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BREAKING NEWS
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The Fed opens with a softer tone in 2019

It's been a long six weeks since the Federal Open Market Committee (FOMC) last met and raised its policy rate, helping to set off one of the most volatile periods for markets in this decade. This week's 2019 inaugural meeting promised a gentler approach, and it delivered. The Fed made no mention of further rate increases in its statement, and it pledged to be flexible in the pace of balance sheet normalization.

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WHAT HAPPENED?

The Federal Reserve (Fed) made no changes to interest rate policy at its January meeting, but it certainly made news with its post-meeting statements. The FOMC statement no longer contains an explicit mention of further planned rate increases and instead uses the symmetrical term "adjustments" to convey that rate policy is truly data dependent.

A separate statement pledged that the Fed "is prepared to adjust any of the details for completing balance sheet normalization in light of economic and financial developments." In layman's terms, this means the Fed may slow the pace of unwinding its quantitative easing programs if conditions warrant.

Prior to the meeting, it had been reported that the Fed was debating a plan to leave its balance sheet far larger than originally intended. The Fed's statement seems to confirm those reports.

SINCE WE LAST MET...

Much has changed since Fed policymakers raised the benchmark range to 2.25% to 2.50% on December 19. Global equity prices are lower and economic policy uncertainty has increased sharply for various reasons. Markets had largely priced out expectations for future hikes even before this meeting. We expected a gentler tone from the Fed in its statement and Powell's remarks, and that's what we got. While there was no change to interest rate policy, the FOMC statement was less full-throated in its recent assessment that the U.S. economy is "strong." In particular, the Fed apparently no longer regards high inflation as a significant risk in 2019.

The Fed probably went further in the dovish direction than markets had anticipated, judging from the fall in the U.S. dollar and the surge in U.S. equity markets immediately following the meeting. The markets' main concern in recent months has been that the Fed could over-tighten monetary policy and eventually cause growth to slow or contract.

Chair Powell's remarks in December were seen as insufficiently sensitive to signals from the markets that financial conditions were becoming restrictive.

In his public comments since then—including in his press conference after this meeting—he has exhibited a more finely tuned ear on matters ranging from interest rate policy moving forward to the size and trajectory of the Fed's balance sheet.

While markets do not expect any further Fed rate hikes in the next few years, we are not yet convinced. With U.S. real gross domestic product (GDP) growing above trend and wage growth continuing to accelerate, the Fed may yet have to tighten policy once policy uncertainty has dissipated, though we do not expect this would happen before September.

THE QUESTION OF THE BALANCE SHEET

Why is the Fed's balance sheet, which rose in value from around $800 billion to more than $4 trillion in the emergency response to the 2007-2009 financial crisis, such an important issue? Because as some of that money rolls off—even in an orderly fashion—the supply of Treasuries available to other investors increases. The potential effects include higher interest rates (higher supply leading to lower bond prices) or lower prices on other assets like corporate bonds or equities as virtually risk-free Treasuries flood the market.

Of course, the Fed is far from the largest source of new Treasury supply this year. That award goes to the expansionary turn in U.S. fiscal policy, which has resulted in 2019 net new issuance approaching $1 trillion. Powell's willingness to slow the Fed's roll off may derive from concern that the market already has enough new Treasury securities coming on line.

For more information, please contact your financial advisor or visit our website.
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Endnotes

Sources

Federal Reserve Statement, January 2019.

Bloomberg.

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Glossary

The **Federal Open Market Committee (FOMC)** holds eight regularly scheduled meetings per year to review economic and financial conditions, determine the appropriate stance of monetary policy and assess the risks to its long-run goals of price stability and sustainable economic growth.

A **basis point** is a common unit of measure for interest rates and other percentages in finance. One basis point is equal to 1/100th of 1%, or 0.01%.

A word on risk

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