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US: Fed turning a corner, but into which direction?

■ Although US growth remains strong, global headwinds, softer survey data and tighter financial conditions have put the FOMC in risk management mode ■ Policy remains data dependent, but a patient stance will be adopted before deciding on the next move in monetary policy ■ Inflation, which remains well under control, facilitates this wait-and-see attitude ■ Markets are now pricing in a policy easing in the course of 2020. More than anything else, this shows to which extent uncertainty has taken its toll on confidence

"Uncertainty is not the friend of business". This quote from Jerome Powell in his post-FOMC meeting press conference this week neatly summarises what is at the heart of the global slowdown which started in 2018 and is finally impacting the US as well.

Uncertainty is multi-faceted. Last December Mario Draghi called it *"increased general uncertainty, which takes the shape now and then of different phenomena"*. Watching the ECB president last week and the Fed chairman this week, there are a lot of commonalities in their analyses. This is not surprising: the Chinese slowdown, the trade negotiations, Brexit worries, the US government shutdown are globally relevant. Powell spoke about a US economy which remains strong, despite the weakening of some survey data, but which is increasingly faced with the "cross-currents" mentioned before. This puts the Fed in risk management mode which dictates a patient approach. Waiting for more data before deciding on the next policy move (note that the direction is not mentioned) is all the easier because *"the case for raising rates has weakened"*. Inflation risks have declined and risks from financial imbalances (i.e. bubbles) have receded. Even more so, financial conditions, which the Fed assesses on the basis of a large number of market data such as volatilities and spreads, had tightened significantly in December and despite some easing, have remained rather restrictive.

Financial conditions are important in Fed thinking. After all, as mentioned by Powell, monetary policy works through changes in financial conditions in order to influence growth and inflation. This also means that tighter conditions influence the growth outlook and hence the assessment of what is an appropriate monetary policy stance.

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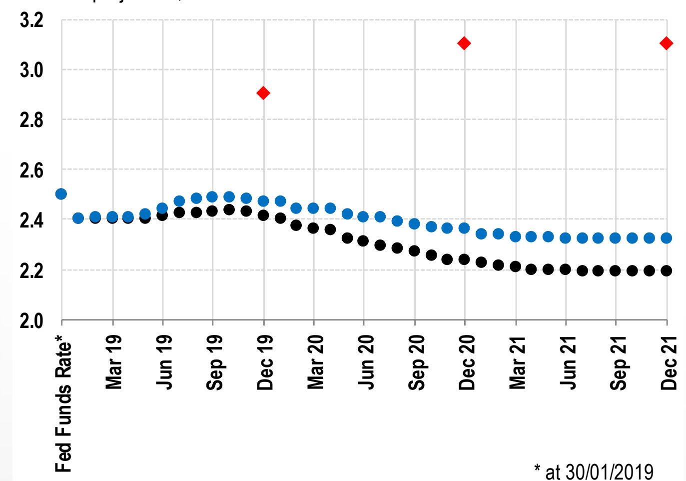
FEDERAL FUNDS: IMPLIED RATE BASED ON FUTURES CONTRACTS

● Expected fed funds rate (based on fed funds futures, 21/01/2019)
● Expected fed funds rate (based on fed funds futures, 30/01/2019)
♦ FOMC projection, 19/12/2018



Source: Datastream, BNP Paribas

p. 3 Markets Overview
p. 4 Pulse & Calendar
p. 5 Economic scenario

ECONOMIC RESEARCH DEPARTMENT

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Quite understandably, the FOMC's conclusion has been that the combination of cross-currents, less supportive financial conditions, softer survey data and inflation which remains fully under control warrant to be patient. This is all the more appropriate considering the symmetric inflation objective and the limited policy leeway to address a major slowdown or recession.

This more dovish message obviously caused a decline in bond yields and in the expected path for the federal funds rate (chart 1). The equity market had a cheerful reaction as well: lower rates imply a higher net present value of future cash-flows. Eventually, concern will however shift from the denominator (the discount rate) to the numerator (cash-flows) and in this respect the fact that fixed income markets are now pricing in a policy easing in the course of 2020 is sobering. If this pricing would turn out to be correct, it would mean that in about 12 months' time the FOMC would consider that policy has actually become too tight giving the growth outlook.

Clearly, this is still a long way off and market pricing will float on the waves of the economic data. The Markit manufacturing PMI data for January (chart 2) provided ammunition for those arguing that the glass is now half empty. Although France rebounded, the eurozone number is now very close to 50 and Germany has moved just below this mark (49.9 versus 60.6 in February last year!). Spain is up but Brexit fears are taking their toll in Ireland. Importantly, the Chinese index has dropped further below 50.

