Perspectives

PGIM FIXED INCOME

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The Fed's Challenge of Squaring the Dots

Since December 2018, the Federal Reserve's change in stance stabilized the markets, breaking a cycle of tightening financial conditions that threatened the wellbeing of the mature economic expansion. This paper looks at: 1) the message that the Fed heard from the markets late last year; 2) how the Fed responded; 3) the upcoming task of "squaring the dots" (i.e. the projections for the Fed funds rate) at the upcoming March meeting, and, perhaps most important; 4) why the Fed's late-stage fine tuning has taken on such importance this cycle.

1. The Message the Fed Heard from the Markets

Here's the Fed's take on the markets' Q4 antics:

"Market participants appeared to interpret FOMC communications at the time of the December meeting as not fully appreciating the tightening of financial conditions and the associated downside risks to the U.S. economic outlook that had emerged since the fall. In addition, some market reports suggested that investors perceived the FOMC to be insufficiently flexible in its approach to adjusting the path for the federal funds rate or the process for balance sheet normalization in light of those risks."[1]

In short, the Fed heard that the markets thought it had blinders on and was missing the developing economic risks as it was tightening away.

2. How the Fed Responded

The Fed made a few significant changes at its policy meeting in January 2019. First, it shifted from a tightening bias to a "no judgement" bias. From the meeting minutes:

"In light of the range of uncertainties associated with global economic and financial developments, the Committee decided that it was not useful at this time to express a judgment about the balance of risks."[2]

Far from signaling that the next move would be a cut, the wording had a sparse touch, which may reflect significant ambivalence within and across FOMC members as to whether the next move for the Fed funds rate will be up or down—more on this later.

The second shift at the January meeting was turning off the autopilot on the balance sheet roll off. Fed members previously described their hope and expectation that the balance sheet roll off process would be something akin to watching paint dry: a set it and forget approach to an event they saw as benign. But this too has changed.

[1] *The Minutes of the Federal Open Market Committee, January 29-30, 2019, released on February 20, 2019; Italics by PGIM Fixed Income.*
[2] *Ibid; Italics by PGIM Fixed Income.*

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From the press conference following the January 30th meeting: "*...as far as the particular details of normalization are concerned, we will not hesitate to make changes in light of economic and financial developments. This does not mean that we would use the balance sheet as an active tool, but occasional changes could be warranted…While the federal funds rate would remain our active tool of policy in a wide range of scenarios, we recognize that the economy could again present conditions in which federal funds rate policy is not sufficient. In those cases, the FOMC would be prepared to use its full range of tools, including balance sheet policy.*"[3]

So, the Fed suggested that it could stop the roll off, but ending quantitative tightening (QT) still wasn't its preferred near-term action.

Third, as an important technical point, the Fed finally arrived at a framework for managing the funds rate going forward: a so-called "floor" system.[4] This had two benefits: 1) it answered the question of how the Fed would manage the funds rate once the roll off ended; and 2) it clarified that it would be using a system that requires maintaining a lot of excess reserves. **For a skittish market, this had the added benefit of assuring participants of the Fed's intent to avoid liquidity crunches.**

This response culminated with a reminder that the Fed possesses a battleship of a balance sheet that can be used for fighting financial crises—it has a substantial capability to buy assets and provide financing. For market participants, that's always reassuring to hear, even if the prospects of usage are hopefully remote. But while Committee members were hardly chomping at the bit to stop the roll off, in toto, the markets accepted the Fed's stance as flexible enough.

3. The Upcoming Task of "Squaring the Dots"

Over the last several weeks through the press conference, meeting minutes, and several speeches from a range of FOMC members, the Fed has successfully wooed the markets with its intended "patience and flexibility in terms of setting policy," and risk markets have stabilized.

But there may be a bit of a misunderstanding. At this point, the markets have moved to pricing the Fed's next move as a rate cut, possibly putting the markets on a collision course with the actual views of FOMC participants. Although they thought it best to not specify a future policy bias, it seems unlikely that the FOMC expects the next rate move to be a cut. In fact, once the dust settles, it seems much more likely that they may return to deciding when—rather than if—to hike rates, rather than cut.

Will It All Unravel in March?

Unlike the January meeting, the FOMC meeting on March 19th and 20th will be accompanied by the Fed's economic projections and, of course, the dot plot reflecting participants' expectations for the future path of the funds rate. Will the projections at the March meeting prove agnostic regarding future rate movements? Or will they be biased towards further hikes?

