

March 21, 2019

## The Fed Squares the Dots—Markets Yet to be Convinced

By Robert Tipp, CFA, Chief Investment Strategist and Head of Global Bonds

The latest Fed meeting saw a continuation of its pivot from tightening (as recently as December 2018) to an extremely patient, if not “on hold,” posture. **While not unprecedented, the drop in the Fed's expected median path for the Fed funds rate—a parallel shift 50 bps lower over the next few years—was large in magnitude, but also impressive in breadth as nearly every participant appears to have dropped his or her “dot forecasts” for the funds rate for 2019, 2020, and 2021.** Additionally, participants signaled the balance sheet roll off—a policy widely viewed as a modest tightening measure—would slow in May and end in September 2019.

The Fed's big shift comes amid a confluence of factors. U.S. data have slowed a bit, but growth elsewhere in the world remains distinctly soft. U.S. inflation is around target, but upside pressures are limited, and, significantly, some measures of inflation expectations continue to fall. Meanwhile, central banks around the world are struggling with moribund growth and below-target inflation, leaving them generally constrained relative to their zero or negative interest-rate lower bounds.

Taken together, the Fed likely saw a compelling set of reasons for going on hold and strongly signaling that intent, at least for this year. **Indeed, continue hiking, and it may slow growth and risk dampening inflation further below target levels—arguably a trademark problem of the Fed's for some time. Furthermore, to the extent that further hikes would have guided the economy towards a lower equilibrium level of interest rates, the Fed may have inadvertently contributed to the “proximity to the zero lower bound” problem faced by other major central banks, which is one that the Fed would really like to avoid (see “[The Fed's Challenge of Squaring the Dots](#)” for additional details). By contrast, if the Fed stops now, it may achieve the elusive soft landing. Yet, if its latest shift was not sufficiently dovish, it risked pushing the markets back towards last year's vicious risk-off cycle of tightening financial conditions.**

The immediate market reactions were mixed. The currency market clearly saw the outcome as more dovish than expected with the U.S. dollar dropping versus most currencies. The interest-rate markets, which were already pricing in a slow and modest easing cycle over the next few years, proceeded to price in a slightly steeper downward course for rates with the 10-year Treasury yield dropping by about 8 bps to [2.53%](#). After brief bounces in the corporate credit and equity markets, gains evaporated into the close with stocks generally ending the day lower. Perhaps these economically sensitive “risk markets” took the Fed's downgraded economic assessment to heart.

**Although the markets' conviction that the Fed will be cutting rates grew after the meeting, they may not be easily convinced that the economy is back on Easy Street. Instead, the markets are reacting as if we are in a late-cycle investment environment, which gets riskier for stocks as growth ebbs, but more positive for bonds as the rate cycle has presumably crested.**

From an international perspective, while foreign investors may quibble about the slope of the U.S. yield curve and the high cost of hedging, on a relative basis, U.S. yields remain quite high, perhaps offering opportunities for capital gains relative to foreign investors' low and sometimes even negative yielding domestic markets. As for spread product, while growth may or may not be strong enough to keep equity investors enthused, it may be good enough to support credit quality and spread-sector outperformance, driven by an ongoing, gradual “search for yield.”

Source(s) of data (unless otherwise noted): PGIM Fixed Income as of March 21, 2019

PGIM Fixed Income operates primarily through PGIM, Inc., a registered investment adviser under the U.S. Investment Advisers Act of 1940, as amended, and a Prudential Financial, Inc. ("PFI") company. PGIM Fixed Income is headquartered in Newark, New Jersey and also includes the following businesses globally: (i) the public fixed income unit within PGIM Limited, located in London; (ii) PGIM Japan Co., Ltd. ("PGIM Japan"), located in Tokyo; and (iii) the public fixed income unit within PGIM (Singapore) Pte. Ltd., located in Singapore. Prudential Financial, Inc. of the United States is not affiliated with Prudential plc, which is headquartered in the United Kingdom. Prudential, PGIM, their respective logos, and the Rock symbol are service marks of PFI and its related entities, registered in many jurisdictions worldwide.

