# Need to Know

Portfolio Advisory Group – U.S. Fixed Income

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### What's inside




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# September 2018 FOMC Meeting

## Near neutral

To nobody's surprise, the Fed raised rates for the 3rd time this year and the 8th time this cycle, bringing the Fed Funds rate to a range of 2.00%-2.25%. The underlying changes to the Fed's projections and statement lean dovish, in our view, and this was confirmed by the reaction in the bond market. The Fed no longer expects policy to remain accommodative, yet officials appear poised to continue hiking rates at a similar pace of the last 2 years – an ode to current economic strength.

- **Easy no more.** Officials eliminated a longstanding reference that categorized policy as "accommodative." With inflation at 2% and unemployment well below long-run estimates, the need to justify an accommodative stance is all but gone, and with the Fed Funds rate now at or near various estimates of the true neutral rate, officials, in our view, were right to remove this language after 8 rate hikes. To us this is an indication that we are nearing the end of the Fed's hiking cycle, and that we will soon be in an environment where each additional rate hike may be categorized as "tightening" rather than "removing accommodative policy."
- **4 hikes in 2018.** Officials made no changes to the 2018 projection of 4 rate hikes, meaning a December, or 4th hike, is very much on the table. Since June, the gap between officials supportive of a 4th hike in 2018 rather than 3 has widened from just 1 vote to 8. While there are still a variety of factors like trade, and the yield curve that could present a headwind, it looks increasingly likely that we will see the 9th hike of this cycle come December.
- **2020 and done?** The Fed added a new 2021 'dot' to its rate hike forecast, yet at 3.375%, officials are projecting that no rate hikes will be needed following the year 2020. This helps cement our view that the 10-year treasury yield is likely capped at 3.50% for the current cycle, as the 10-year yield and Fed Funds rate have typically peaked at equivalent levels in the past.
- **Market reaction:** The bond market rallied upon the release of the statement, with rates 2-3 bps lower across the curve. The dovish tone was well received by equity markets, with investors likely finding solace in the fact that the Fed will attempt to stick a soft landing at the end of the cycle by 2020 rather than projecting a more aggressive pace. U.S. equities are up ~0.2% on the day.

## New stage of policy – where we go from here

With monetary policy no longer 'accommodative,' Chairman Jerome Powell is tasked with trying to pull off a rare feat the central bank has accomplished only once in its 104-year history – engineering a 'soft landing' of the economy by raising rates just enough to prevent overheating, but not so much that they trigger a recession.

The median estimate among officials is that 3 rate hikes in 2019 remains appropriate, but we note that estimates for 2019 policy exhibit significant deviation. Some officials still see low unemployment presenting an upside risk to inflation and prefer a more aggressive path, while others view yield curve flatness as a sign that policy rates are near the 'neutral rate' of interest and prefer a more gradual approach. Our view remains that the FOMC will continue to take it slow and gradual, and we believe that 3 hikes in 2019 is unnecessarily aggressive, and as a result, we still expect the Fed to pause the hiking cycle at some point next year in order to combat yield curve flatness and allow the economy to run amidst mostly neutral monetary policy.

## Economic Projections

**Higher growth, lower inflation.** Now that the Fed has proof that second quarter growth surpassed 4%, a 3% full-year GDP growth rate is very likely. As a result, officials upgraded the full-year GDP forecast to 3.1% from 2.8%, and also upgraded the 2019 forecast to 2.5% from 2.4%. However, officials actually *lowered* the 2019 inflation projection to 2% from 2.1%, indicating a belief that higher economic growth is unlikely to fuel runaway inflation. To us this can also be viewed as dovish, as this "goldilocks" scenario provides shelter for the Fed to keep rate hikes gradual, if not slower, in the coming years.