The most likely projection: more hikes. After all, most meeting participants undoubtedly are using the same models in March 2019 as they used in December 2018. Financial conditions have calmed down (click here for more on the Fed "Collar"). On balance, the backward-looking data / inputs have not changed much. Recent speeches by various FOMC members, while indicating flexibility and patience, have not renounced the Philips curve or other considerations that heretofore have driven their forecasts for further rate hikes. **Relative to December, the dots may remain more unchanged than not—i.e., most participants still expect rate hikes over the next few years, not cuts (see Figure 1).**

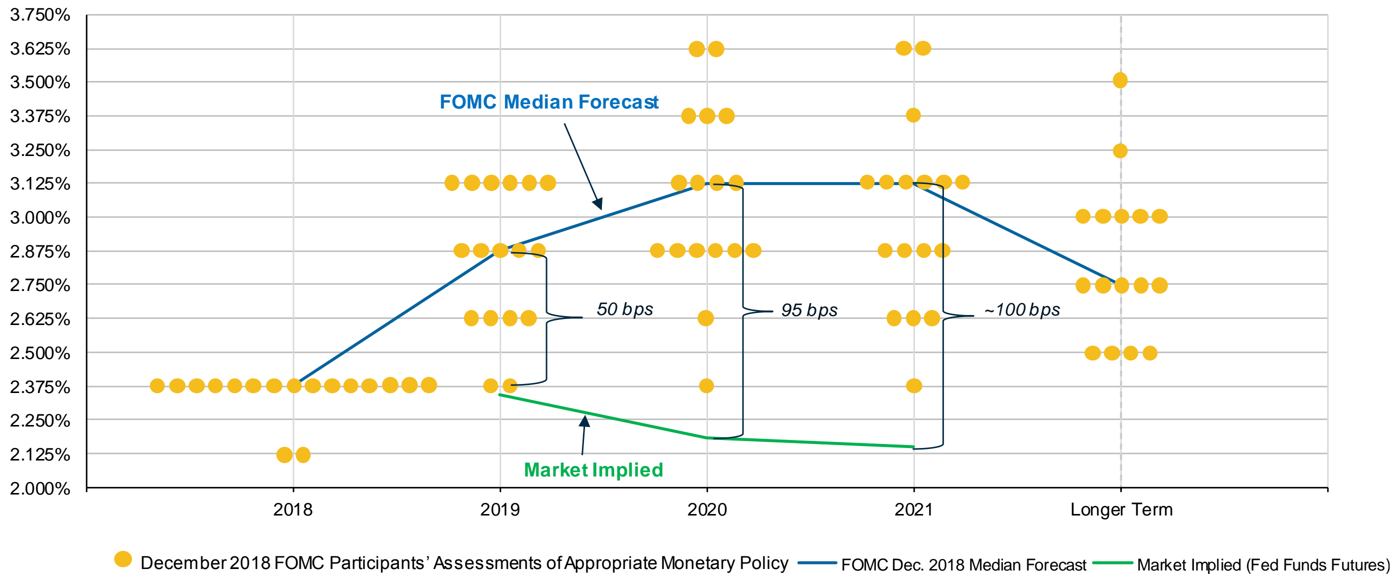
Figure 1 shows the upward trajectory of the Fed funds rate forecasts for the individual FOMC meeting participants (yellow dots) along with the median of those observations (blue line) that were released at the conclusion of the December 2018 meeting. The green line that extends to the end of 2021 shows market expectations for the path of the Fed funds rate (as reflected by Fed funds futures contracts). Contrary to the expectations of FOMC participants, the market's expectations are substantially below the FOMC's median path. In short, most FOMC participants expect significant hikes; the market modest cuts. Figure 1 shows that the gap between the expectations starts at 50 bps as of the end of 2019 and rises to roughly 100 bps by the end of 2020 and 2021. Hence, the Fed's challenge of squaring the dots.

