



January 31, 2020

Fed Rate Outlook Unchanged While Financial Markets Predict Otherwise

Transcript

Bill Emmons: Hi, Bill Emmons, and today is Friday, January 31. I'd like to talk about the FOMC meeting that took place this week. I'd characterize the Fed outlook as basically unchanged, and I want to talk about some of the market reactions.

So, takeaways from the meeting include a continuing moderate economic expansion, good job growth and household spending. Meanwhile, business investment and exports are lagging. Inflation remains below target. The committee decided to leave its Fed funds target range unchanged between 1-1/2 and 1-3/4 percent. Small changes on the interest on excess reserves increased 5 basis points to 1.6, and the Fed will continue money market interventions that have been going on for a few months, that are supplying reserves, but they hope to end those extraordinary actions by the second quarter of this year. We got our first look at full-year 2019 GDP growth and inflation. GDP came in at 2.3 percent in 2019, down a bit from 2018. Inflation ran at about 1.4 percent, noticeably below the 2 percent target of the Fed.

I think that the most important outcome, really, from this meeting and moving forward is that a gap between the Fed and the market seems to be opening up a little bit again in terms of rate expectations. As you recall, the last quarterly projections, as of December of 2019, from the FOMC have the median member expecting no change in the Fed funds rate this year and, actually, a single quarter-point increase next year. At this week's press conference, Chairman Powell gave no hints that I could see that the FOMC consensus on rates has changed.

Meanwhile, however, financial market indicators are pointing toward one and possibly two quarter-point rate cuts by the end of this year, and longer-term interest rate expectations are very low. For example, the 30-year Treasury yield is near 2 percent. So, if you look at the futures markets at the July meeting, financial markets are putting a 60 percent probability that there will be at least one rate cut by that time. Looking to the end of the year at the December 2020 meeting, investors are saying there's an 85 percent chance that there will be at least one cut and a 51 percent chance of at least two cuts by the end of 2020, so quite a bit of divergence from the unchanged outlook we're projecting from the Fed.

As I mentioned, the 30-year Treasury is near 2 percent, which is an all-time low. Also, if you look at the yield curve, which had been inverted in 2019 and then uninverted as the Fed dropped the short-term rates, as of Thursday this week, did move into inversion again. The 10-year yield went slightly below the three month. And as we've talked about in the past, this is traditionally a very strong indicator of weaker growth ahead and, often, lower Fed interest rates.

So the implications for banks include, still, a healthy job market and consumer spending that the Fed expects to continue this year, and looking for about a 2 percent pace of economic growth. No interest rate changes are projected by the Fed, in fact, a slight increase next year. Meanwhile, the financial markets appear to be looking for one and possibly two rate cuts this year. And I think one of the implications is that investors may see a somewhat softer economy and lower inflation than the Fed.

So what should you expect? The FOMC does not appear to be ready to move in either direction with rates, and I think we would be hearing more about that if it were going to happen. The Fed has signaled that the money



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market interventions should be ending by the second quarter and will get to a stable position with the balance sheet, larger than it was at the end of 2019. And, as always, the Fed will be watching very carefully the economic developments, both here and overseas and financial markets, for any signs that the currently favorable outlook has changed.

Thanks for listening, and we'll see you next time.

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