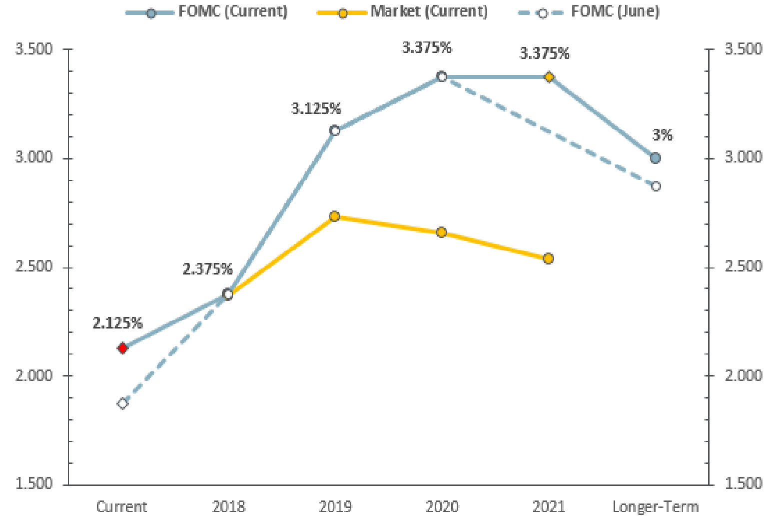
## Notes from the Powell presser

Fed Chair Jerome Powell made sure to downplay the significance of the removal of the word "accommodative," noting that it does *not* signal a rate path change. However, he did note that "it is very possible" that rates are pushed up higher than neutral and into restrictive territory, but that policy is still slightly accommodative. Because the statement and forecasts are a means of forward guidance, Powell's statements simply show that officials see no further use of any mention of accommodative, or easy policy going forward. Most estimates of the neutral rate are still slightly above the effective Fed Funds rate, but as Powell notes – not for long.

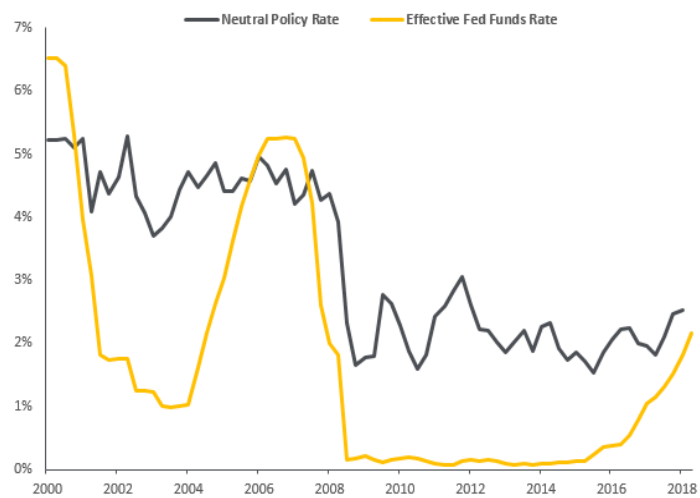
Powell continued to tout his data dependent, wait-and-see approach to monetary policy as he deflected questions from the impact of tariffs to multi-decade low unemployment by saying, 'We will react when we see it in the data". Additionally, when asked if monetary policy works with a lag he said, "the fact that we have moved quite gradually allows us to watch data and markets to see how the economy is processing higher interest rates and limits the long and variable lags problem."

## Market Reaction

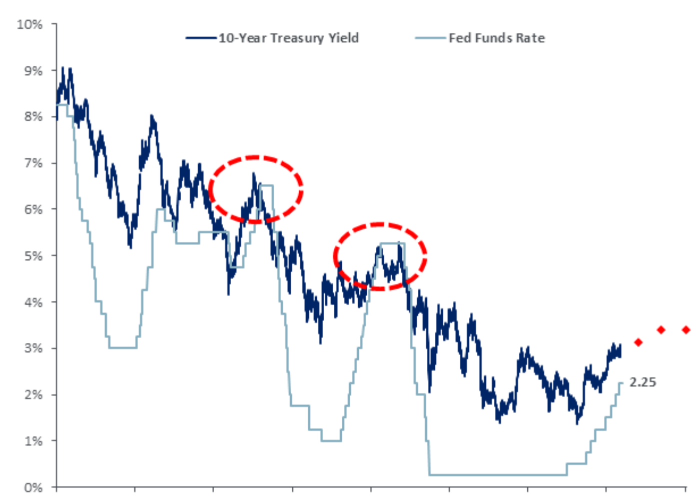
The 10Y yield has retreated further from the pre-meeting test of 2018's year-to-date high of 3.11%, settling in near 3.06% following Powell's presser. Prior to the meeting a key risk to the 10-year yield was the 2021 dot, which, if higher, may have opened up a runway for higher longer-term rates. But since the 2020 and 2021 projections both sit at 3.375%, we continue to see 3.50% as the cap on the 10-year this cycle and 3.11% may prove to be the high for the current year.




**Policy could soon become restrictive**




**Sticking with 3.50% as the 10-year cycle peak**




Source: RBC Wealth Management, Bloomberg

# Third-party disclaimer

References herein to “LIBOR”, “LIBO Rate”, “L” or other LIBOR abbreviations means the London interbank offered rate as administered by ICE Benchmark Administration (or any other person that takes over the administration of such rate).

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