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FOMC UPDATE: GOLDILOCKS AND THE THREE BEARS

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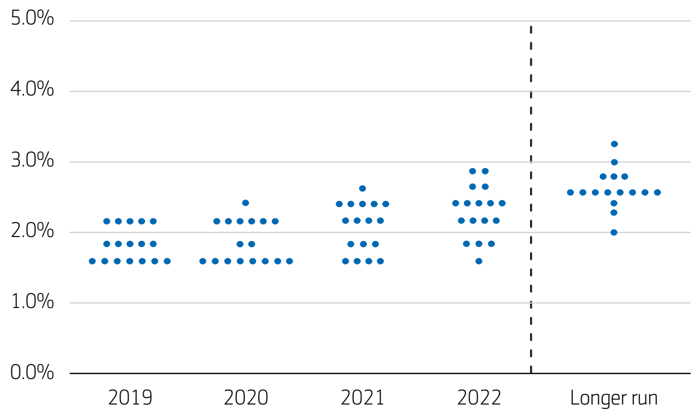
As expected, the Federal Open Market Committee (FOMC) lowered its target range for the federal funds rate by 25 basis points to 1.75 – 2.00% on Wednesday, September 18. The Committee also lowered the interest rate on excess reserves (IOER) by 30 basis points to 1.80%, which was also anticipated. The committee vote was 7-3, with dissenters Esther George and Eric Rosengren wanting no change to the rate, and James Bullard wanting a 50 basis point cut.

Interestingly, the updated median level of individual committee members' expectations for the appropriate level of the federal funds rate (i.e. the "dot plot") reflects no additional changes through the end of 2020, followed by one hike in 2021. This stands in stark contrast to the market's expectation the FOMC will cut rates again by year-end 2019, and twice more in 2020.

When looking at the Committee members' individual dots, and corroborated by the disparate rationale of dissents, it appears the FOMC is fractured in regards to future monetary policy. Similar to the tale of Goldilocks and the three bears, one group of committee members believes the funds rate is too high, one group thinks it is too low, and one group thinks it is just right (illustrated in Exhibit 1).

Exhibit 1: FOMC Updated Dot Plot



Source: The Federal Reserve. As of September 18, 2019.

There are some good reasons for this disagreement on the Committee. Five committee members likely subscribe to the efficacy of the Phillips Curve in predicting inflation, believing the current historically low-levels of unemployment will translate to an upward influence on inflation. The "Phillips-Curvers" have most likely reached the conclusion the federal funds rate is too low.

On the flip side, seven committee members appear to believe the Phillips Curve is not a good predictor of future inflation, instead prescribing more weight to the economic headwind likely to result from impending tariffs on Chinese imports. Then there is the group of five stuck in the middle; it appears they are unsure of what they should do, and, under pressure likely just punted by projecting no change to the federal funds rate.

Representing such a divided committee seemed like an extraordinarily difficult challenge for Chairman Powell at his press conference after the FOMC meeting. Powell, however, came prepared to tiptoe around these potential landmines, stressing the FOMC will "respond as appropriate" with its future monetary-policy decisions, and remain "data-centric." Fortunately, he made no mention of this cut being a "mid-cycle adjustment." During questions, he demurred when asked if this cut signified a regime change in FOMC policy. At one point, he even appeared open to a wide variety of monetary easing, if it was needed, including a resumption of QE. He was quick to point out, however, this was not the committee's base case scenario of continued economic expansion. Overall, Powell appeared to do as well as he could under the circumstances, although the bond market did appear a bit disappointed he wasn't more dovish.

For investors, we believe the absence of a consensus one way or the other from the committee suggests the FOMC will defer to the market in the coming months. More than likely, this means the FOMC will follow the market, rather than the market following the Fed.

We continue to believe we've seen the apex of economic growth this cycle, and that if scheduled tariffs go into place, the FOMC will likely cut three more times through mid-2020. After today's meeting, this opens the door to curve steepeners, as market odds for a second cut in 2020 declined from about 50% to only 24%. We remain roughly neutral to slightly long duration for longer-term rates.

Lastly, a word on the short-term funding markets. Despite all the hubbub and media sensationalism over the last couple of days, we are not concerned about the recent spike in overnight repo rates. We view the root cause of this disturbance to be highly technical in nature, and not indicative of a larger level of stress in short-term markets or foreshadowing another financial crisis. The Fed did step in yesterday and today to alleviate the situation (these used to be commonplace), and we anticipate it will implement a standing repo facility at some point in the not-too-distant future. In the meantime, it will continue to make repo lines available, as needed.

On this topic, it's worth noting that most other central banks already have a standing repo facility to function as a ceiling on their funds rate, but the Fed does not. This is understandable, since quantitative easing (QE) injected plenty of liquidity within the banking system, largely eliminating the need for a repo facility. However, since the FOMC began reducing the size of its balance sheet a couple of years ago, it has drained about $650 billion in excess reserves from the system. The recent hiccup in the repo markets could be a side effect of this, suggesting the balance sheet reduction may have gone far enough for now. A standing repo facility could help alleviate these side effects on a more permanent basis, and would function in a complementary fashion to IOER, since IOER serves as a floor to the federal funds rate. This would give the Fed both a ceiling and a floor for its funds target, and give the FOMC a valuable tool for monetary policy in the future, especially if it eventually decides to resume the unwind of its balance sheet.

Disclosure