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FOMC COMMENTARY – FED DOVISH SHIFT FALLS SHORT

The Fed shifted dovish at its December meeting but by less than expected and an unsatisfactory press conference intensified risk-off dynamics. Markets (perhaps excessively) moved to price a Fed policy error: March hike probabilities and dollar higher, equities lower, credit spreads wider, yields and inflation break-evens lower. The shortfall relative to expectations was not that large, with "some" in the statement qualifying the extent of further gradual rate increases, the median projection for hikes in 2019 and (importantly) longer run neutral coming down, new monitoring language heightening data dependence and Powell stating that the timing / pace of increases and the extent of "any further increases" will depend on incoming information. We still think the Fed will slow down and pencil in the next move for May / June.

But in the current febrile market a miss is as good as a mile. Investors had already discounted a more dovish Fed following Powell's Economic Club speech. Today, Powell failed to quell fears that the Fed could be slipping behind the curve on risks while coming across aloof on the stock market sell-off and rigid regarding a balance sheet on "autopilot". Excessive sensitivity to equity prices is not a virtue in a central banker, but sensitivity to market signals is, and reconciling this conflict is not easy. It was unrealistic to expect a sudden shift on the balance sheet. But more nuanced comments might well have prevented such an adverse overall response. With little priced into the forward rates curve, the balance sheet cannot in truth be on autopilot from here regardless of changes in the outlook.

On a few specific points:

1. **The language on the economy was virtually unchanged from November, with multiple references to strong conditions and no recognition in the statement of slightly weaker inflation and break-evens.** The upbeat commentary in the statement underlines that the Fed remains confident in the US economy but if it was intended in part to boost market confidence in the outlook it did not have that effect and the failure to recognize weaker break-evens was an invitation for break-evens to trade still lower.
2. **The Fed qualified its guidance on interest rate hikes, stating that the FOMC judges that "some" further gradual increases will be appropriate – but failed to strengthen the language on data-dependence in the statement.** We and many others had expected the Committee to go further and either kill the "further gradual increases" phrase outright or directly amend it to emphasize that both the timing and the extent of additional rate increases would be data dependent. "Some" was a formula used by Vice-Chair Clarida weeks ago. It sounded timely then; it feels a little dated now. Nonetheless, it expresses the sense that the Committee is now moving into the range of estimates for the longer-run neutral rate setting.

