QNB Economics
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Unpacking the US Federal Reserve dovish hike

The US Federal Reserve, widely known as simply 'the Fed,' delivered another 25 basis point (bp) hike in its policy rate following the 18-19th December meeting of its Federal Open Market Committee (FOMC). The decision comes despite political pressures, a substantial tightening in financial conditions, a less impressive growth outlook and softer inflation and inflation expectations.

The rate hike was the fourth of the year and the ninth since the tightening cycle started in December 2015. While the target range for the Fed funds rate was lifted to 2.25-2.50%, the path for future rates or the median projection for 25bp rate hikes over 2019-2021 was lowered to 3 from 4 in September.

Our analysis delves into the two reasons for hiking and maintaining quantitative tightening and the two reasons for conveying a more dovish message about the future policy path.

On the reasons for hiking and maintain quantitative tightening.

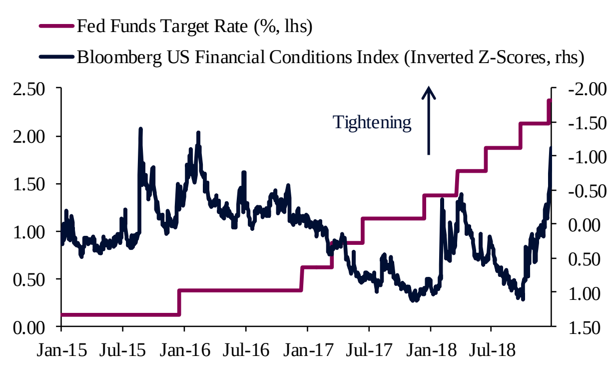
First, monetary policy normalization is supported by a well performing US economy with solid growth, low unemployment and a tight labor market that keeps on strengthening. As the economy continues to grow around 2.5-3% y/y or 0.6-1% above the 1.9% GDP potential growth rate, spare capacity is diminishing rapidly. Different measures of unemployment are hovering around multi-decade lows, while wage growth is accelerating to close to 10-year highs. In addition, the latest tax cuts contributed to lift the optimism of US consumers and businesses. Gauges of consumer and small business confidence had recently reached levels only previously seen at the peak of the 1990s technology boom or other record highs registered some 45 years ago.

An internal buildup of macroeconomic and financial imbalances with distortions in goods, labor or asset markets may follow a period of overconfidence and overspending. The US monetary policy is still away from tight territory. Even after this well-telegraphed 25bp rate hike, the Fed funds target range is almost 75bp below the official estimate of a long-run equilibrium or so-called 'r*' policy rate of around 2.75-3.00%. Supply side improvements could lift GDP potential and push this long-run or neutral level of interest rates further up, creating a wider gap.

Second, when it comes to balance sheet normalization, recent market concerns about the potential impacts of quantitative tightening (QT) or the unwind of quantitative easing are misplaced. There is no evidence to the idea that the recent market sell-off is driven by a QT-led squeeze in market liquidity. Should it be the case, and given the composition of the assets under the Fed's balance sheet, the market would be overwhelmed by duration risk and the term premium of Treasury yields would be widening instead of narrowing. The US Treasury curve has flattened recently, with 10-year yields back down to 2.74%, only 16bp above 1-year yields and 18bp above both 2- and 5-year yields. While the Fed's balance sheet and banks' excess reserves are down USD 440 billion and USD 1.1 trillion from their peak, respectively, excess reserves are still very high at USD 1.6 trillion.

Monetary authorities have enhanced their communication strategy since the 2013 Taper Tantrum, when uncertainty about the future of the Fed's balance sheet created market turmoil. Based on that experience, the Fed designed the current passive and predictable policy in which assets wear off naturally with no replacement of maturing securities. The bar is really high to halt the QT and this is unlikely to take place unless there is very clear new evidence of its effect on broader financial conditions.

Tighter monetary and financial conditions



Sources: Bloomberg, QNB Economics analysis

On the reasons for a more dovish message about the future policy path.

First, inflation and inflation expectations edged down in recent months. CPI and core CPI inflation are down to 2.2% from 2.5% and 2.9% in July, respectively. Similarly, market 5-year/5-year forward inflation expectations are also down 30bp. This should be considered in a context in which the Fed is willing to tolerate a modest overshoot of its 2% inflation target to compensate for the long-period of sub-2% inflation this decade and reach the so-called "symmetric" inflation target.

Second, on top of that, a significant correction in equity markets are driving an exogenous tightening of financial conditions. According to the Bloomberg US Financial Condition Index, which tracks the overall level of stress in money, bond, and equity markets to help assess the availability and cost of credit, financial conditions have tightened considerably since October and turned restrictive in early December. In other words, financial markets are doing part of the job for the Fed, leaving less room for future hikes.

In short, as the economy continues to perform but tighter financial conditions increase the downside risks for the economy, the Fed is expected to proceed with rate normalization in a more cautious and data dependent way.

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