[3] *Transcript of Chairman Powell's Press Conference, January 30, 2019. Italics by PGIM Fixed Income.*

[4] *While there are a number of ways a central bank can manage an administered rate, in a floor system, the central bank sets a target rate and offers to pay that rate on excess reserves in the system. It then endeavors to keep more than enough reserves in the system to meet the needs of market participants. The intended result: there are no reserve shortages, and the Fed's floor rate clears the market. If the Fed, alternatively, left reserves at a low level that created shortages, it would be forced to intervene and inject reserves through market operations. This could be unwieldy given the size of the markets and with the undesirable effect of creating stress for financial institutions, which can depress lending and economic activity.*

If the dots released at the upcoming March meeting remain squarely on the same hiking trajectory as December, that could disappoint the markets, which are expecting a less-hawkish tack, and send them back into risk-off mode. However, if there is some downward movement of the dots, that could be enough to convince markets the Fed is truly becoming unbiased in its expectations for the future rate path, opening the possibility that the Fed will keep inching the dots down towards market expectations.

FIGURE 1: THE FEDERAL RESERVE "DOT PLOT" AS OF DECEMBER 19, 2018: RISING FED DOTS AT ODDS WITH MARKET EXPECTATIONS FOR RATE CUTS



Source: Bloomberg as of February 26, 2019

4. Why All the Angst About Fed Tightening? And Why So Much in This Particular Cycle?

As we wait for the March resolution, it's worth pondering the question: why are the markets so concerned that the Fed's policy may be too tight, too soon, and/or for too long? In addition to more traditional concerns covered later, the markets may have concerns about these potential problems:

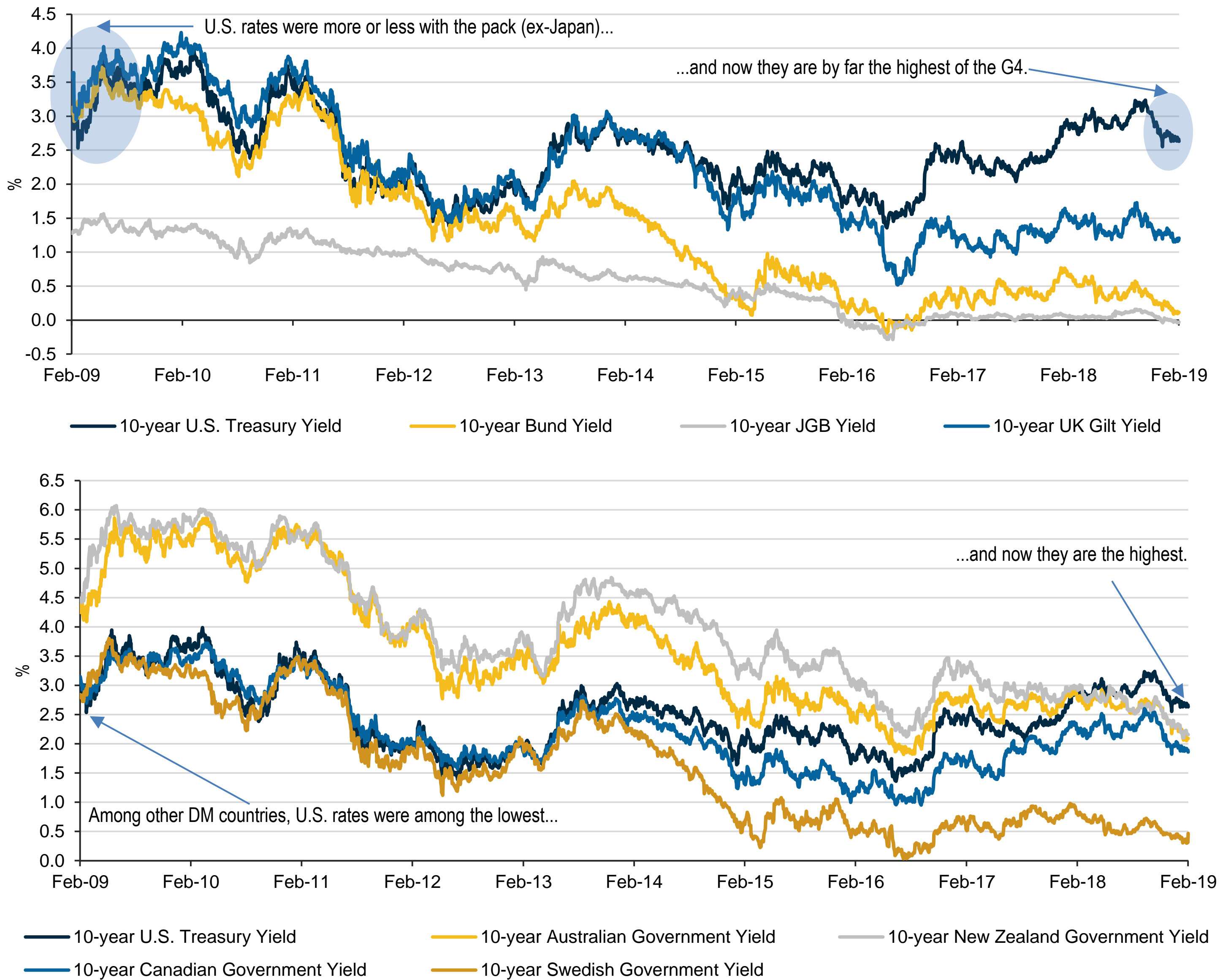
1. Is policy already tighter than the Fed thinks and therefore dampening growth and inflation—like driving with a foot on the brake?
2. If that's the case, is the Fed unwittingly pushing the U.S. towards the predicament faced by Europe and Japan: the "proximity to the lower bound" problem?