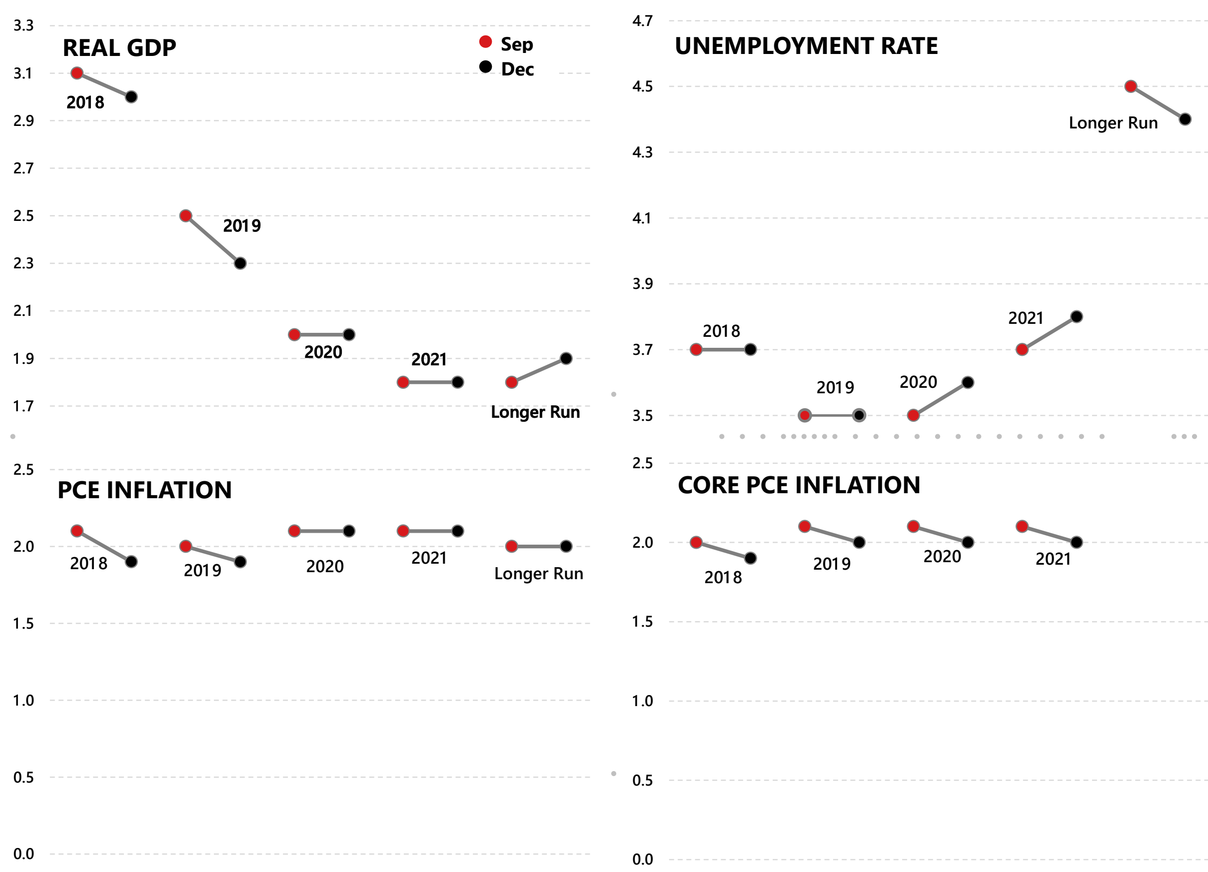
3. **The FOMC added new language saying it would continue to “monitor global economic and financial developments and assess their implications for the economic outlook.”** This can be read as adding a heightened degree of data-dependence as by implication the policy path may be sensitive to these developments. This language might have appeared far-sighted in November, less so today, though we think it is appropriate and may turn out to be consequential.
4. **The median projection for rate hikes in 2019 fell from three to two and the median estimate of the longer run neutral rate also fell from 3 to 2.75 per cent alongside a slight decline in estimates of the sustainable unemployment rate.** The Summary of Economic Projections more broadly showed FOMC participants responding to weaker global growth and tighter financial conditions by taking out a little tightening and shaving forecasts for both growth and inflation in 2019.
5. **In the press conference Powell tried to thread the needle between emphasizing that the US economy has been strong in 2018 and this “remain[s] true today” while recognizing the “cross-currents” of weaker global growth and tighter financial conditions.** This appeared to work at first, but the chair had some difficulty reconciling the different aspects of the Fed’s communications, admitting that the Fed has not achieved its inflation target on a sustained basis and declaring himself agnostic as to whether it might or might not be necessary for the Fed to move rates into restrictive territory.
6. **Powell repeatedly used a formula in the press conference that there is “significant uncertainty about both the path and ultimate destination” on rates, with “path” replaced by “pace” at least once.** This came close to mirroring the language we mistakenly expected to see replace / heavily qualify the further gradual rate increases formula in the statement. But in our view the formula should not emphasize uncertainty, it should emphasize that the pace and extent will respond to changes in the outlook and balance of risks.
7. **The Fed chair did not provide a clear steer on pace, and the continued use of “further gradual increases” in the statement leaves some ambiguity as to whether the default might still be to continue at a quarterly pace near term, though we think not.** We would have preferred a clearer indication that the FOMC judges that it can now take advantage of subdued inflation and inflation break-evens to slow down, look around and take its time before making the next move on rates. Still, Powell talked about the Fed’s “ability to be patient” which we interpret as consistent with our baseline view that the next rate hike is penciled in for May / June, with all meetings now of more equal status with press conferences at each, even if they are not really all live.
8. **At the risk of sounding unfair, the overall package came across as both not data-dependent enough in places (the statement) and too data-dependent in others (the press conference on all matters other than the balance sheet).** Powell is absolutely correct that the Fed will need to feel its way to neutral while in parallel taking the opportunity to learn about the sustainability of current historically low unemployment. But as we have written many times in the past, data-dependence is not a strategy, it is an attribute of a strategy, and the strategy piece was a bit light.

