# Need to Know

Portfolio Advisory Group – U.S. Fixed Income

December 19, 2018

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# December 2018 FOMC Meeting

## Swing and a Miss

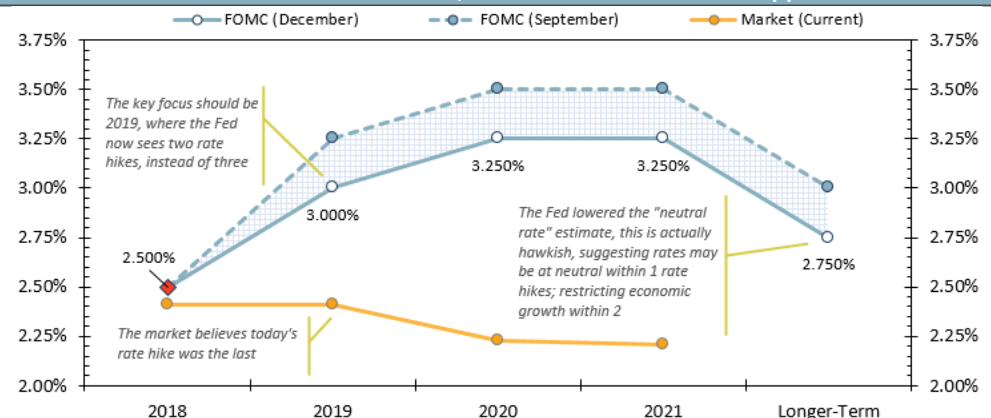
The Fed decided to swing for the fences and raise rates to a range of 2.25-2.50% in the face of historically weak domestic and international markets, significantly tighter financial conditions, and signs of economic data beginning to roll over. In our view, they missed an opportunity to be truly "data dependent" and show that policy is not on a pre-set path by pausing this quarter. This would have allowed markets to steady, while giving officials and investors time to assess how the previous eight rate hikes to this point are working through the economy. Instead the Fed is putting this economic expansion in jeopardy. We have long expected the Fed to pause the rate hike process around 2.75%, we now expect them to pause after today's move; *we expect no further rate hikes in 2019.*

- **The rate hike outlook might actually be more-hawkish.** We expected the pace of rate hikes forecasted in 2019 to slow to two, as the Fed now expects, but the Fed actually cut one rate hike from its entire forecast horizon. On the face of it, that seems pretty dovish, but we actually view this as hawkish. By lowering the longer-term estimate – or the "neutral" level of policy rates that neither restricts nor boosts economic activity – the Fed is saying that we are now just one rate hike from neutral (2.75%), and one more beyond that to reach a point where the Fed may be restricting the economy; and at the Fed's current pace this could happen by June. Recent market volatility has largely been driven by fear that the Fed was approaching that breaking point too quickly, and now based on their own forecasts that point isn't any further down the road.

- **Economic projections decline for 2019.** As would be expected with a downgrade of rate hike expectations, the Fed lowered its expectations for GDP, now seen at 2.3% vs 2.5% previously, and inflation, now 2.0% compared to 2.1%. Labor market forecasts were little changed, with the unemployment rate seen at 3.5% next year.

- **Market reaction:** Markets perhaps expected too much from the Fed, and it's showing in the aftermath of today's meeting. The Dow was up nearly 400pts on the day prior to the release, it is now down nearly 400pts. Yield curves have flattened significantly, and the 2Y-5Y part of the curve, which had inverted earlier this week, has inverted again. The long end of the curve is rallying, with the 10Y now below a key level of 2.80%, and the 30Y has dropped below 3.0% for the first time since August.

"Dot Plot" Shifts: Rate hike forecasts fall, but it's not as dovish as it appears




Source: RBC Wealth Management, Bloomberg, Federal Reserve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All values in U.S. dollars and priced as of 12/19/2018 @ 2:00 pm ET

## Our thoughts – The Fed’s Policy Error

Equity markets were down nearly 12% from October’s highs prior to today’s meeting. Financial conditions had tightened by a magnitude that we haven’t seen since the Fed first raised rates in December 2015, which was then followed by the Bank of Japan taking rates negative, oil prices collapsing, and genuine global recession fears. We felt that would have been enough for the Fed to take a pass at today’s meeting. Markets were priced for such, and the immediate reaction to today’s announcement suggests that markets see the decision as a potential policy error.