With Rates So Low, How Could Fed Policy Be Too Tight?

While U.S. rates may somehow "feel" low, the fact of the matter is that they are actually quite high in an international context (see the following Figures). The Fed may think that it is just getting to the low end of the neutral zone, but what if it is already running tight monetary policy? **If so, the Fed's policy stance may have contributed to the U.S. economy's subpar growth this cycle and the persistent inflation undershoots relative to target—**not to mention the stress that tightening U.S. monetary policy has caused across a range of markets and for emerging market economies in general.

FIGURE 2: DO U.S. RATES FEEL LOW? RELATIVE TO OTHER DM COUNTRIES, THEY ARE ACTUALLY HIGH

U.S. yields split apart from other G4 rates and are now in a higher realm of their own (top Figure). Meanwhile, relative to other developed market government bond yields over the past decade—i.e., Australia, New Zealand, Canada, and Sweden (bottom Figure)—U.S. rates have gone from being among the lowest to being the highest.



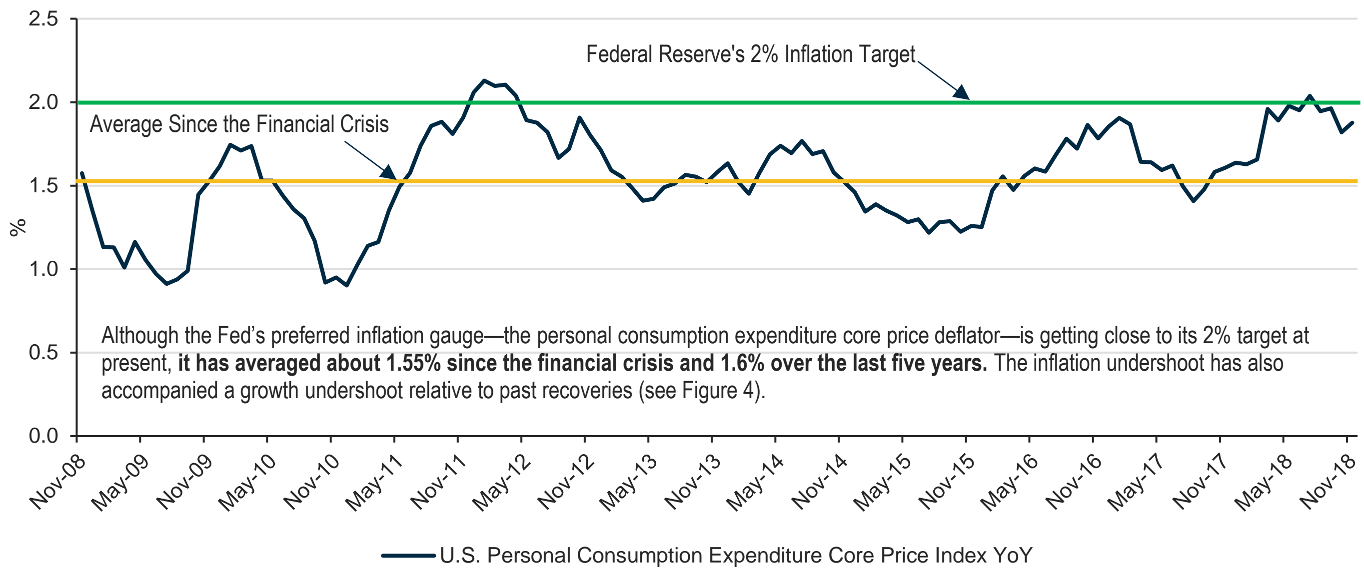
Source: Bloomberg as of February 26, 2019

How Would We Know If Policy Has Been Too Tight?