9. **The Fed chair simply repeated Fed orthodoxy on the balance sheet – that there are reasons why this should proceed on autopilot with rates as the active instrument of policy – but this came across as rigid and intensified the adverse market reaction.** It was always unrealistic to think the Fed would make a large change in balance sheet policy at this meeting. But we would distinguish between the argument that the Fed should slow or stop balance sheet run-off immediately and the argument that the Fed needs to do a better job of articulating how it adds up the multiple forms of tightening under way and how it intends to ensure that the overall stance of policy remains at all times appropriately calibrated relative to a changing outlook.

   The Fed may legitimately view the rate path as a tool of first resort in responding to changes in the outlook, but uncertainty over the magnitude of balance sheet tightening effects complicate this as the amount of expected future rate increases declines both in absolute terms and relative to the balance sheet tightening ahead. This is accompanied by a clear disconnect between equity investors renewed hypersensitivity with regard to the balance sheet and the Fed's skepticism that there are significant channels through which the balance sheet impacts financial conditions that do not have to run first through the term premium on yields.

   But the notion that run-off is on autopilot needs qualification even under the Fed's own framing. This is because with barely half a hike priced in for 2019 there is no longer a sizeable buffer in terms of expected Fed rate hikes that could be taken out if the outlook were to darken materially from here. It would be strange for the Fed to cut rates while continuing to tighten via balance sheet run-off. So we must now be in a situation in which plausible further shifts in the outlook and balance of risks might require the Fed to take the balance sheet off autopilot. A more nuanced answer on the balance sheet might have mitigated market dynamics today, while fears of excess aggregate tightening across rates and the balance sheet could help explain why risk assets could perform so badly with only relatively near term rate hike probabilities moving up and longer term rates moving lower (though this again requires the existence of channels other than the term premium channel). In any event we think the balance sheet discussion will take on additional prominence into 2019.