**These materials are for informational or educational purposes only. The information is not intended as investment advice and is not a recommendation about managing or investing assets. In providing these materials, PGIM is not acting as your fiduciary.** These materials represent the views, opinions and recommendations of the author(s) regarding the economic conditions, asset classes, securities, issuers or financial instruments referenced herein. Distribution of this information to any person other than the person to whom it was originally delivered and to such person's advisers is unauthorized, and any reproduction of these materials, in whole or in part, or the divulgence of any of the contents hereof, without prior consent of PGIM Fixed Income is prohibited. Certain information contained herein has been obtained from sources that PGIM Fixed Income believes to be reliable as of the date presented; however, PGIM Fixed Income cannot guarantee the accuracy of such information, assure its completeness, or warrant such information will not be changed. The information contained herein is current as of the date of issuance (or such earlier date as referenced herein) and is subject to change without notice. PGIM Fixed Income has no obligation to update any or all of such information; nor do we make any express or implied warranties or representations as to the completeness or accuracy or accept responsibility for errors. **All investments involve risk, including the possible loss of capital. These materials are not intended as an offer or solicitation with respect to the purchase or sale of any security or other financial instrument or any investment management services and should not be used as the basis for any investment decision. No risk management technique can guarantee the mitigation or elimination of risk in any market environment. Past performance is not a guarantee or a reliable indicator of future results and an investment could lose value. No liability whatsoever is accepted for any loss (whether direct, indirect, or consequential) that may arise from any use of the information contained in or derived from this report. PGIM Fixed Income and its affiliates may make investment decisions that are inconsistent with the recommendations or views expressed herein, including for proprietary accounts of PGIM Fixed Income or its affiliates.**

The opinions and recommendations herein do not take into account individual client circumstances, objectives, or needs and are not intended as recommendations of particular securities, financial instruments or strategies to particular clients or prospects. No determination has been made regarding the suitability of any securities, financial instruments or strategies for particular clients or prospects. For any securities or financial instruments mentioned herein, the recipient(s) of this report must make its own independent decisions.

**Conflicts of Interest:** PGIM Fixed Income and its affiliates may have investment advisory or other business relationships with the issuers of securities referenced herein. PGIM Fixed Income and its affiliates, officers, directors and employees may from time to time have long or short positions in and buy or sell securities or financial instruments referenced herein. PGIM Fixed Income and its affiliates may develop and publish research that is independent of, and different than, the recommendations contained herein. PGIM Fixed Income's personnel other than the author(s), such as sales, marketing and trading personnel, may provide oral or written market commentary or ideas to PGIM Fixed Income's clients or prospects or proprietary investment ideas that differ from the views expressed herein. Additional information regarding actual and potential conflicts of interest is available in Part 2A of PGIM Fixed Income's Form ADV.

***In the United Kingdom and various European Economic Area ("EEA") jurisdictions, information is issued by PGIM Limited with registered office: Grand Buildings, 1-3 Strand, Trafalgar Square, London, WC2N 5HR. PGIM Limited is authorised and regulated by the Financial Conduct Authority of the United Kingdom (Firm Reference Number 193418) and duly passported in various jurisdictions in the EEA. These materials are issued by PGIM Limited to persons who are professional clients as defined in Directive 2014/65/EU (MiFID II). In certain countries in Asia, information is presented by PGIM (Singapore) Pte. Ltd., a Singapore investment manager registered with and licensed by the Monetary Authority of Singapore. In Japan, information is presented by PGIM Japan Co., Ltd., registered investment adviser with the Japanese Financial Services Agency. In South Korea, information is presented by PGIM, Inc., which is licensed to provide discretionary investment management services directly to South Korean investors. In Hong Kong, information is presented by representatives of PGIM (Hong Kong) Limited, a regulated entity with the Securities and Futures Commission in Hong Kong to professional investors as defined in Part 1 of Schedule 1 of the Securities and Futures Ordinance. In Australia, this information is presented by PGIM (Australia) Pty Ltd ("PGIM Australia") for the general information of its "wholesale" customers (as defined in the Corporations Act 2001). PGIM Australia is a representative of PGIM Limited, which is exempt from the requirement to hold an Australian Financial Services License under the Australian Corporations Act 2001 in respect of financial services. PGIM Limited is exempt by virtue of its regulation by the Financial Conduct Authority (Reg: 193418) under the laws of the United Kingdom and the application of ASIC Class Order 03/1099. The laws of the United Kingdom differ from Australian laws. In South Africa, PGIM, Inc. is an authorised financial services provider – FSP number 49012.***

© 2019 PFI and its related entities.

2019-1419