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The Fed strikes a dovish tone

Following a two-day meeting, on 30 January (US time) the Federal Reserve put rates rises on hold and said it will be "patient" in determining any future interest-rate moves, as well as signalling flexibility on the path to shrinking its balance sheet[1]. Megan E. Greene, our global chief economist at Manulife Asset Management, believes that the Fed has turned overwhelmingly dovish, and outlines what she thinks could happen next.

The Fed has turned overwhelmingly dovish

In Greene's view, going into this Federal Open Market Committee (FOMC) meeting, there was a real risk of the Fed over-promising and under-delivering, particularly as investors were hoping the Fed might indicate whether it would adjust the speed at which it's shrinking its balance sheet. The market didn't get that, but it did get a lot of other indications that the Fed has turned overwhelmingly dovish.

In his press statement[2], Powell started off by saying that the Fed's overarching goal is to sustain the economic recovery, maintain a strong labour market and keep inflation within target. Powell was speaking within his mandate, certainly, but placing the economic recovery at the forefront of the Fed statement does suggest that the "Powell put"[3] is back.

In sharp contrast to December 2018, the Fed is now uncertain whether its next move will be a hike or a cut. During the press conference, Powell said that because of the Fed's "data dependence", he couldn't say whether this is the end of the tightening cycle or just a pause[4]. This represents a real sea-change from the recent Fed preference for forward guidance.

As it does every January, the Fed released some longer-term analysis in a general statement, suggesting it'll keep its 2% inflation target and, most importantly, that it'll maintain a "floor system" instead of reverting to the previous "corridor system"[1]. In Greene's view, this is important because it means the Fed will conduct monetary policy using the interest on excess reserve, and the repo rates to manage the Fed fund rate. Before the global financial crisis, the Fed managed the fund rates by buying and selling reserves. This suggests the Fed's balance sheet is going to end up much larger than originally thought, which was the consensus the market has been coming to over the past year. That means we may not get as much tightening than the market initially feared.

[1] FOMC press release, 30 January 2019 (US time).
[2] Source: CNBC LIVE: "Fed Chair Jerome Powell holds press conference", 30 January 2019 (US time).
[3] "Powell put" was understood as the Fed's interest-rate policy was designed to keep the stock market from falling too much.
[4] Wall Street Journal: "Fed Signals Hold on Rate Increases", 30 January 2019 (US time).

Overall, Greene continues to believe we are in “pause” territory and this is the end of the tightening cycle. As Powell highlighted, there are a number of risks: slowing global growth, slowing Chinese growth, trade issues, Brexit, the US government shutdown. However, Greene thinks as 2019 progresses, some of these risks will alleviate, the equity market could do well, and that could ease financial conditions, in which case the Fed does have some room left for at least one more hike, if not two.

Powell’s main message to the market: “We’re listening to you”

Powell also highlighted that inflation seems to be muted, and used that as an excuse for pausing. That is within the Fed’s mandate, certainly, but equally inflation has been muted for much of this entire recovery, with the exception of last summer, when inflation was accelerating because of one-off statistical factors. But it does raise the bar for a future hike, because the Fed would want to see more inflation in order to resume raising rates. Inflation, though, has been frustratingly absent in this recovery, and probably will continue to be so.

Greene thinks some of the risks Powell highlighted could abate, meaning we could expect the Fed to hike once if not twice later this year. The Fed has made a marked switch from forward guidance to data-dependence, and Greene thinks Powell’s main message to the market is that “we’re listening to you”. The “Powell put” is back.

A dovish Fed supportive of emerging markets, pressuring US dollar

According to Global Asset Allocation’s Macroeconomic Strategy team at Manulife Asset Management, markets are now pricing in only a 10% chance of a rate hike by September 2019 and as much as a 20% chance of a cut by January 2020. A dovish Fed and the resurgence of a global central bank ”put” has had the predictable impact on markets; supporting general risk sentiment and investor confidence, particularly for emerging markets, and pressuring US dollar strength.

However, if the Macroeconomic Strategy team is correct and the Fed has one more hike left in its cannon in the spring of 2019, it’s reasonable to expect some short-term turbulence as bond yields will need to reprice and make one final push higher leading into the spring. Upside surprises to economic data and more positive geopolitical headlines could yield more outsized market reactions than we are accustomed to.

In the Macroeconomic Strategy team’s view, markets will also need to contend with questions about what a more flexible balance sheet run-off means in practice. We still need to know what the balance sheet’s target will be, its composition, when tapering may start, and at what pace. Markets will focus intently on these questions, which will inevitably increase volatility. The bigger picture is that it’s clear the Fed is at the end of its tightening cycle as global central banks prepare for a particularly difficult US and global slowdown into 2020. That could keep markets from being too exuberant and continue to make global bonds attractive over the next 12 to 24 months.

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