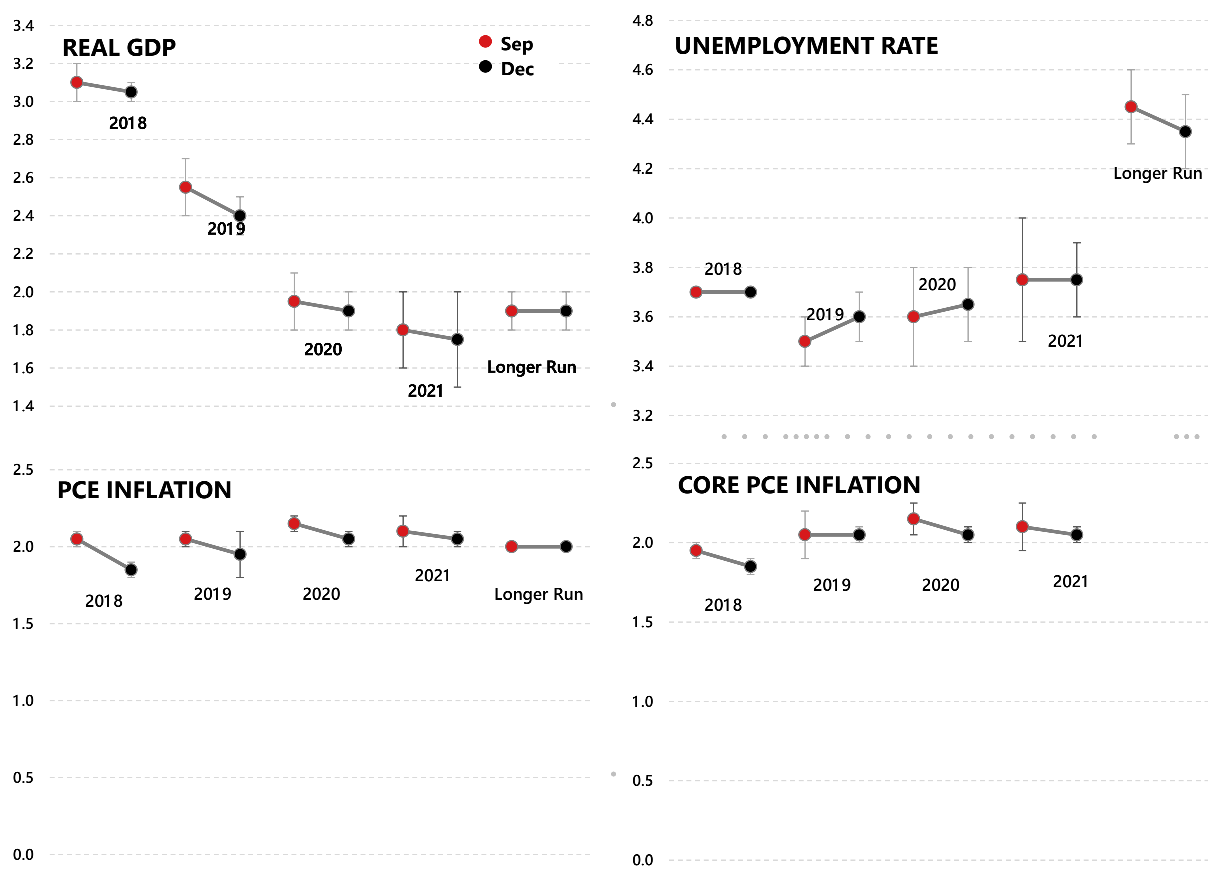
Change in the Summary of Economic Projections, Sep to Dec 2018
Medians



Source: Federal Reserve, Evercore ISI.

