Powell Douses Rate Cut Pricing

- **Chair Powell used his press conference to push back against market pricing for rate cuts and sounded convincingly upbeat.** On net this is a step in favour of our forecast for the US Treasury curve to remove cut pricing and remove curve inversion over the year. If developments proceed as we anticipate, then it remains plausible the Fed returns with mild tightening as per our forecast. In short, nothing here says the Fed is priming for a rate cut and it is sending a message to overly aggressive markets. The market reaction was a wild ride as the 2 year Treasury yield plunged by over 5bps after the statement but then soared by 10bps during the press conference for a net 5bps cheapening. Fed funds futures contracts followed a similar profile and ended up with the December contract pricing a materially lower chance of a rate cut this year. The USD appreciated by about ½% on net. The S&P500 sold off by about ¾% after all communications had been digested.
- **The FOMC statement itself was a fairly tame affair.** It repeated reference to being **"patient"** as expected. As the attached statement comparison demonstrates, all of the changes were in the opening paragraph that focuses upon current conditions. **The economy was upgraded to growing at a "solid" rate, with job growth "solid" absent qualifiers in a "strong" labor market. Inflation is "running below 2 percent" which is just a statement of fact with the real information on inflation coming in the press conference.** Markets over-reacted to this statement of fact on inflation before Powell then basically dismissed it in the press conference. Key is that the statement's broad policy guidance remained unchanged as follows:

  > "The Committee continues to view sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2 percent objective as the most likely outcomes."

- **The relative hawkishness (to market pricing) came through the press conference.** Overall, **Chair Powell sounded considerably more encouraged by developments in the domestic and global economies while sounding generally dismissive toward soft core PCE inflation** in favour of emphasizing temporary factors weighing it down that are expected to lift going forward. Powell concluded there was no strong case for moving rates in either direction right now. He also observed that while past cycles offer interesting comparisons of when the Fed eased, he noted there is little point to spending much time on such comparisons given unique challenges in this cycle.
- **The overarching key is that Powell dismissed the deceleration in core PCE during Q1 as transient in favour of an unchanged base line expectation for inflation to be at 2% over time.** The minute he said that is when markets did an about-face. He referenced developments in **slack in the economy** as the US economy has pushed into excess demand conditions and how this should lift inflation. Powell gave examples of **transient downside pressures upon core PCE that included apparel prices, temporary softness in portfolio management services after Q4 market developments that have since turned, and airfare prices**. Powell also noted that measures like the **Dallas Fed's trimmed mean inflation rate have remained around 2%** (1.96% y/y as of March) throughout the period in which headline PCE diminished and so only components in the tails of the price distribution are distorting inflation composites while the bulk of the basket of prices is more stable.

