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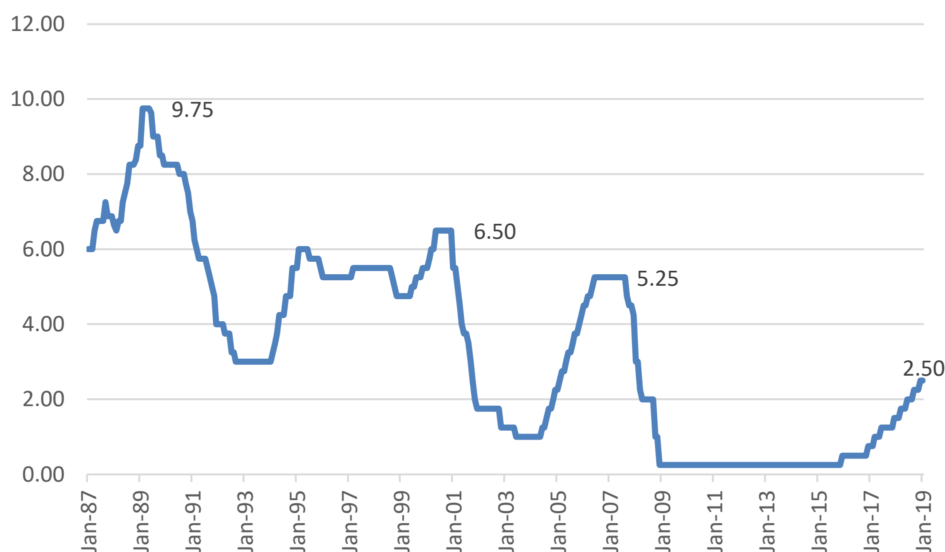
US FOMC – patience is a virtue

Facts

- The US Federal Open Market (FOMC) meeting was held from 29 to 30 January. As expected, the FOMC committee decided to maintain the Federal Fund Rate (FFR) target range between 2.25% and 2.25%. In the accompanying statements, the FOMC members continue to express their conviction of strong labour market condition and economic activities have been growing at a solid rate.
- The statement regarding the balance sheet normalization indicates that the Fed primary monetary policy tools will continue to revolve around the FFR. Apart from that, the committee is stand ready to alter the size and composition of Fed balance sheet should the future economic condition warrants for further policy accommodation. Currently, the size of Fed balance sheet stands at USD4.05 trillion as of 23 January 2019 from last year's average of USD4.28 trillion.
- Interestingly, the FOMC also indicates that committee will be patient in determining the future adjustment of FFR in order to support their dual mandate i.e. fostering the maximum employment and ensuring the price stability. It was a unanimous decision among the FOMC member. The FOMC meeting will be held between 19 and 20 March 2019.

Chart 1: Federal Fund Rate (FFR)