Change in the Summary of Economic Projections, Sep to Dec 2018

Central tendency



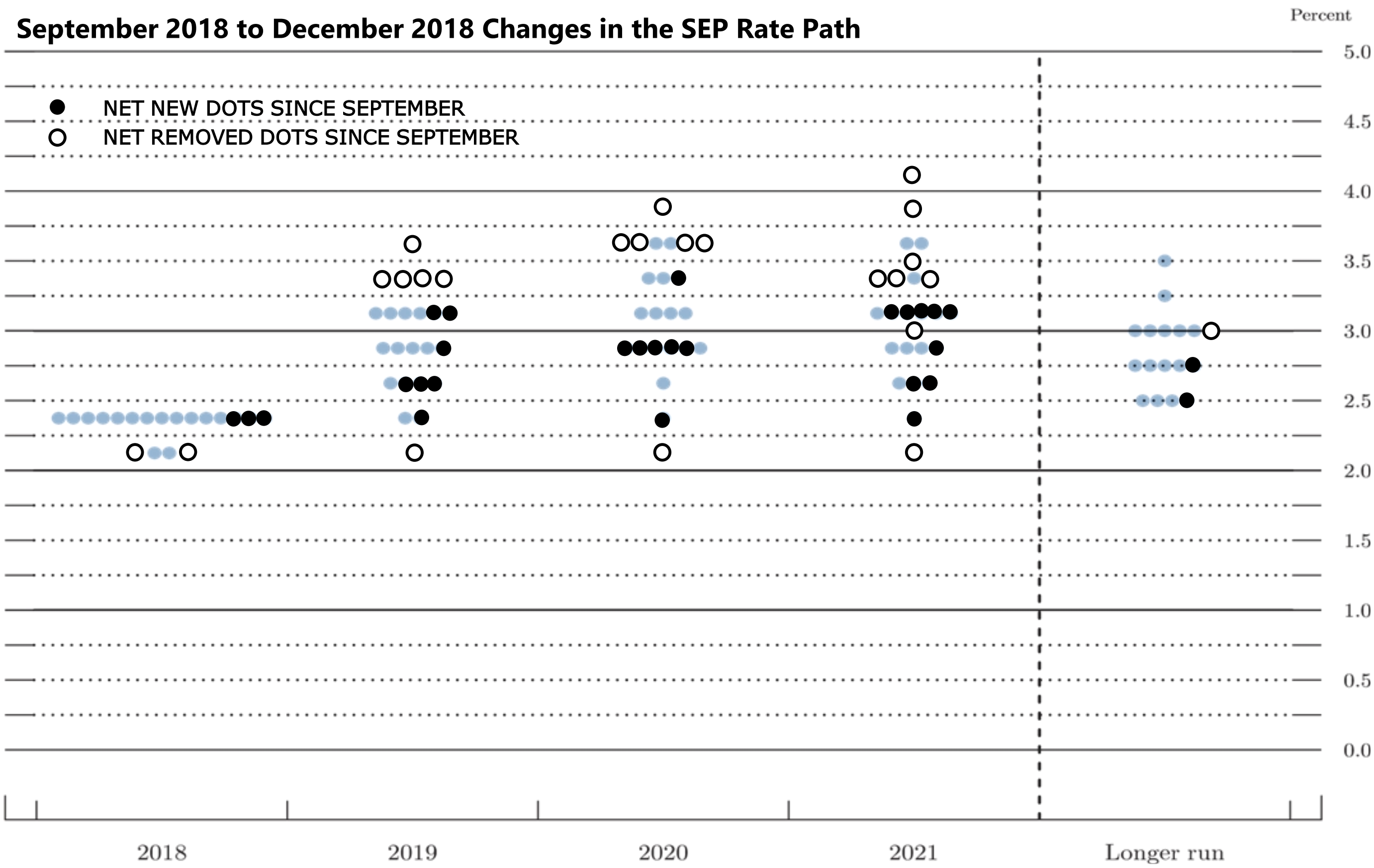
Source: Federal Reserve, Evercore ISI.

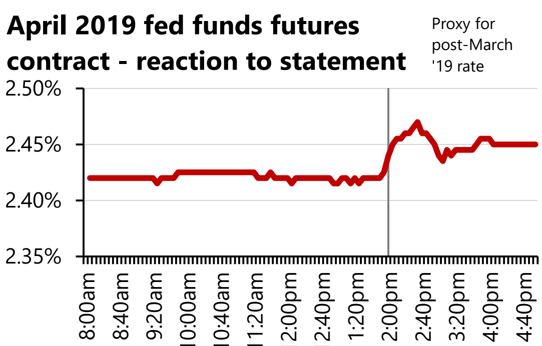
Net change in rate path dots, Sep - Dec 2018*

	2018	2019	2020	2021	Longer Run
- 1/8	0	0	0	0	0
0	0	0	0	0	0
1/8	0	0	0	0	0
1/4	0	0	0	0	0
3/8	0	0	0	0	0
1/2	0	0	0	0	0
5/8	0	0	0	0	0
3/4	0	0	0	0	0
7/8	0	0	0	0	0
1	0	0	0	0	0
1 1/8	0	0	0	0	0
1 1/4	0	0	0	0	0
1 3/8	0	0	0	0	0
1 1/2	0	0	0	0	0
1 5/8	0	0	0	0	0
1 3/4	0	0	0	0	0
1 7/8	0	0	0	0	0
2	0	0	0	0	0
2 1/8	-2	-1	-1	-1	0
2 1/4	0	0	0	0	0
2 3/8	+2	+1	+1	+1	0
2 1/2	0	0	0	0	+1
2 5/8	0	+3	0	+2	0
2 3/4	0	0	0	0	+1
2 7/8	0	+1	+5	+1	0
3	0	0	0	-1	-1
3 1/8	0	+2	0	+5	0
3 1/4	0	0	0	0	0
3 3/8	0	-4	+1	-3	0
3 1/2	0	0	0	-1	0
3 5/8	0	-1	-4	0	0
3 3/4	0	0	0	0	0
3 7/8	0	0	-1	-1	0
4	0	0	0	0	0
4 1/8	0	0	0	-1	0
4 1/4	0	0	0	0	0
4 3/8	0	0	0	0	0
4 1/2	0	0	0	0	0

