

Treasuries React Dovishly To The Fed

- The Fed funds target range was left unchanged at 1.5–1.75% as expected
- The IOER rate was raised 5bps to 1.6%...
- ...as the Fed acknowledged improved funding conditions...
- ...and extended repo operations until “at least” April
- Dovish inflation references sparked a mild rate rally
- Powell guided T-bill tapering around mid-year

Markets reacted dovishly to the full suite of communications by placing greater emphasis upon what Chair Powell and the unanimously supported statement said about inflation and the avoidance of an early T-bill taper than the fact that the FOMC raised the IOER rate by 5bps and indicated that Treasury bill purchases would be tapered around the middle of the year. **It was a nearly perfect overall balancing act that worked well with kudos to the FOMC and Powell for pulling it off.**

The statement itself was largely shaken off and so was the partly priced IOER hike that was positioned to recognize relative stability in short-term rates, but markets had a dovish response to the press conference at precisely the moment when Chair Powell signalled discomfort if sub-2% inflation were to persist. **That leans against an impression in the market that the Fed may not react if down the line they continue to fall short of the inflation goal.** The two year Treasury yield fell by about 2–3bps immediately after the comment.

The statement itself contained only two wording changes as highlighted in the accompanying statement comparison. The first was immaterial in that referring to household spending rising at a “moderate” rate instead of “strong” is largely a statement of fact that should surprise no one.

DOVISH INFLATION GUIDANCE

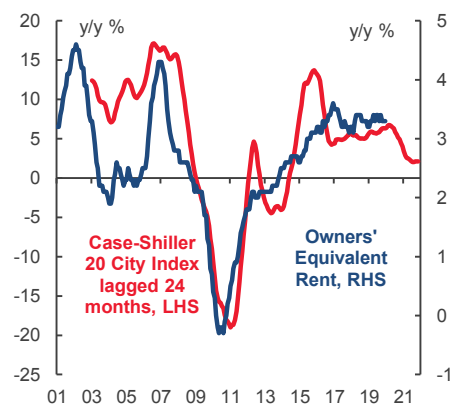
The second wording change piqued curiosity and it is where the statement shifted from “inflation near” the goal to “inflation returning to” the goal. Markets needed further clarification about why the wording was changed and Powell obliged when he was asked in the press conference about the significance of this change. He said “yes there is something to that change but **we wanted to underscore that 2% is not a ceiling and we’re not satisfied with inflation running below 2%.**” He also noted that “**We wanted to avoid suggesting that some policy makers would be comfortable with inflation below 2%.**” He also noted that 2% is not an inflation ceiling and that **the FOMC is determined to avoid the scenario that has plagued other regions as low inflation expectations dragged down actual inflation.**

That said, Powell stated in his opening remarks that **the FOMC “expects inflation to move closer to 2% over coming months as abnormally low prior readings**

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US Core CPI Could Face Downside Risk



Sources: Scotiabank Economics, BLS, Bloomberg.

drop out. That remains to be tested. My personal view is that core inflation will persist below 2% and will be weighed down by a combination of soft trend growth, ongoing USD pressures, declining nominal and real wage gains and idiosyncratic factors such as weak home price drivers of owners' equivalent rent which is basically the only main driver of overall inflation (recall [here](#)). The accompanying chart 2 shows that OER within CPI is likely to come under lagging downward pressure due to softer home price inflation. A similar influence upon the Fed's preferred core PCE gauge is expected.

When asked, Powell also noted that while the FOMC is comfortable with its stance now, over time, **an average inflation targeting framework—if adopted—would result in a different approach to monetary policy.** Their current framework is one in which they are equally concerned about deviations on either side of 2% but that doesn't express a specific intent to have these deviations symmetric.

Powell also guided that the FOMC had a further discussion about the ongoing strategic review. Expect further discussion about this in the meeting minutes in keeping with prior rounds of discussions in the minutes. Powell also repeated that they expect to conclude the review around the middle of the year and that they are just at the point of pulling it all together as a group now. There is little appetite across the FOMC for inflation make-up strategies like price level targeting for instance but it has not been made clear what the FOMC's stance is toward more of an average inflation targeting framework.

