncertainty have clearly weighed on pockets of the U.S. economy.

IS THE ECONOMY WORSE OFF THAN WE THOUGHT?

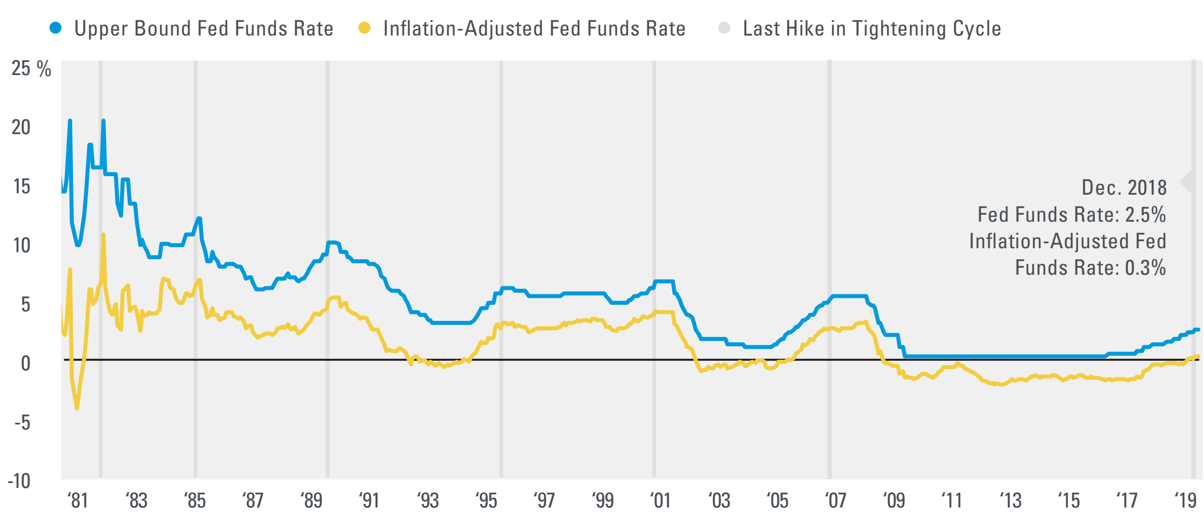
The Fed's switch doesn't mean investors should brace themselves for an economic downturn. In fact, Powell emphasized several times in his press conference that the U.S. economy is solid and inflation remains manageable.

Recent data confirm the Fed's economic view. Payrolls rose the most since July 2016 over the past two months while wage growth remained healthy but contained, according to the January jobs report released February 1. Unemployment remains low, even as labor force participation has ticked up to the highest point in five years as people enter the workforce, enticed by higher wages, with an extra after-tax boost from fiscal policy, and solid economic conditions. Gauges of manufacturing health rebounded in January, and the Bloomberg economists' consensus estimate puts gross domestic product (GDP) at 2.6% in Q4 2018. Still, heightened uncertainty and weakening sentiment may be increasingly weighing on economic data, hence the Fed's caution. Overall, we see low odds of a recession in the next year, based on our *Recession Watch Dashboard*.

WHERE DOES THE FED GO FROM HERE?

If the Fed is done hiking rates for the foreseeable future, are policymakers implying we've reached the neutral rate—or the point where policy is neither restrictive nor accommodative to the economy? The best signals are in the Fed's dot plot, which tracks policymakers' interest rate projections. The Fed's December dot plot implies two rate hikes this year, with a long-term (neutral) rate of 2.50–2.75%, but we expect policymakers to adjust their rate-hike expectations down in the next dot plot update, scheduled for March.

2 RATES ARE HISTORICALLY LOW COMPARED TO PAST TIGHTENING CYCLES



Source: LPL Research, Federal Reserve 01/31/19

Chart assumes last rate hike in the current tightening cycle is December 2018.

Inflation-adjusted fed funds rate is the upper fed funds rate minus year-over-year growth in the Consumer Price Index.

To be clear, we still think the Fed has the ability to hike rates further without economic implications, based on current conditions. Interest rates are still historically low, especially on an inflation-adjusted basis [Figure 2].

Even though policymakers expect the neutral rate to land around the current levels, they've built in wiggle room (according to the December dot plot) to increase rates beyond neutral in case inflation rises too quickly. Powell also said last week that the Fed's next rate decision will be based "entirely on the data," reiterating the Fed's data-dependent, pragmatic view of policy. The Fed has done well at keeping its mandate this cycle, and we have enough faith in the Fed to expect policymakers' decisions won't significantly impede economic progress.

WHAT ABOUT THE BALANCE SHEET?

The Fed said it would continue its planned pace of $50 billion in targeted balance sheet runoff, its process of reducing the amount of Treasuries and mortgage-backed securities it owns. However, Powell said the Fed will consider ending balance sheet normalization sooner, leaving a larger amount of assets on the balance sheet than what was initially expected. He emphasized that rates are still the Fed's main policy tool, which we read as a sign that the Fed will not drastically change its balance sheet plans. Even though no changes have been finalized, Powell's message of flexibility on the balance sheet was exactly what investors were looking for. Markets' positive reaction to the Fed's announcement further demonstrated that balance sheet tensions have largely been a consequence of fragile sentiment and not a policy mismatch.

WHAT ABOUT THE BALANCE SHEET?

As discussed in our *Outlook 2019*, we believe solid U.S. economic trends will produce GDP growth of 2.5–2.75% in 2019. We expect to see one or two more interest rate hikes this economic cycle, and not necessarily in 2019, if inflationary pressures build too quickly or other signs of excesses appear. We haven't seen evidence of these two things happening, nor have we seen any signs of a deflationary threat, so we expect the Fed to continue to pause in the near term. ■

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