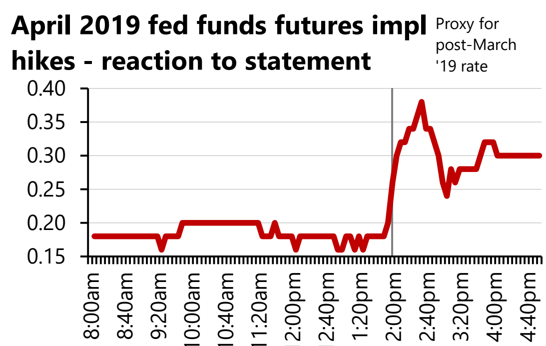
	2018	2019	2020	2021	Longer Run
MEDIAN					
Sep 2018	2.38	3.13	3.38	3.38	3.00
Dec 2018	2.38	2.88	3.13	3.13	2.75
CHANGE	0.00	-0.25	-0.25	-0.25	-0.25
MEAN					
Sep 2018	2.31	3.02	3.28	3.23	2.88
Dec 2018	2.34	2.85	3.07	3.01	2.84
CHANGE	0.03	-0.17	-0.22	-0.23	-0.04
MODE					
Sep 2018	2 3/8	3 1/8	3 5/8	3 3/8	3
Dec 2018	2 3/8	3 1/8	2 7/8	3 1/8	2 7/8
CHANGE	0	0	- 3/4	- 1/4	- 1/8
TRIMMED MEAN (DROP 3 HIGHEST/SMALLEST)					
Sep 2018	2.14	2.80	3.07	2.95	2.36
Dec 2018	2.16	2.88	3.06	2.99	2.57
CHANGE	0.02	0.08	-0.01	0.03	0.20
4TH LOWEST					
Sep 2018	2 1/8	2 7/8	3 1/8	2 7/8	2 3/4
Dec 2018	2 3/8	2 5/8	2 7/8	2 5/8	2 1/2
CHANGE	1/4	- 1/4	- 1/4	- 1/4	- 1/4
3RD HIGHEST					
Sep 2018	2 3/8	3 3/8	3 5/8	3 5/8	3
Dec 2018	2 3/8	3 1/8	3 3/8	3 3/8	3
CHANGE	0	- 1/4	- 1/4	- 1/4	0

