Central Banks

FOMC with stoic response to market uncertainty

Nathaniel Karp and Boyd Nash-Stacey

As expected, at their March 19th-20th meeting, the Fed left rates unchanged and maintained their patient bias. This is not surprising considering the weak incoming data, the downward bias to the committee's outlook and increasing downside risks abroad. In fact, the median projection for 2019's GDP growth declined to 2.1%, which is 40bp below the committee's September projections and 20bp below December's forecasts. For inflation, the committee once again lowered its expectation for headline PCE to 1.8%. However, the incremental changes to growth and inflation since September are modest when compared to the significant revision to the committee's Fed Funds projections, which are 70bp lower in 2019, and 80bp lower in 2021.

At the press conference, the Chairman confirmed that the committee still views domestic conditions positively, but stressed that the growth outlook in Europe, Brexit negotiations and slower growth in China remained concerns for the committee. The Chairman, in response to a question about the committee's discussions on inflation, also stressed the he was disappointed with the Fed's ability to achieve its "symmetrical" goal on inflation.

In light of this, the FOMC median projection of the Fed Funds rate shifted downward, and now better reflects the Fed's commitment to a "patient" strategy, whereby rates would be on hold at least throughout 2019. Before, the committee was signaling the most likely path would be one that rates reached a level above neutral and thereafter descended towards neutral levels. Now, given the concerns about financial vulnerabilities and the risks from abroad, the committee is signaling ascension towards the neutral levels. In fact, eleven out of seventeen members project that rates will remain unchanged in 2019. Last December, the same number of members expected at least two rate increases.

Despite the dramatic downward shift to the interest rate outlook for 2019, four members still expect one more rate increase in 2020 while six participants anticipate two or more rate increases. This would put rates closer to the central range of estimates for long-term neutral levels of around 2.8%.

Chart 1. FOMC Median Projections for GDP, Q4/Q4 %

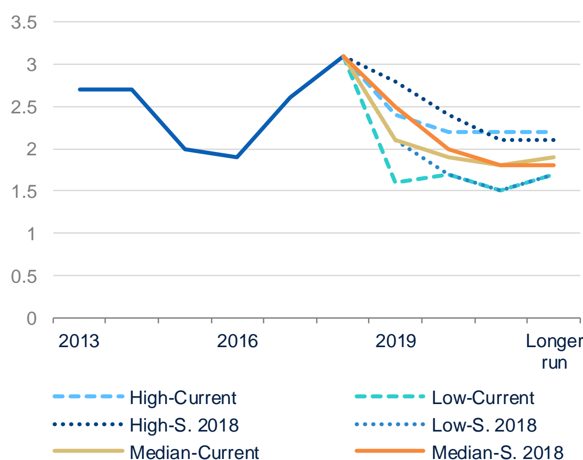
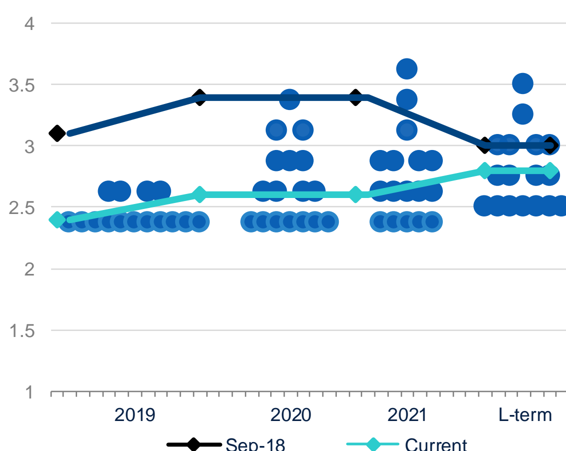


Chart 2. FOMC Median Projections for Fed Funds Rate, %



Source: Summary of Economic Projections, Federal Reserve

The committee also supplemented its plans for balance sheet normalization. First, in May, the committee will lower the caps on monthly redemptions for Treasuries from $30 billion to $15 billion. Second, the Fed will conclude its reduction in its SOMA portfolio in September, after which they will reinvest maturing mortgaged backed securities into Treasury securities. Third, for a time, they plan to hold the size of their portfolio constant, allowing for a more gradual decline in reserves to a level they feel will allow them to efficiently and effectively execute their new operating framework also known as a floor system. Fourth, while the Balance Sheet Normalization Principles and Plans contained no specific target level for the balance sheet, at the press conference, chair Powell said that by the end of the year the portfolio would be around 17% of GDP, or slightly more than $3.5 trillion. Last, in the short term, the committee will reinvest proceeds from its MBS portfolio into Treasury securities that will roughly match the maturity distribution of outstanding Treasury debt; in the long run, the committee has not committed to a specific portfolio composition.

Bottom line:

The weaker domestic outlook and rising concerns about growth abroad suggests there is increasing probability of no more rate increases in 2019. In fact, statements such as “[t]he data that we are seeing is not currently sending a signal which suggest moving in either direction from here” suggests that without higher inflationary pressures or a more benign risk outlook the committee would be comfortable with keeping rates unchanged. Moreover, if economic conditions were to deteriorate significantly, the Fed could begin to consider potential rate cuts. This abrupt and dramatic shift in the Fed’s policy course over the past three months highlights the increased importance the Chairman has given to risk monitoring and uncertainty, a signature of his tenure.

In terms of the balance sheet, ending the balance normalization process at year-end and holding the size of the balance sheet constant for some period of time is consistent with our view and a more cautious Fed. The technical adjustment to the size of the Treasury caps will have a minor impact on markets, considering that the change will only affect the normalization strategy for five months and that the total change on redemptions will be $42 billion; a small amount when considering the size of the terminal level of the portfolio will be around $3.5 trillion. Notwithstanding possible transitional frictions, the changes should have a positive impact on market expectations, ease pressures on bank’s balance sheets, and have a minor impact on liquidity.

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