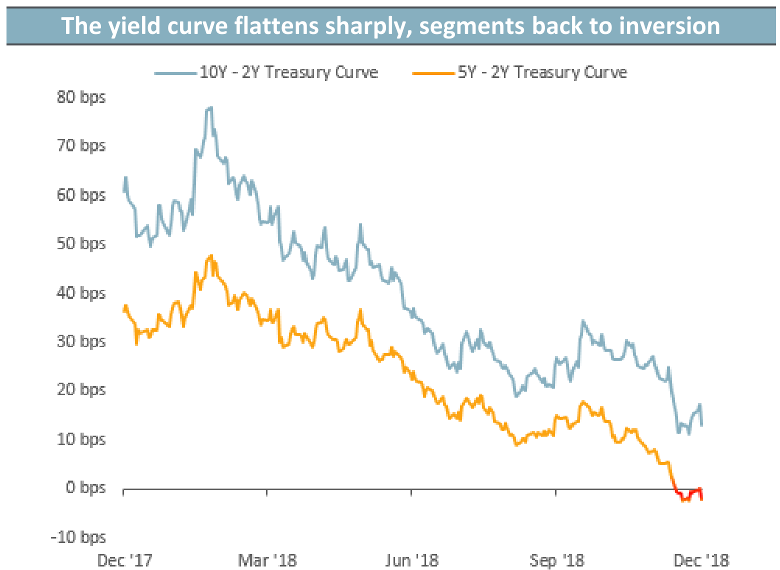
**Where to from here?** There were no dissents with respect to today’s decision, and now we face a relatively long wait until the next Fed meeting that takes place on January 30, 2019. Next year, each meeting will be accompanied by a press conference, so we won’t have to wait until March before we get more formal insights from the Fed as we have in years past. However, we expect market volatility to remain, and there will be even more-heightened focus on each incoming piece of economic data, as well as on the yield curve, as recession fears grow.

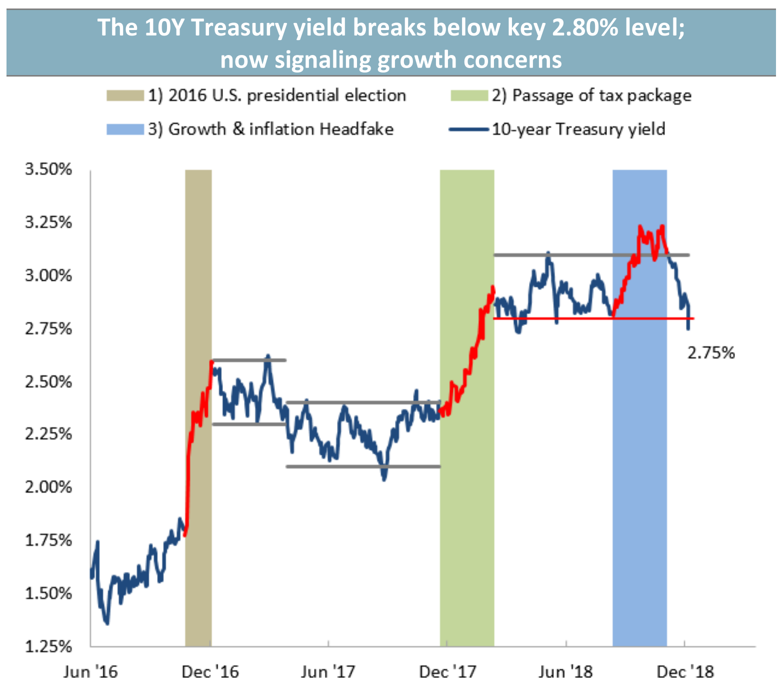
In our view, there are already signs that Fed rate hikes are starting to weigh on the economy, from lower PMI data, falling Fed business surveys, and slowing home sales and builder confidence. We believe the Fed pauses from here.

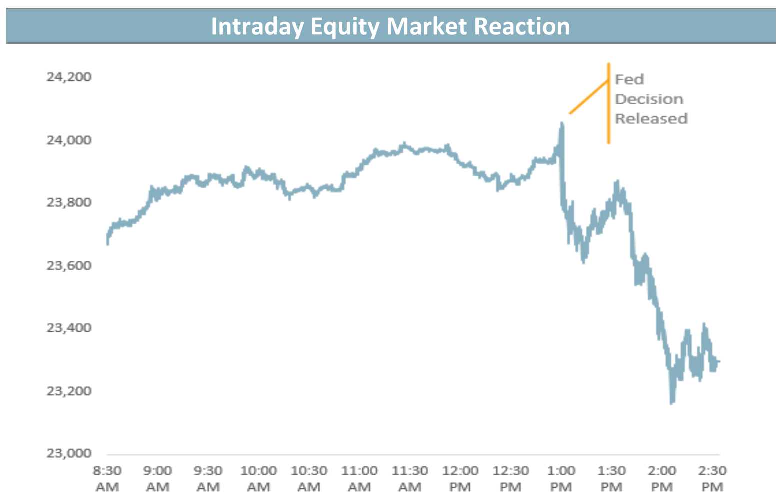
**Chart 1) Yield curves inverting again.** The first chart shows the 2Y-5Y part of the curve has inverted once again, and the 2Y-10Y curve – a classical sign of growing recession risks – is flattening again to just 13bps, and may be soon to follow the front-end of the curve to inversion in the weeks & months ahead.

**Chart 2) 10Y yield breaks below key level.** While many were concerned about rising yields, we were mostly concerned about what would happen should yields fall. The 10Y Treasury yield held a range of 2.80-3.10% for much of 2018 following the passage of tax cuts. Those were supposed to boost the economy, but with many expecting that sugar high to fade in 2019, a drop in the 10Y below 2.80% can only suggest that the growth outlook for the economy is fading materially.

**Chart 3) Equity markets are disappointed, to say the least.** The Dow was already down over 8% for the month of December, so it’s not like there was already a lot of Fed-related optimism priced into markets. But even against that easy setup, the Fed failed to deliver.




Source: RBC Wealth Management, Bloomberg

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