The Fed's Dovish Hike – But is it Enough for Markets?

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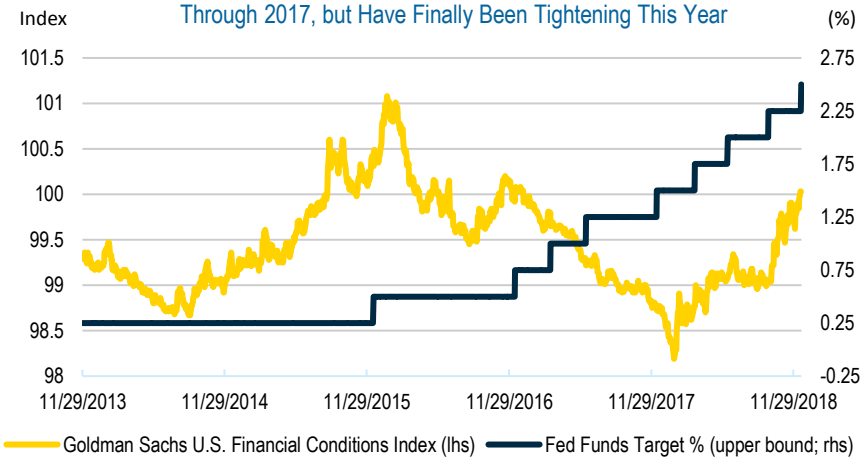
At its meeting on December 19, 2018, the Federal Reserve raised the Fed funds target rate range another 25 bps to 2.25%-2.5%, as widely expected. Although the Fed tweaked its GDP growth and inflation forecasts slightly lower**, it still anticipates solid GDP growth of 2.3% in 2019, a further drop in the unemployment rate from 3.7% this year to 3.5% next year, and inflation that is close to—albeit slightly below—target at 1.9% in 2019.**

But with financial conditions now tighter (see Figure 1), economic growth likely past its peak, and inflation on a softening trend since last spring, the **Fed also moderated its median projection for additional hikes going forward**. Rather than the three rate hikes it had been anticipating for 2019, **the Fed's median projection is now for just two rate hikes next year, which would lift the Funds rate to 2.9% by end-2019.** The removal of one of the projected rate hikes for next year effectively just unwound the additional rate hike that the Fed had penciled in last March for 2019—just after fiscal stimulus was implemented, but before potential tariff increases and slower economic growth abroad became elevated concerns. With fewer projected hikes in 2019 and the Fed still anticipating one more rate increase in 2020, **the Fed now projects the Fed funds rate will peak at 3.1% this cycle, rather than the 3.4% previously expected**. Moreover, the range of estimates for rate hikes over the next three years also narrowed considerably, with the most hawkish forecasts notably moving lower.

The Fed's median estimate of the long-run neutral Fed funds rate also dropped to 2.8%, from 3.0% previously, but the range of long-run estimates remains 2.5% to 3.5%. December's rate hike has now put the Fed funds rate roughly at the lower end of that long-run neutral range, explaining the Fed's desire to move now to a more data-dependent state.

At the press conference following the Fed's meeting, Chairman Powell noted part of the reason for lowering the number of projected rate hikes in 2019 was the recent tightening of financial conditions. **Until this year, financial conditions had been generally *easing,* despite the Fed's pivot to monetary tightening in late 2015.** Indeed, credit spreads narrowed over this period, equities soared after the 2016 elections, and the U.S. dollar declined over the course of 2017. **It wasn't until 2018 that financial conditions finally began to tighten alongside Fed policy, driven in part by a strengthening dollar since the spring and reinforced by a selloff of risk assets since early fall.**

Figure 1: Despite Fed Rate Hikes, Financial Conditions Continued to Ease Through 2017, but Have Finally Been Tightening This Year



Source: Bloomberg as of December 19, 2018

Part of the tightening of financial conditions over the last year may also have reflected the Fed's Quantitative Tightening (QT) as the Fed's balance sheet has shrunk and bank reserves have declined. At the December meeting, the Fed in fact tweaked its IOER target rate for the second time this year, raising it just 20 bps, alongside the 25 bp hike in the Fed funds rate. But at the press conference, Powell reiterated that recent tightening in the Fed funds market likely reflected heavy Treasury bill issuance and other factors—not a scarcity of bank reserves. And as such, he indicated QT will remain on auto pilot.

Prior to yesterday's meeting, the market had almost fully priced in a December rate hike, but had only priced in half an additional hike in 2019, and none thereafter. Following the meeting and Chairman Powell's press conference, the short-end of the curve thus moved only modestly, with two-year Treasury rates little changed. **The longer-end of the Treasury curve rallied significantly, however, with the 10-year Treasury rate down 6 bps to 2.76% and the 30-year Treasury rate down 9 bps to 2.98%. Equities sold off sharply, with the S&P 500 Index ending the day at a level last seen in September 2017.** This risk off tone may be reflective of a market that was disappointed that the Fed wasn't yet more dovish. Our own base case for two rate hikes in 2019 is more in line with the Fed's new projections, but we think there are downside risks at this point and anticipate that the auto-pilot rolloff of the Fed's balance sheet will likely need to be revisited at some point in the upcoming year.

Source(s) of data (unless otherwise noted): PGIM Fixed Income as of December 2018

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