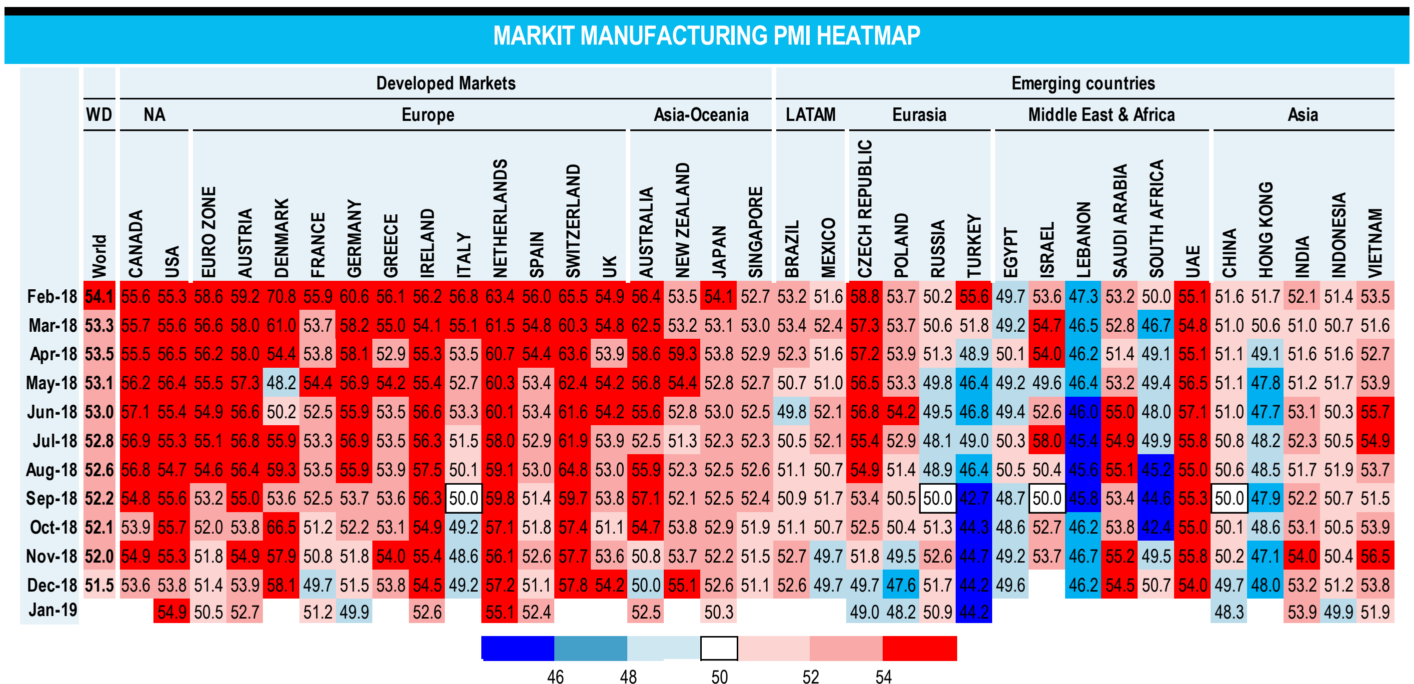
At the press conference following the FOMC decision, a journalist asked whether the change in tone from the Fed is a case of yielding to pressure from the White House. Unsurprisingly, this triggered a forceful answer (*"we never discuss political considerations"*). The Fed chairman also skilfully avoided answering directly a question on whether he had now provided a Powell put[1] to financial markets. In reality there is an alignment of objectives: the US administration needs a thriving economy, equity investors want earnings growth and the Fed wants to achieve its mandate[2].

To this end it has now turned the corner but it is not clear where the road is leading us: tightening or easing? The reduction of uncertainty on US-China trade relations would help in increasing visibility. It would also increase the effectiveness of the Chinese efforts to boost growth, something which is of global importance.

William De Vijlder

[1] This topic is quite popular in financial markets and has been discussed in Ecoweek of 11 January 2019.

[2] *"The Federal Open Market Committee (FOMC) is firmly committed to fulfilling its statutory mandate from the Congress of promoting maximum employment, stable prices, and moderate long-term interest rates."* (source: Federal Reserve, Statement on Longer-Run Goals and Monetary Policy Strategy, 29 January 2019)



