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The Fed's Likely to Take a Rate-Hike Breather in 2019

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Federal Reserve Chairman Jerome Powell and his colleagues are likely to turn more wary about marching interest rates higher after delivering a widely anticipated quarter percentage-point increase in December.

Prospects for slowing global economic growth, fading U.S. fiscal stimulus and volatile financial markets all argue for more caution once officials lift rates next month near or into neutral territory, where policy neither spurs nor reins in economic activity.

Investors have already reduced bets on how many times the central bank will hike next year, partly reflecting a more dovish tone from policy makers in the past week, though a move at next month's meeting is still firmly priced with odds above 70 percent.

"December is probably too early for pause, but we could certainly see it in the first half of next year,'' said Gene Tannuzzo, fund manager and deputy global head of fixed income at Columbia Threadneedle Investments. "Markets need to adjust to lower and slower, both in terms of growth and interest-rate increases."

That would probably be welcome news for a stock market that is struggling to find a floor after selling off from record highs. The S&P 500 Index has fallen about 10 percent from a September peak on a variety concerns, from worries about the U.S.-China trade war to doubts about lofty valuations of technology shares. Corporate bond spreads have widened as well as investors have become more risk averse.

Federal Open Market Committee members in September provisionally penciled in three rate increases for 2019, according to their median forecast released at that time. They are due to update that forecast at their Dec. 18-19 meeting.

With stocks down and growth in Germany and Japan contracting last quarter, "I wouldn't be surprised if the Fed backs away from the three hikes it has built into 2019,'' said Donald Ellenberger, a senior portfolio manager at Federated Investors Inc.

Gautam Khanna, a senior fund manager at Insight Investment, agreed that the recent pick-up in financial markets' volatility will probably prompt the Fed to reassess its 2019 rate hike plans. At the start of this month Khanna had expected the Fed to deliver the three hikes it signaled in September.

Collectively, traders in money-market derivative contracts are betting on just over one 2019 rate hike — pricing in only about 0.33 percentage point of tightening. That's down from the more than 0.50 percentage point they expected earlier this month.

Some long-time Fed watchers, though, are sticking with their forecasts of four hikes in 2019, arguing that a solid domestic economy and ultra-low unemployment call for higher rates.

They include JPMorgan Chase & Co.'s Michael Feroli, Goldman Sachs Group Inc.'s Jan Hatzius and Bank of America Merrill Lynch's Ethan Harris. Peter Hooper, a 26-year veteran of the Fed who is chief economist for Deutsche Bank Securities, is also currently predicting four increases, although he allowed that call could change given recent softness in inflation.

What Our Economists Say:
"The key question for the Fed is whether the terminal policy rate will end up lower than in previous tightening cycles. Central bank officials may not be able to precisely identify the neutral policy rate in real time, but a continual decline in the terminal fed funds rate over the past several tightening cycles serves as a cautionary reminder that a smaller dose of normalization may prove adequate this time around.''

— Yelena Shulyatyeva, Tim Mahedy and Carl Riccadonna, Bloomberg Economics
Powell will get chance to spell out the Fed's thinking when he addresses the Economic Club of New York on Nov. 28. Speaking in Dallas last week, he laid out a scenario for a pause in the central bank's interest-rate hiking campaign sometime next year by highlighting potential headwinds to the U.S. economy.

Powell's decision to hold a press conference after every policy-making meeting starting next year gives the FOMC more flexibility to pause because it will have a realistic option of raising rates at its next gathering, said Nathan Sheets, chief economist at PGIM Fixed Income.

More Press Conferences
The Fed currently only holds a press conference every other meeting and investors have tended to discount non-press-conference meetings for policy action, even though officials have repeatedly said every meeting is live.

Any scaling back in the Fed's rate projections would face complications. President Donald Trump has vociferously and repeatedly criticized the Fed's rate increases. "We have much more of a Fed problem than we do with anyone else,'' he told reporters in Washington on Tuesday.

The last thing that Powell and his colleagues probably want is to be seen as caving in to the president's demands. That would undermine the central bank's credibility and could cripple its ability to steer the economy.

The Fed also likely wants to avoid being seen as rushing to the rescue of the beleaguered stock market. Powell said last week that equity price moves were only one of many factors that the Fed takes into account in setting policy.

"Central banks by their nature don't want to seem fickle,'' Feroli said. "If their rhetoric changes abruptly, people will think they're playing to the equity market.''

Besides, the Fed has been seeking some tightening of financial conditions in the markets to help slow growth and prevent the economy from overheating. For much of its rate hiking campaign that hasn’t occurred. And even with the recent market turmoil, financial conditions are still supportive of growth, Hooper said.

The risk is that the market moves could happen in a “very sharp and non-linear’’ way rather than being the “gradual thing that everybody always hopes for but never seems to happen,’’ Tobias Adrian, financial markets chief at the International Monetary Fund, told a Cato Institute conference in Washington on Nov. 15.

Powell said last week that policy makers will be monitoring how financial markets, businesses and the economy respond to dearer credit as the FOMC weighs how far and how fast to raise rates.

“The debate right now isn’t whether they go in December,’’ Bank of America’s Harris said. “It’s about when do they pause next year. That’s going to be increasingly data dependent and it’s going to be a game-day decision to some degree as we go into next year.’’