Source: Bloomberg

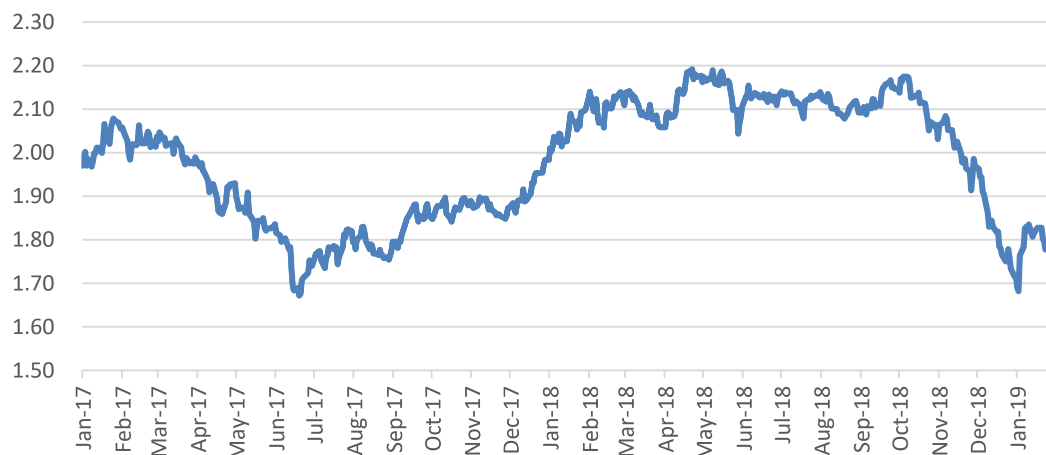
Over View

In a nutshell, the Fed is expected to keep the rate unchanged at the prevailing level throughout the year 2019. The FOMC is cognizant on the evolving economic outlook especially in the context of heightened uncertainties with respect to the trade discussion between the US and China, UK Brexit, slowing China's economy and volatility in the financial and commodities markets. At the current juncture, there has been talks that the Fed would cut the FFR at some point beyond this year. Official organization such as the US Congressional Budget Office (CBO) has predicted the FFR would be reduced in 2023 as the output gap would turn negative during that year. Even some traders are seeing the Fed would reduce the rate as early as in 2020. The Fed also playing down the sentiment on possible reduction in their balance sheet size by indicating that it may alter the size as they deem fit. They are not in a hurry to offload their government securities.

So what does this mean? The FFR would have reached its neutral level – a rate that is neither contractionary nor expansionary. Following this, the effect of the previous tightening would starts to be felt. This is especially true as the monetary policy response would take a while to make an apparent impact to the real economy. Thus far, the inflation expectation has been low at around 1.83% compared to last year's average of 2.08%. The implied inflation expectation was premised on the difference between the 10-year Nominal US Treasury yield and the 10-year Treasury Inflation Protected Securities (TIPS).

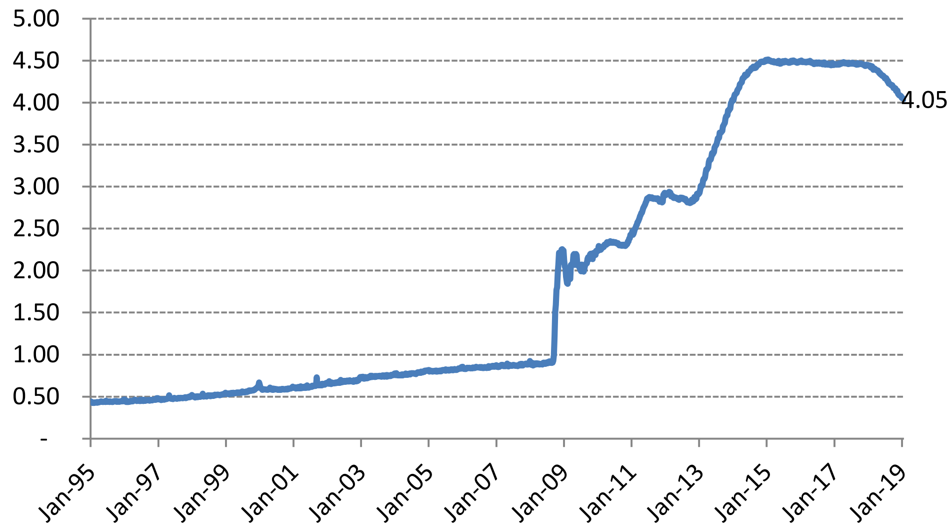
Therefore, the narrative of slowing economy is still valid although the Fed may want to stop hiking its policy rate. Already, we have seen the Global Purchasing Managers Index (PMI) has been declining from 54.5 points in December 2017 to 51.5 at the end of last year, suggesting that the degree of optimism among the businesses are faltering. Against such backdrop, the bond yields are expected to come down as demand for the risk-free assets could be higher at a time when risk aversion would become prevalent.

Chart 2: Inflation expectation - 10-yr UST Nominal Yield less 10-yr TIPS



Source: Bloomberg

Chart 3: Federal Reserve balance sheet (USD trillion)



Source: Bloomberg

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