Technical tweaks and dovish squeaks

FOMC Post-Meeting Comment

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Summary

- The FOMC kept the target range for the federal funds rate unchanged at 1.50%-1.75%. Powell repeated that it would take a 'material reassessment' of the economic outlook to change the current stance of monetary policy. Overall, the FOMC statement and Powell sounded dovish with a slight downgrade of household spending, a more explicit commitment to get inflation back to target, an acknowledgement of the serious nature of the Corona virus, and the acknowledgement of remaining trade policy uncertainty.
- The Board of Governors made an upward technical adjustment of 5 bps to the IOER rate and the ON RRP rate to force the effective federal funds rate closer to the midpoint of the target range.
- The FOMC directed the Open Market Desk to continue its purchases of Treasury bills at least into Q2, and to continue its term and overnight repo operations at least through April (instead of January).
- While the Fed thinks it made a mid-cycle adjustment to the target range for the federal funds rate last year, the economic indicators suggest we are late in the cycle. Therefore, we expect the Fed will be forced to cut the lower bound for the federal funds rate all the way back to zero before the end of the year.

Dovish squeaks

As expected, the FOMC kept the target range for the federal funds rate unchanged at 1.50%-1.75%. During his press conference Chairman Jerome Powell repeated that it would take a 'material reassessment' of the economic outlook to change the current stance of monetary policy. Overall, the FOMC statement and Powell's words were dovish. The formal statement described household spending rising at a 'moderate' pace, instead of a 'strong' pace as in December. Powell also explained that the change in language from describing inflation as 'returning to' its 2% target supported by the current stance of monetary policy instead of 'near' target was to underscore the commitment of the Committee to the 2% target rather than being comfortable with inflation persistently below target. He expects the review of the monetary policy framework to be concluded by the middle of the year. Powell did not downplay the possible impact of the Corona virus and said that it was a very serious issue and that the Fed was very carefully monitoring the situation. Finally, Powell said that the Phase 1 trade deal and the USMCA were potentially positive developments, but he stressed also that trade policy uncertainty remains elevated with businesses having a wait and see attitude whether this is going to be sustained. On balance, it sounded as if a material reassessment of the outlook is more likely to lead to a rate cut than a hike.

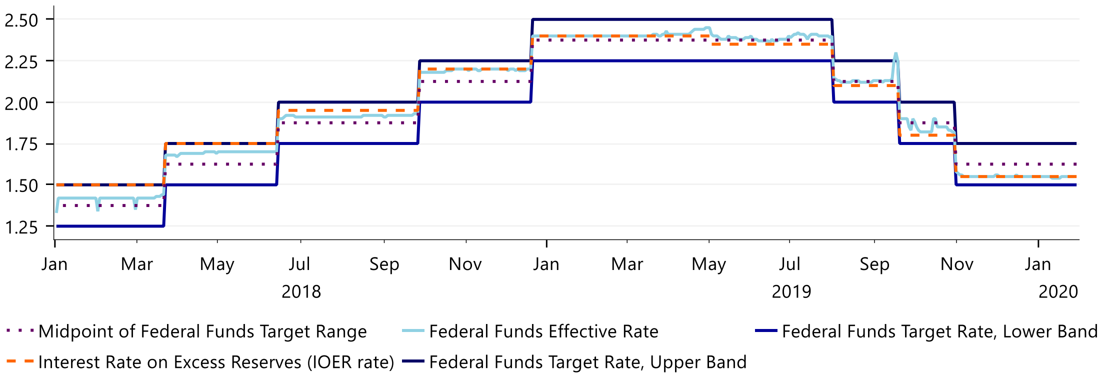
Technical tweaks

While the FOMC kept the target range for the federal funds rate unchanged at 1.50%-1.75%, the Board of Governors decided to make an upward technical adjustment of 5 bps to the IOER rate and the ON RRP rate, as suggested in our FOMC preview. Effective tomorrow, the IOER rate will rise to 1.60% (from 1.55%) and the ON RRP rate will rise to 1.50% (from 1.45%). According to the implementation note this is intended to foster trading in the federal funds market at rates well within the FOMC's target range. So it is merely a technical adjustment, not a change in the stance of monetary policy.

In October, when the FOMC reduced the target range for the federal funds rate by 25 bps to 1.50-1.75%, the Board of Governors made a similar size cut to the IOER rate, from 1.80% to 1.55%. However, since then the effective federal funds rate has dropped below the midpoint of the target range and has been close to the IOER rate (figure 1). In order to get the effective federal funds rate back to the midpoint of the target range (1.625%), the IOER rate should be raised by approximately 0.075% from 1.55%. So a 5-10 bps technical hike in the IOER rate should do the trick, as we proposed in [Another tweak to the IOER rate?] prior to the December meeting. A rise in the ON RRP rate would reinforce this for a wider group of counterparties. Today, the Board of Governors decided to first try 5 bps. However, as the balance sheet continues to be expanded we may see the Board make another 5 bps hike in the IOER and ON RRP rates (at least in relative terms) somewhere down the road.

