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NEUTRAL MEANS A HIKE IS JUST AS LIKELY AS A CUT

FOMC UPDATE

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This is Christian Brobst. I'm here with Matt Freund to get his thoughts and assessments on this afternoon's Fed statement and the subsequent press conference with Federal Reserve Board Chairman Jerome Powell.

Q: *Matt, in light of today's statement, I'll ask you the same question I did six weeks ago: Has the Fed made a policy mistake somewhere along the way here?*

A: No, I don't think they have. I think that when you look at the Fed actions, specifically in December, the Fed did what was largely priced into the market. Things really didn't start to unravel until the following press conference where, quite frankly, people were surprised by the strength of the chairman's statements about future hikes. In hindsight, I think the markets might have made a mistake and given a little bit too much conviction to the statements, or had too much confidence in the statements of the new Fed chairman. I think communication is still an issue where we are learning how to interpret Chairman Powell's statements.

Q: *To that point, we've talked before about Chair Powell's press conference comments straying somewhat from the content of the Fed statements. Did anything of that nature stand out to you today?*

A: Again, no. His comments were very, very consistent with today's press release following the announcement and really stayed on message. So, there was nothing that came out that was dramatically different than what the Fed released in its statements earlier in the day.

Q: *Post-statement, the market is pricing in roughly a 40% chance of a Fed rate cut in 2019. Does that seem reasonable to you?*

A: You know, I think the markets may be making a mistake here. It's a small one, but I think they're making a mistake. The dot plots that came out along with the Fed statement show that there are zero hikes priced in for the rest of the year. And the market celebrated and said, "Look, that's a ceiling on interest rates and the next move is most likely down." I think, though, when you listen to what Chairman Powell said, it's a ceiling but it's also a floor. He has been very, very consistent in saying that we are now at neutral despite what he may have indicated a quarter or two ago. Being at neutral, he can see no reason for rates to be higher or lower.

I think what that means is they're data dependent and that a hike is just as likely as a cut.

Q: *What about the status of the yield curve post-meeting? Is there anything that stands out to you there?*

A: When you look at the yield curve and the difference between very short rates and longer rates, specifically 3-month rates and 10-year rates, the yield curve continues to flatten. We thought it was fairly flat when it was 15 basis points and now it's 10 basis points or slightly less. What I think that means is that the economy is under a lot of pressure and that's a key cause for concern. You think about a flat yield curve and how it affects the market. It really affects both the providers of capital and the users of capital. Think about financials: They generally don't do well in a flat curve and certainly not in an inverted curve. And the reason for that is they're less likely, they're less willing, to provide capital when they are borrowing and lending off the same rate. It's hard to make money, so you'll hear talk about the net interest margin shrinking. At the same time, the users of capital find that when their expected return on that capital starts approaching the cost of that capital, it makes more sense to delever. So, a flat yield curve shows pressure on the economy. We actually think it's more important now because of the high levels of debt—with demographics that have clearly turned negative here in the United States—and also the absolute level of rates. With rates this low, there is very little margin for error.

Q: *Lastly, what about the details of the balance sheet runoff and taper plan? Is there anything there that stood out to you about the details?*

A: That's a great question. It really was surprising. Prior to today's announcement, we thought they had a much longer runway. In fact, we were told that the balance sheet runoff was on autopilot and it would be like watching grass grow or paint dry. It turns out that Chairman Powell grabbed the wheel more quickly than anyone thought. So, they talked about reducing the taper until the fall—about September—and then in September potentially stopping shrinking their balance sheet. It's too soon to know exactly what that means. There's going to be an awful lot of work done over the next days and weeks trying to understand all the ramifications.

But right off the bat, it appears that the Fed was very concerned with liquidity in financial conditions. We noticed that the Fed funds rate was really at the ceiling of their range and that we were hearing anecdotally that the very short-term markets were getting much more difficult in Q4. Couple that with uncertainties going on outside the United States and pressures that we're seeing with global central banks, and I think it was enough for caution. But, again, the jury's still out.

Thanks very much for sharing your insight today, Matt. We'll look forward to checking in again following the May 1st meeting.

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