Are there any economic data that might suggest the Fed has rates too high and policy too tight? First, U.S. core PCE has spent the vast majority of this 10-year business cycle below the Fed's 2% target. Second, this has been one of the slowest post-war expansions (see Figures 3 and 4). While these conditions have been chalked up to factors like globalization, retiring baby boomers, and lingering headwinds from the global financial crisis, maybe they are also the result, to some extent, of restrictive U.S. monetary policy.

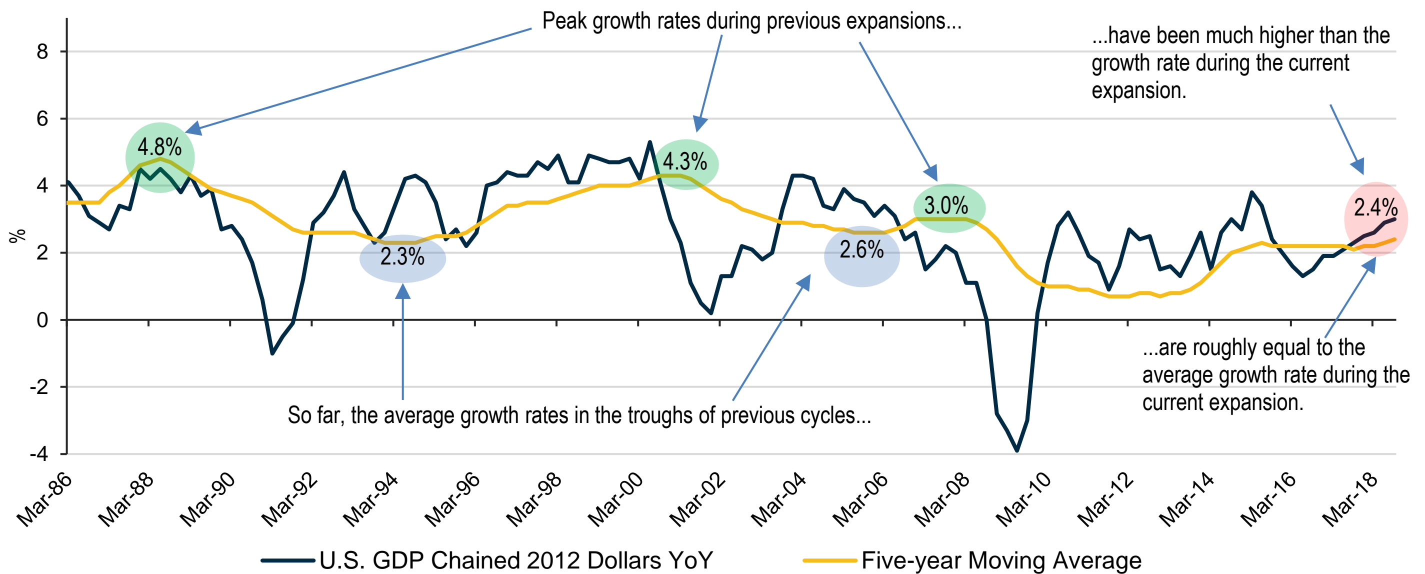
Indeed, the markets may fear that the Fed is inadvertently running overly tight policy, which is dampening growth while also preventing inflation from reaching and sustaining its 2% target.