IOER GUIDANCE

Powell guided that the FOMC's goal is to keep IOER well within the fed funds target range but resisted being pinned down on a rate. That said, he did indicate "clearly 5bps from the bottom or the top isn't that." Given the target range of 1.5–1.75%, that would seem to imply the IOER target is 1.6–1.65% which is in keeping with the 1.625% middle of the range. Why not just say it! **In any event, maybe this is a one and done IOER hike.**

As an aside, Powell noted that the Fed will be announcing its findings on the drivers of funding market challenges in terms of one-off factors and structural forces. He guided that a "tonne of work" has been done but that he didn't have anything formal to share today.

Personally I still don't see what their rush to hike IOER was about after having fouled up the early responses to funding challenges and they only tipped that "at some point" they might do it in the minutes after which no FOMC official spoke to it. Hence it was a coin toss into the meeting but not a material one. The FOMC faces high funding hurdles going forward but **the extension of repo operations "at least" through April assists** alongside guidance that the motive to this change is in part to get beyond the next tax season. I suppose they could well have also left the rate alone and adjusted repos later if needed, but that's not the route the Fed chose to take at this point.

BALANCE SHEET POLICY AND TAPER GUIDANCE

On balance sheet policy, Chair Powell offered a few forms of updated guidance.

1. The FOMC wants **reserves to be no lower than US\$1.5 trillion.** They expect reserves will continue to move up and down over the calendar year in a wide range but US\$1.5 trillion is the bottom end of the target range.
2. They will know that the system has ample reserves when they no longer have to make heavy use of open market operations to control rates within their target range. Market pricing will reveal optimal reserves which is welcome by comparison to the Fed's earlier efforts during the unwinding phase toward seeking to guide what markets need in terms of optimal reserves.
3. **They expect this to happen around 2020Q2** given an ongoing US\$60 billion monthly pace of buying T-bills.
4. **At that point, they expect to begin to taper treasury bill purchases** with smaller purchases thereafter while slowing the range of change in the balance sheet. **This approach pushes back on fears that the Fed might have pursued an early tapering of bill purchases. This may have also played a role in the market reaction in that it avoided taper tantrum concerns.**

5. **On the Standing Repo Facility**, Powell noted that there may well be a role for repo activity even after ample reserves are achieved but that they have not made a decision on a standing repo facility but will return to this fairly soon. They are debating how useful it would be and the costs relative to the benefits and went on to guide that one shouldn't assume a decision one way or the other and that there is no urgency to do so.

Powell was also asked about the impact of the coronavirus and predictably noted that there is likely to be some disruption to activity in China and elsewhere but the situation is in its early stages and it is very uncertain what may be the macroeconomic effects. Powell concluded that "In light of that uncertainty, I will not speculate at this point but we are carefully monitoring the situation."

This comment mildly tempered an otherwise cautious degree of optimism toward a possible but modest pick-up in global economic activity with Powell concluding "We are not at all assured of a global rebound but there are causes for some optimism as we monitor the coronavirus."

Please see the attached statement comparison.

RELEASE DATE: JANUARY 29, 2020

Information received since the Federal Open Market Committee met in December indicates that the labor market remains strong and that economic activity has been rising at a moderate rate. Job gains have been solid, on average, in recent months, and the unemployment rate has remained low. Although household spending has been rising at a **moderate** pace, business fixed investment and exports remain weak. On a 12-month basis, overall inflation and inflation for items other than food and energy are running below 2 percent. Market-based measures of inflation compensation remain low; 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. The Committee decided to maintain the target range for the federal funds rate at 1-1/2 to 1-3/4 percent. The Committee judges that the current stance of monetary policy is appropriate to support sustained expansion of economic activity, strong labor market conditions, **and inflation returning to** the Committee's symmetric 2 percent objective. The Committee will continue to monitor the implications of incoming information for the economic outlook, including global developments and muted inflation pressures, as it assesses the appropriate path of the target range for the federal funds rate.

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 monetary policy action were Jerome H. Powell, Chair; John C. Williams, Vice Chair; Michelle W. Bowman; Lael Brainard; Richard H. Clarida; Patrick Harker; Robert S. Kaplan; Neel Kashkari; Loretta J. Mester; and Randal K. Quarles.

RELEASE DATE: DECEMBER 11, 2019

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