CIO | VIEW
CIO Flash
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DWS

THE FED SWEETENS AS ITS VIEW SOURS

The U.S. Fed succeeded in surpassing already dovish market expectations. Don't get too excited about it.

This time Europe has shown the way. The Federal Reserve's (Fed's) interest-rate decision on Wednesday had many parallels with the European Central Bank's (ECB's) decision on March 7 (see CIO Flash of March 8, 2019). Both central banks proved even more dovish than the already dovish markets expected. Bond and currency markets celebrated and stock markets initially welcomed the decision before getting cold feet from the reasons given for the unexpectedly dovish turn in monetary policy. Following a similar trajectory to the Stoxx 600 Europe, the S&P 500 initially rose before going into reverse after about an hour. The financial sector in particular pulled the overall market down.

The Fed's most important signals from our point of view were that the median forecast for gross-domestic-product (GDP) growth was revised downward by 0.2 percentage points for 2019 and by 0.1 percentage points for 2020, to 2.1% and 1.9% respectively. Inflation expectations for 2019 were reduced by 0.1 percentage points and for 2020 by 0.2 percentage points, to 1.8% and 1.9% respectively. Fed Chairman Jerome Powell commented that "growth is slowing somewhat more than expected". And the Federal Open Market Committee (FOMC) members lowered their interest-rate projections (the dots). This year the dots now point on average to no interest-rate hikes, and only one in 2020. This means the federal funds rate is expected to peak at 2.5% to 2.75% probably in 2020, a reduction of 0.5 percentage points in the past three months. Another important change was to the planned reduction in the Fed's balance sheet. The run-off of the Fed's bond holdings is to be reduced from 30 to 15 billion dollars a month from May onwards and will only continue until September. The fact that the Fed is sticking to its wait-and-see mode for the coming months, that it has made further data-dependent decisions and that it has left the current key interest rate at 2.25% to 2.5% are comparative side notes.

Overall, we believe that the Fed's policy is unlikely to change in coming quarters, unless there is an exceptional shock. The hurdle for a rate hike is now quite high, but that is also the case for a rate cut. To justify a further interest-rate hike there would need to be clear indications that the economy can again grow above trend, with corresponding impacts on the labor market and inflation expectations. For interest rates to be lowered, the economic outlook would have to deteriorate significantly and thus be well below our core forecast (and the Fed's). In the past, cycles of interest-rate cuts have always begun when unemployment rates were above the non-accelerating inflation rate of unemployment (NAIRU) (see Chart of the Week of March 15, 2019), from which we are currently far off. In fact, we continue to believe the economy will recover in the course of the year and that an interest-rate hike is more likely than rate cuts, even if we do not expect them in the near future. We would not over-interpret the new framework for balance-sheet reduction. Although this plan implies a somewhat slower than expected reduction, we do not believe this is less a monetary-policy signal than a technical decision relating to the management of central-bank reserves. The balance sheet is currently not an active instrument of monetary policy (although it could become one again, if necessary).

The market reaction shows investors' restrained delight in a Fed that is now even more accommodative than planned. Even though the Fed spoke in its communiqué of a healthy economy and a still strong labor market, the idea that interest rate rises have already come to a halt with a real interest rate close to zero is not very reassuring for anyone. The yield curve will now also be watched again suspiciously by many. Following the Fed's decision, U.S. government bonds with maturities of up to seven years are now trading below the effective fed funds rate. We maintain our forecast that there will not be a profit recession this year and that economic growth should pick up again in the second half of the year. However, in most asset classes this positive scenario already appears to be largely priced in.

GLOSSARY

Dove
Doves are in favor of an expansive monetary policy.

European Central Bank (ECB)
The **European Central Bank (ECB)** is the central bank for the Eurozone.

Federal funds rate
The **federal funds rate** is the interest rate, set by the Fed, at which banks lend money to each other, usually on an overnight basis.

Federal Open Market Committee (FOMC)
The **Federal Open Market Committee (FOMC)** is the committee that oversees the open-market operations (purchases and sales of securities that are intended to steer interest rates and market liquidity) of the U.S. Federal Reserve.

Gross domestic product (GDP)
The **gross domestic product (GDP)** is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

Inflation
Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

Key interest rates
Key interest rates stated by central banks to determine the most important rates of borrowing.

Monetary policy
Monetary policy focuses on controlling the supply of money with the ulterior motive of price stability, reducing unemployment, boosting growth, etc. (depending on the central bank's mandate).

Non-Accelerating Inflation Rate of Unemployment (NAIRU)
The **Non-Accelerating Inflation Rate of Unemployment (NAIRU)** refers to a level of unemployment below which inflation accelerates.

S&P 500
The **S&P 500** is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

Stoxx Europe 600
The **Stoxx Europe 600** is an index representing the performance of 600 listed companies across 18 European countries.

U.S. Federal Reserve (Fed)
The **U.S. Federal Reserve**, often referred to as **"the Fed"**, is the central bank of the United States.

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