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- While he views core PCE softness as transient, **Powell still cautions that the FOMC is watching it very closely to see if the forces are transient.** He said he needs to see a sustained period of weak inflation to prove that transient forces are not responsible, but does not define what a "sustained period" is, nor was he asked. Powell noted that given that the surprises on inflation have more often been to the downside, it can make it harder to support the economy in difficult times if they don't treat sustained downsides seriously. Nevertheless, Powell went on to give the past example of mobile phone service pricing influences to the downside and then when that effect lifted inflation shot back up to 2% last year. He thinks this time will be similar but they'll react in either direction if they're surprised.
- Powell might have also added a reference to the broad dollar's lagging influences upon disinflation into 2019 as another likely transitory influence. Unlike past episodes, including when former vice chair Fischer gave a full speech on dollar effects upon inflation and trade, Powell has generally avoided reference to the dollar and deferred to the Treasury which is more the norm for the Fed. That doesn't mean markets should do so.
- **Powell emphasized that risks the outlook have moderated. He flagged improvements in European and China, the pushed off risk of a disorderly Brexit, and progress in trade talks with China.**
- **The IOER rate was reduced by 5bps to 2.35%.** The motivations to doing so have been explained ad nauseam elsewhere including in this morning's Daily Points, and the move was not unexpected. Powell emphasized that this is not a change in policy direction and is only a technical adjustment. Will it work? One short rate proxy—the 90 day bills rate—fell by about 2bps right away but then regained this drop and shook it off. Powell also noted that they are just now entering the period of learning about demand for reserves given that the tapering of reinvestments into Treasuries to US$15 billion/mth from twice that before now has only just begun and along with that the more positive implications for reserve balances.
- **Balance sheet plans were left entirely unchanged for now, but Powell emphasized that the FOMC will revisit two issues later.** They will return to discussing a potential alteration of **duration management through reinvestment plans by late year** but that there is no pressing urgency to do so now. They will also **discuss a possible repo facility over "coming meetings"**.
- **Powell flagged strong Q1 GDP growth of 3.2%.** While **he acknowledged that the consumption and investment parts of the picture were weak, he also said that "recent data suggest" both components will bounce back**, supporting a positive outlook over the remainder of the year. That's consistent with this take. **This strongly states that the Fed's economists are not fussed by holes in Q1 GDP and they take it as a strong reading with more to come.**
- **On the downside to ISM-manufacturing this morning, Powell answered that the FOMC sees that reading as still positive** and what it expects in terms of moderate or modest growth. He noted that services have been growing faster than manufacturing all around the world but he does expect a positive contribution to growth from the manufacturing sector.
- **On how the FOMC sees financial conditions and stability, Powell said he doesn't see any evidence the economy is overheating and downplayed stability concerns.** He referenced how households are in good shape, nonfinancial corporates represent some concerns through high leverage, and leverage in the financial system is very low. Powell concluded that, on balance, vulnerabilities are moderate.
- **Lastly, when asked about the potential effects of the resolution of trade disputes in favour of deals, Powell noted that it would be a positive for business sentiment but that most of the gains would come over time as opposed to rapidly.**

RELEASE DATE: MAY 1, 2019

Information received since the Federal Open Market Committee met in March indicates that the labor market remains strong **and that economic activity rose at a solid rate**. **Job gains have been solid**, on average, in recent months, and the unemployment rate has remained low. Growth of household spending and business fixed investment **slowed** in the first quarter. On a 12-month basis, overall inflation and inflation for items other than food and energy have declined and are **running below 2 percent**. On balance, market-based measures of inflation compensation have remained low in recent months, and survey-based measures of longer-term inflation expectations are little changed.

Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. In support of these goals, the Committee decided to maintain the target range for the federal funds rate at 2-1/4 to 2-1/2 percent. The Committee continues to view sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2 percent objective as the most likely outcomes. In light of global economic and financial developments and muted inflation pressures, the Committee will be patient as it determines what future adjustments to the target range for the federal funds rate may be appropriate to support these outcomes.

In determining the timing and size of future adjustments to the target range for the federal funds rate, the Committee will assess realized and expected economic conditions relative to its maximum employment objective and its symmetric 2 percent inflation objective. This assessment will take into account a wide range of information, including measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial and international developments.

Voting for the FOMC monetary policy action were: Jerome H. Powell, Chair; John C. Williams, Vice Chair; Michelle W. Bowman; Lael Brainard; James Bullard; Richard H. Clarida; Charles L. Evans; Esther L. George; Randal K. Quarles; and Eric S. Rosengren.

RELEASE DATE: MARCH 20, 2019

Information received since the Federal Open Market Committee met in January indicates that the labor market remains strong but **that growth of economic activity has slowed from its solid rate in the fourth quarter. Payroll employment was little changed in February, but job gains have been solid**, on average, in recent months, and the unemployment rate has remained low. **Recent indicators point to slower growth** of household spending and business fixed investment in the first quarter. On a 12-month basis, overall inflation has declined, largely as a result of lower energy prices; inflation for items other than food and energy **remains near 2 percent**. On balance, market-based measures of inflation compensation have remained low in recent months, and survey-based measures of longer-term inflation expectations are little changed.

Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. In support of these goals, the Committee decided to maintain the target range for the federal funds rate at 2-1/4 to 2-1/2 percent. The Committee continues to view sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2 percent objective as the most likely outcomes. In light of global economic and financial developments and muted inflation pressures, the Committee will be patient as it determines what future adjustments to the target range for the federal funds rate may be appropriate to support these outcomes.

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