MARKIT MANUFACTURING PMI HEATMAP

	WD	Developed Markets: NA		Europe												Asia-Oceania			
	World	CANADA	USA	EURO ZONE	AUSTRIA	DENMARK	FRANCE	GERMANY	GREECE	IRELAND	ITALY	NETHERLANDS	SPAIN	SWITZERLAND	UK	AUSTRALIA	NEW ZEALAND	JAPAN	SINGAPORE
Feb-18	54.1	55.6	55.3	58.6	59.2	70.8	55.9	60.6	56.1	56.2	56.8	63.4	56.0	65.5	54.9	56.4	53.5	54.1	52.7
Mar-18	53.3	55.7	55.6	56.6	58.0	61.0	53.7	58.2	55.0	54.1	55.1	61.5	54.8	60.3	54.8	62.5	53.2	53.1	53.0
Apr-18	53.5	55.5	56.5	56.2	58.0	54.4	53.8	58.1	52.9	55.3	53.5	60.7	54.4	63.6	53.9	58.6	59.3	53.8	52.9
May-18	53.1	56.2	56.4	55.5	57.3	48.2	54.4	56.9	54.2	55.4	52.7	60.3	53.4	62.4	54.2	56.8	54.4	52.8	52.7
Jun-18	53.0	57.1	55.4	54.9	56.6	50.2	52.5	55.9	53.5	56.6	53.3	60.1	53.4	61.6	54.2	55.6	52.8	53.0	52.5
Jul-18	52.8	56.9	55.3	55.1	56.8	55.9	53.3	56.9	53.5	56.3	51.5	58.0	52.9	61.9	53.9	52.5	51.3	52.3	52.3
Aug-18	52.6	56.8	54.7	54.6	56.4	59.3	53.5	55.9	53.9	57.5	50.1	59.1	53.0	64.8	53.0	55.9	52.3	52.5	52.6
Sep-18	52.2	54.8	55.6	53.2	55.0	53.6	52.5	53.7	53.6	56.3	50.0	59.8	51.4	59.7	53.8	57.1	52.1	52.5	52.4
Oct-18	52.1	53.9	55.7	52.0	53.8	66.5	51.2	52.2	53.1	54.9	49.2	57.1	51.8	57.4	51.1	54.7	53.8	52.9	51.9
Nov-18	52.0	54.9	55.3	51.8	54.9	57.9	50.8	51.8	54.0	55.4	48.6	56.1	52.6	57.7	53.6	50.8	53.7	52.2	51.5
Dec-18	51.5	53.6	53.8	51.4	53.9	58.1	49.7	51.5	53.8	54.5	49.2	57.2	51.1	57.8	54.2	50.0	55.1	52.6	51.1
Jan-19			54.9	50.5	52.7		51.2	49.9		52.6		55.1	52.4			52.5		50.3	

	Emerging countries: LATAM		Eurasia				Middle East & Africa						Asia				
	BRAZIL	MEXICO	CZECH REPUBLIC	POLAND	RUSSIA	TURKEY	EGYPT	ISRAEL	LEBANON	SAUDI ARABIA	SOUTH AFRICA	UAE	CHINA	HONG KONG	INDIA	INDONESIA	VIETNAM
Feb-18	53.2	51.6	58.8	53.7	50.2	55.6	49.7	53.6	47.3	53.2	50.0	55.1	51.6	51.7	52.1	51.4	53.5
Mar-18	53.4	52.4	57.3	53.7	50.6	51.8	49.2	54.7	46.5	52.8	46.7	54.8	51.0	50.6	51.0	50.7	51.6
Apr-18	52.3	51.6	57.2	53.9	51.3	48.9	50.1	54.0	46.2	51.4	49.1	55.1	51.1	49.1	51.6	51.6	52.7
May-18	50.7	51.0	56.5	53.3	49.8	46.4	49.2	49.6	46.4	53.2	49.4	56.5	51.1	47.8	51.2	51.7	53.9
Jun-18	49.8	52.1	56.8	54.2	49.5	46.8	49.4	52.6	46.0	55.0	48.0	57.1	51.0	47.7	53.1	50.3	55.7
Jul-18	50.5	52.1	55.4	52.9	48.1	49.0	50.3	58.0	45.4	54.9	49.9	55.8	50.8	48.2	52.3	50.5	54.9
Aug-18	51.1	50.7	54.9	51.4	48.9	46.4	50.5	50.4	45.6	55.1	45.2	55.0	50.6	48.5	51.7	51.9	53.7
Sep-18	50.9	51.7	53.4	50.5	50.0	42.7	48.7	50.0	45.8	53.4	44.6	55.3	50.0	47.9	52.2	50.7	51.5
Oct-18	51.1	50.7	52.5	50.4	51.3	44.3	48.6	52.7	46.2	53.8	42.4	55.0	50.1	48.6	53.1	50.5	53.9
Nov-18	52.7	49.7	51.8	49.5	52.6	44.7	49.2	53.7	46.7	55.2	49.5	55.8	50.2	47.1	54.0	50.4	56.5
Dec-18	52.6	49.7	49.7	47.6	51.7	44.2	49.6		46.2	54.5	50.7	54.0	49.7	48.0	53.2	51.2	53.8
Jan-19			49.0	48.2	50.9	44.2							48.3		53.9	49.9	51.9

Legend: 46 48 50 52 54

Source: Markit, BNP Paribas