** NOTE: RATE DOTS REPRESENT MIDPOINT OF EACH PARTICIPANT'S JUDGEMENT OF THE APPROPRIATE TARGET RANGE.*

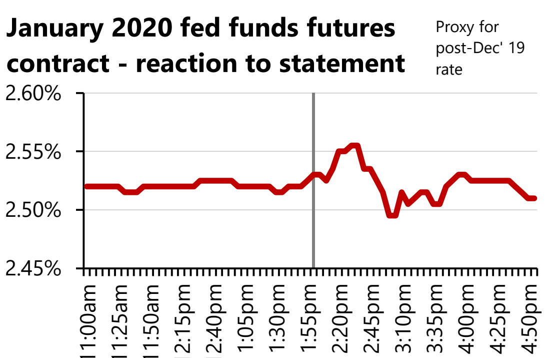




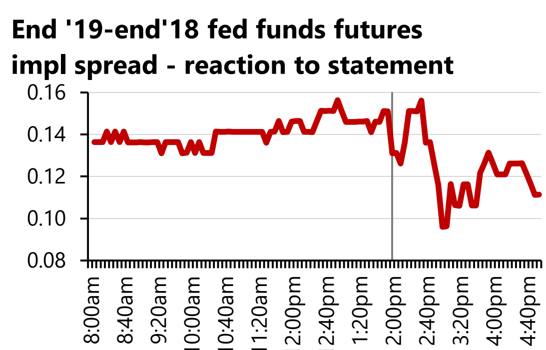
Source: Bloomberg



Source: Bloomberg, Evercore ISI

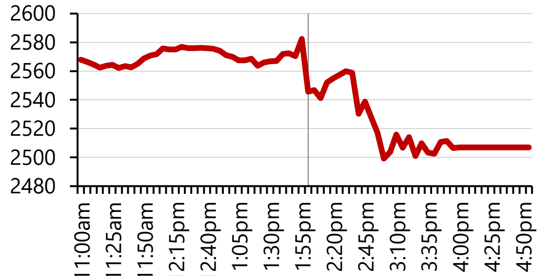


Source: Bloomberg



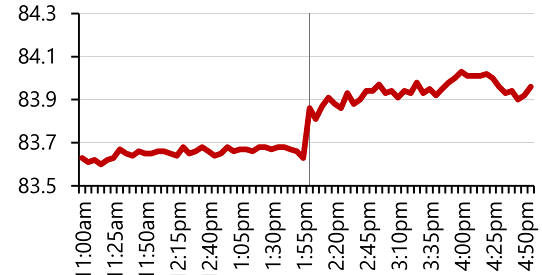
Source: Bloomberg, Evercore ISI

S&P 500 - reaction to statement



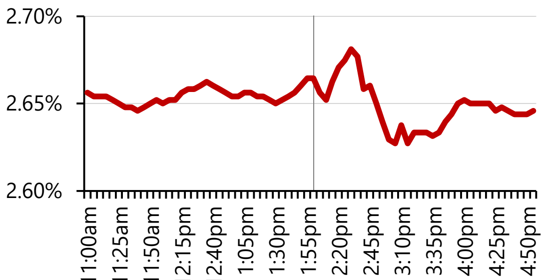
Source: Bloomberg

DB TW USD - reaction to statement



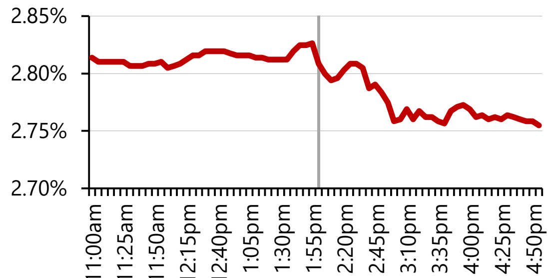
Source: Bloomberg

US govt 2yr bond yield - reaction to statement



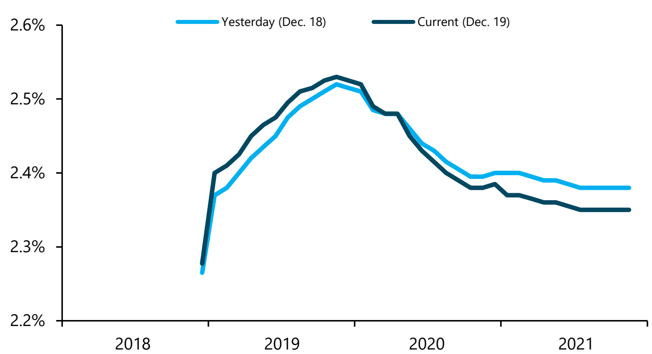
Source: Bloomberg

US govt 10yr bond yield - reaction to statement



Source: Bloomberg

Evolution of fed funds futures implied rate curve



Source: Bloomberg, Evercore ISI

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