Basically, this and possible further hikes in the IOER rate would be the reverse of what we saw in June 2018, December 2018 and September 2019, when balance sheet normalization (= reduction) played an important role in pushing up the effective federal funds rate within its target range. In response, the Board of Governors made three technical downward adjustments of 5 bps to the IOER relative to the target range for the federal funds rate (i.e. a 20 bps hike, a 20 bps hike, and a 30 bps cut in the IOER rate). Now that the Fed is expanding its balance sheet again to stabilize the repo market, the opposite is happening. In addition to the balance sheet expansion, temporary repo operations are also pushing the effective federal funds rate down.

Figure 1: Fed funds rate and IOER rate



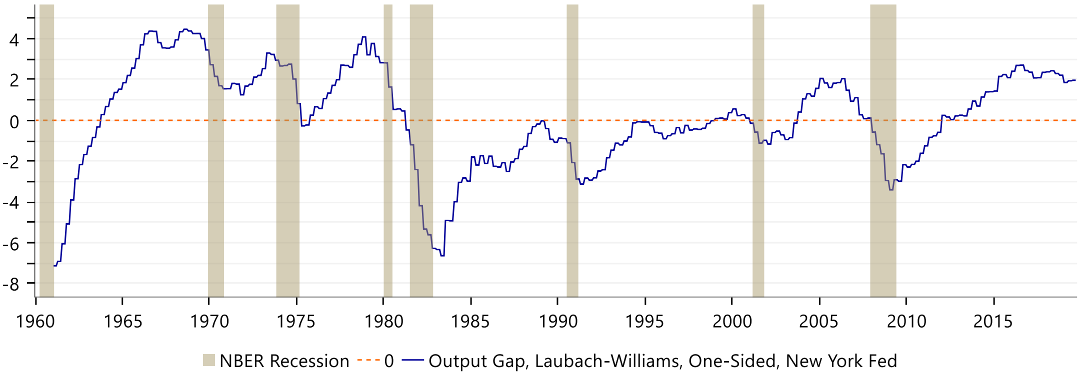
Source: Macrobond

The repo problem

The persistent cause of the drift in the effective federal funds rate – making the technical tweaks necessary – is the changing size of the Fed's balance sheet, while the temporary repo operations are adding to the problem. While the repo markets reached the new year without the turmoil that we saw in September, this was largely due to the large injections of reserves by the Fed. However, the underlying problem in repo markets remains. As we have explained in [Repo control], if the Fed does not develop better tools to control the repo markets - such as a standing repo facility -, it is only a matter of time before we get another episode of repo stress.

During the press conference, Powell said that the Fed had not yet made a decision on the potential role of a standing repo facility. However, they would fairly soon return to this question. He said the Fed was still learning about the ample reserves regime and what role repo would play in it. The Fed will be announcing their findings on the investigation into the repo turmoil, but he already indicated that in order to be in an ample reserves regime the level of reserves should not be below $1.5 trillion. However, this is the bottom end of the range and most of the time it would be substantially higher. Powell said that he expects to reach an ample reserves regime sometime in Q2. Then the Fed can slow down its pace of bill purchases and its use of repo operations. Repo operations may continue to serve as a backstop. However, for now the FOMC implementation note repeated that it directs the Open Markets Desk to continue purchasing Treasury bills at least into Q2, and to continue conducting term and overnight repo operations at least through April (instead of January).

Figure 2: Output gap has peaked



Source: Macrobond

Material reassessment ahead?

So it will take a 'material reassessment' of the economic outlook for the FOMC to change the current stance of monetary policy. For now, the Committee thinks that it made a mid-cycle adjustment in 2019 with three insurance cuts. In contrast, we think that the leading indicators point to the late phase of the cycle, see for example the output gap in figure 2. Therefore, we expect the Fed will be forced to cut rates all the way back to zero before the end of the year. Our full forecast of the Fed's path for the federal funds rate is summarized in table 1.

Table 1: Rabobank forecasts of FOMC decisions

FOMC meeting	*Decision*	*Target range for the federal funds rate (%)*
29 Jan 2020		1.50-1.75
18 Mar 2020		1.50-1.75
29 Apr 2020	25 bps slowdown cut	1.25-1.50
10 June 2020	25 bps recession cut	1.00-1.25
29 July 2020	25 bps recession cut	0.75-1.00
16 Sept 2020	25 bps recession cut	0.50-0.75
5 Nov 2020	25 bps recession cut	0.25-0.50
16 Dec 2020	25 bps recession cut	0.00-0.25

Source: Rabobank

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