FIGURE 3: MAYBE THE FED HAS ACCIDENTALLY BEEN RUNNING POLICY TOO TIGHT, THUS KEEPING INFLATION BELOW TARGET



Source: Bloomberg as of February 26, 2019

FIGURE 4: AVERAGE GROWTH RATE OF THE CURRENT EXPANSION IS JUST REACHING THE *TROUGH LEVEL* OF THE PREVIOUS TWO CYCLES



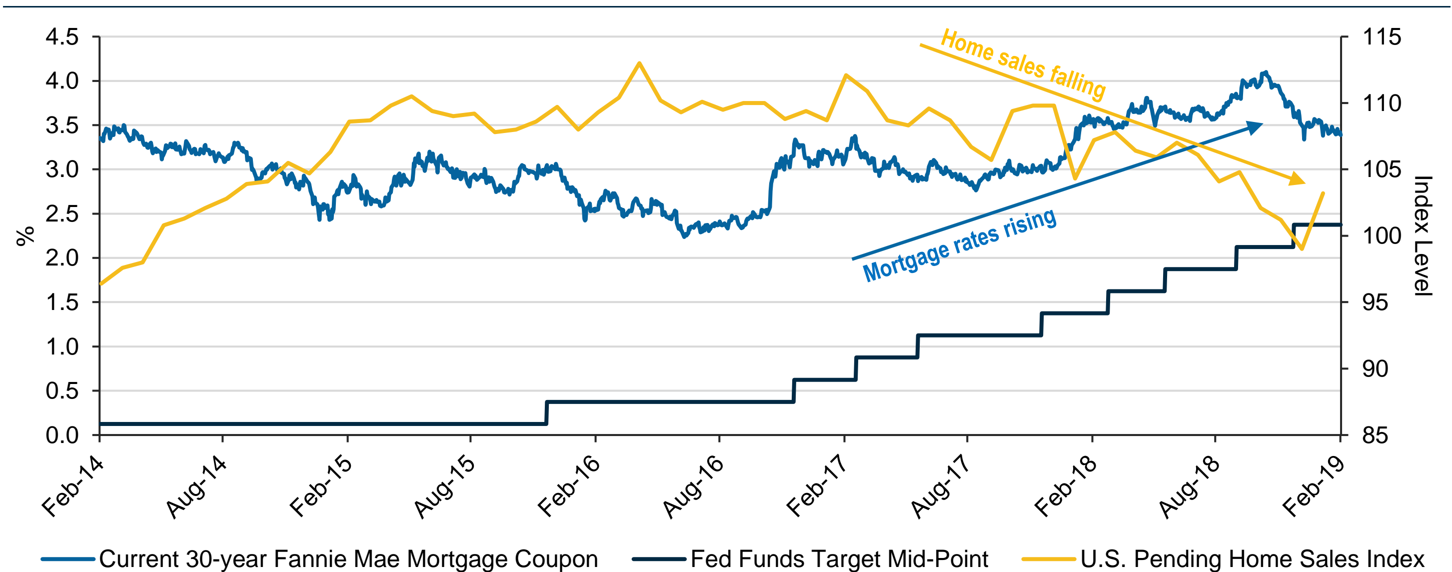
Source: Bloomberg as of February 26, 2019

If policy is too tight and still disinflationary on average, could this create additional risks? In that event, it would turn out that the Fed has been, ex-post, guiding the economy's nominal growth rate and thereby the entire term structure—including the administered rate—lower. That, in turn, will ultimately result in less room for the Fed to cut rates once the cycle turns down. **Ironically, while some at the Fed may be hoping that preemptively raising rates might create room to cut rates later, in fact, it may be driving the U.S. economy towards the low-rate equilibrium it fears: one more akin to Japan's or Europe's where the central bank is at risk of losing control in a downturn.**

And we haven't even touched upon other salient, but more traditional market concerns that may be equally critical, including:

- Is there **a further lagged impact of past hikes** yet to be felt (see Figure 5)?
- What if the **fiscal stimulus** impact to date has been bigger than expected and/or **is about to go into reverse**?
- All else isn't equal outside of the U.S.: economies, both minor and major, from Japan to Europe to China, are predominantly dealing with downside risks and realities with respect to growth and inflation**. Is the U.S. on the horns of a global slowdown—a risk the Fed recognizes, but is too sanguine with regard to the potential impact?**

FIGURE 5: AS THE FED FUNDS RATE AND MORTGAGE RATES HAVE MOVED HIGHER, HOME SALES HAVE TAILED OFF SIGNIFICANTLY



Source: Bloomberg as of February 26, 2019

Right now, the markets are happy enough to assume that the Fed will be on hold and eventually cutting rates. That has allowed an easing of financial conditions that should support growth. The underlying assumption is that the Fed has seen the downside threats, and the next move is a cut. But is that the Fed's view? It's certainly not where FOMC members left off in December 2018 when its dots were pointing towards higher rates. In March, will the Fed be able to square the dots? If the Fed and the markets are askew, as was the case with December's hike, then, once again, look out below.

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