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Wishful thinking about 2020

FOMC Post-Meeting Comment

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Summary

- The FOMC does not expect to hike anymore in 2019, but they think that one hike in 2020 is still warranted.
- The Fed will start to taper its balance sheet normalization in May 2019, end it in September 2019, and then change the composition toward treasuries.
- We still expect the US economy to slide into recession in the summer of 2020 and the Fed to cut rates in 2020, after remaining on hold in 2019.

One more time, but not this year

The FOMC does not expect to hike anymore in 2019, but they think that one hike in 2020 is still warranted. The previous version, published in December, still showed two hikes in 2019 and one in 2020. So the Fed now has a lot of patience, and we would like to add: a lot of wishful thinking. If they are still thinking about a hike in 2020, this means that they think that the current spell of weak data will be followed by a reacceleration of the US economy that will stretch well into 2020. In contrast, we think that the current economic expansion is coming to an end and that it is more likely that the economy will slide into a recession next year.

Powell said that patience means no rush to judgment, but he still thinks that the US economy is in good place, and the FOMC wants to keep it there. However, the FOMC statement acknowledged that growth of economic activity has slowed, in particular household spending and business fixed investment. What's more, the FOMC projections for GDP growth were reduced for 2019 and 2020, and the unemployment projections raised for 2019, 2020, and 2021. The FOMC statement also mentioned that inflation has declined largely due to lower energy prices and PCE inflation projections were lowered for 2019, 2020, and 2021.

The longer run estimate for the unemployment rate was reduced once again, this time to 4.3% from 4.4%. So the lack of serious wage pressures despite unemployment at 3.8% has not gone unnoticed by the FOMC. Interestingly, the longer run estimate for the fed funds rate remains at 2.8%, so the projected 2020-2021 level of 2.6% would still be below neutral. Does that mean that the Fed expects to hike further in 2022, after another pause in 2021? Or is the Fed's plan simply showing a lack of cohesion?

Balance sheet normalization in composition

The Fed will start to taper its balance sheet normalization in May 2019 by reducing the cap (above which redemptions are reinvested) on treasuries to $15bn/month from $30bn/month. At the end of September 2019 the cap on treasuries will be reduced to 0. This means that all proceeds will be reinvested. Beginning in October 2019, the Fed will start to reinvest the principal payments from agency MBS and debt subject to a maximum amount of $20bn/month in treasuries. Anything above this cap will be reinvested in agency MBS. This means that the total amount of securities will remain unchanged from the end of September 2019, which means the end of balance sheet normalization, but the composition will change in line with the Fed's longstanding plan to hold primarily Treasury securities in the long run.

Cutting, not hiking

While the Fed is still thinking of hiking in 2020, we think that the Fed's extended pause is in reality the end of the hiking cycle. We expect the Fed's target range for the federal funds rate to remain unchanged for the remainder of the year, followed by rate cuts in 2020 as the economy starts to slide into a recession. Our recession probability model continues to point to a recession in the summer of 2020, with a 60% probability in July 2020.

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