The Fed in the spotlight

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THE US FEDERAL RESERVE (FED) HAS GARNERED LOTS OF ATTENTION LATELY, WITH MEDIA COMMENTATORS DIVINING VARIOUS OFFICIALS' SEEMINGLY CONTRADICTORY COMMENTS, PRESIDENT DONALD TRUMP FREQUENTLY INVOKING FED CHAIRMAN JEROME POWELL'S NAME, AND NERVOUS INVESTORS WONDERING ABOUT THE CENTRAL BANK'S RATE-HIKE PATH IN 2019. I sat down with Jeremy Forster, a fixed income portfolio manager and member of the Hartford Total Return Bond Fund Team. He focuses on global macro and US rates strategies, including developing fundamental and market-driven valuation models and determining relative value across sectors. I asked him about the current state of the Fed, including his views on key players and where he thinks they are headed.

Nanette: The Fed seems to have changed its posture recently, becoming somewhat more dovish. Is Chairman Powell bowing to political pressure?

Jeremy: No, I believe the Fed is responding to economic data and financial conditions, not political posturing. Higher US interest rates over the past two years are feeding into the real economy in sectors, such as housing. Meanwhile, the global economy is slowing. Those factors, coupled with lower equity markets and wider credit spreads, have tightened financial conditions. There is a lot of support for Chairman Powell in the current administration, and I believe he has enough experience—both practical and political—that he won't feel compelled to adjust policy just to please the president.

Nanette: How would you say the Fed's composition has changed?

Jeremy: Since the financial crisis in 2008, there are more practitioners and fewer academics among the regional bank presidents and governors on the Federal Reserve Board. This mix likely leads to more pragmatic decision-making than a framework more reliant on economic models. For example, I think the Federal Open Market Committee (FOMC) will be less likely to set policy based on the expectation that tightness in the labor market will lead to higher inflation, and will instead wait to see if inflation does, in fact, surpass the target. As a result, I think this means the risk that the FOMC will raise policy rates above 10-year Treasury yields—inverting the yield curve—is lower. Incidentally, this type of pragmatism should be relatively supportive of risk assets, as I think practitioners tend to pay more attention to financial market conditions than academics do.

Key Points

- All eyes will be on decisions that the US Federal Reserve (Fed) will make in 2019 and beyond.
- We may be looking at one more rate hike in 2018 and two in 2019; one less than is currently forecasted.
- It's likely that the Fed will continue to be more focused on the yield curve, market signals, and economic data.

Nanette: So you don't expect the yield curve to invert?

Jeremy: I don't expect 10-year yields to fall below policy rates in the near future. In order to get a fully inverted yield curve, we would need either a much higher probability of recession next year or a notable pickup in inflation that leads to a more aggressive hiking trajectory. I don't see either of these scenarios playing out in 2019. I expect a relatively flat yield curve, with around a 3% yield for both two-year and 10-year US Treasury notes.

Nanette: What do you think the Fed's path will be in 2019?

Jeremy: My base case is a final 2018 hike this month, and then two more increases in 2019, one fewer than the Fed is currently forecasting. I see the federal funds rate ending 2019 at between 2.75% and 3.0%.

Nanette: How tough is the Fed's job at this point of the economic cycle?

Jeremy: Very tough. They are trying to get the right balance between removing 10 years of accommodative policy without curtailing the recovery. Given volatile markets and signs that global growth is slowing, it's likely that the Fed will continue to be more focused on the yield curve, market signals, and economic data. I think it's important to note that the Fed's heightened focus on data doesn't necessarily signal that the end of its hiking cycle is imminent, which is what the market seems to be concluding.

Nanette: It sounds like it will be more difficult to read the Fed's proverbial tea leaves from here out.

Jeremy: Yes, I think so. We'll need to watch how the inflation backdrop develops along with financial conditions and economic activity. If inflation and inflation expectations gradually move higher, I think there will be more scope for increased policy rates through 2019. However, if inflation continues to stay around 2% or lower, then I think we will see a more patient FOMC.

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Investment Implications

Block the political noise. Independence is critical to a central bank's credibility, and the Fed is unlikely to be swayed by political pressure.

The Fed will try to avoid hiking so much as to cause a recession. The Fed's composition tilts it in a dovish manner, and it is unlikely to hike rates much more unless inflation prints consistently above 2%.

Risk assets have the potential to outperform. Despite slowing global growth, if the Fed is mindful not to invert the yield curve, then risk assets are likely to be supported.

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