Federated

Do the right thing

The Federal Reserve was 3-for-3 in correct policy responses at its recent meeting.

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BOTTOM LINE

Faced with decelerating domestic and global economic growth, somnolent inflation and a gaping chasm between Wall Street expectations and the Federal Reserve's then-current summary of economic projections, the Fed did the right thing, in our view, at its Wednesday's policy-setting meeting. First, as we and many others had expected, it kept interest rates unchanged at an upper band of 2.50%.

Second, with Wall Street long expecting the Fed was done hiking rates this cycle, policymakers took off the table the two rate hikes that in December it had signaled for 2019, although it did leave one on for 2020. We thought that third prospective hike would be a goner, too, as the Fed historically doesn't like to change monetary policy in a presidential election year, particularly post Labor Day. Given a long monetary policy time lag and the potential for a post-election downturn in 2021-22, a hike in 2020 could be risky. It could be it doesn't happen or the Fed could pull it forward into late 2019, if the economy rebounds in the second half of this year from what we expect will be a weak first quarter.

Third, the Fed said it expects to finish its balance-sheet run-off by the end of this year's third quarter. Starting in May, the Fed will begin to taper its maturing Treasury run-off from $30 *billion per month to $15 billion, while keeping its pace of maturing mortgage holdings at $20 billion. As such, the Fed will be done shrinking its balance sheet at about $3.625 trillion at the end of September 2019 (down from a peak of $4.5 trillion), at which point it will begin to slowly shift the composition of its balance sheet away from an estimated $1.6 trillion in mortgage-backed securities into Treasuries.*

Fed sees economic growth slowing In part because of slowing growth in both China and Europe, the Fed cut its GDP growth rate for the U.S. from 2.3% to 2.1% in 2019, and from 2.0% to 1.9% in 2020. Here at Federated, we're also expecting slower first-quarter economic growth of only 1.7%, due to a number of transitory factors such as the temporary federal government shutdown, brutally cold and snowy winter weather across most of the U.S., a negative wealth effect due to the fourth-quarter's 20% waterfall collapse in stock prices and the worst December retail sales in a decade.

But those issues will be in the rear-view mirror come the second quarter, and with the personal savings rate spiking to a 3-year high of 7.6%, we're expecting a much stronger consumer to emerge come Easter. As a result, we believe the Fed is too pessimistic, and we expect GDP growth to rebound to 2.6% in both the second quarter and for the full year. In addition, we expect the ongoing China/U.S. trade negotiations to be favorably resolved by June, and President Trump's fiscal policy changes are already driving stronger corporate capital expenditures (capex), which is lifting both productivity and growth.

Inflation is MIA The Fed, which sees no inflationary pressures in the economy at present, cut its core PCE forecast from 1.9% year-over-year (y/y) to 1.8% for 2019, and to 2.0% from 2.1% in 2020. So with core inflation now back below its 2% target, the Fed should have much greater flexibility to be very patient with future rate hikes. A look at several key inflation metrics confirms the Fed's caution:

- **Core Personal Consumption Expenditures (PCE)** After hitting a six-year high at 2.0% y/y growth in July 2018 (up from 1.6% in February 2018), core PCE eased to 1.8% in October and 1.9% in November and December.

- **Core Producer Price Index (PPI)** After peaking at a cycle high of 3.1% y/y growth in September 2018, wholesale inflation (which strips out food, energy and trade) fell to 2.3% in February 2019.
- **Core Consumer Price Index (CPI)** Consumer inflation (which strips out just food and energy prices) peaked at a 2.4% y/y gain in July 2018 (its highest reading in a decade), but has since fallen to 2.1% in February 2019.

Recession head fake? There has been a sharp flight-to-safety rally in benchmark 10-year Treasuries over the past three days, with yields falling from a high of 2.63% on Tuesday to a low of 2.42% today. With the upper range of the fed funds rate unchanged at 2.50%, that means that at least for today, the yield curve has temporarily inverted.

Rather than signaling the start of recession, however, we'd point to German bunds, whose yields slipped into negative territory today at -0.017% and Japanese JGB's, whose yield remains modestly negative at -0.081%, both due to weak economic data and recession concerns. We continue to believe that those low foreign yields are pressuring Treasury yields, rather than low Treasury yields and a modestly inverted yield curve signaling an imminent recession here.

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DISCLOSURES

Views are as of the date above and are subject to change based on market conditions and other factors. These views should not be construed as a recommendation for any specific security or sector.

Consumer Price Index (CPI): A measure of inflation at the retail level.

Gross Domestic Product (GDP) is a broad measure of the economy that measures the retail value of goods and services produced in a country.

Personal Consumption Expenditure (PCE) Index: A measure of inflation at the consumer level.

Producer Price Index (PPI): A measure of inflation at the wholesale level.

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