Market Bulletin

September 27, 2018

The Fed: Raising rates and uncertainty

As expected, the Federal Reserve raised its target for the federal funds rate to a range of 2.00%-2.25%. The language in its statement and its economic projections was slightly more hawkish than in its June meeting. Notably from the statement, the reference to monetary policy being 'accommodative' has been removed. While this was not a big surprise to markets, it does add some uncertainty as to how the Fed views the current stance of monetary policy. In particular:

- In its economic projections, the Federal Open Market Committee (FOMC) upgraded its assessment of short-term U.S. economic growth. With real GDP growth in 2018 being upgraded to 3.1% from 2.8% in their June outlook and the 2019 growth outlook rising 0.1% to 2.5%. This reflects the reality of strong incoming data over the last few months. The long-term growth outlook remained unchanged, with the Fed seeing growth slowly decelerate to 1.8%.
- On other economic variables, the FOMC expect inflation to be broadly on target at 2.1% over the next few years. The Fed forecasts also show that they expect the unemployment rate to rise to 3.7% as we move into 2021, but it remains below what many consider to be a neutral rate of unemployment.
- In its interest rate projections, the FOMC were slightly more hawkish. Investors should expect one further rate hike in 2018 followed by three more rate hikes in 2019. Looking into 2020, the Fed expect one more hike, with interest rates staying flat moving into 2021. In addition, the longer-run interest rate was increased to 3%, its highest level since early 2017.

In other developments, the Fed also tweaked its balance sheet reduction plan, increasing the monthly cap from $24 to $30 billion in Treasuries and from $16 to $20 billion in mortgage backed securities. The Fed has been gradually increasing the pace of their balance sheet reduction program since October 2017 and we expect this to be the final tweak to their plan for the foreseeable future.

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Overall, the Fed is continuing to normalize monetary policy, reflecting a robust economic backdrop. This should feed through to further increases in long-term interest rates over the next year. The challenge for the Fed will come in 2019 where the impact of monetary policy tightening along with fading fiscal stimulus should slow the economy and may mean the committee has to change course.

EXHIBIT 1: FOMC SEPTEMBER 2018 FORECASTS

Percent

	2018	2019	2020	2021	Long Run
Change in real GDP, Q4 to Q4	3.1	2.5	2.0	1.8	1.8
June Forecast	2.8	2.4	2.0	-	1.8
Unemployment Rate, Q4	3.7	3.5	3.5	3.7	4.5
June Forecast	3.6	3.5	3.5	-	4.5
PCE Inflation, Q4 to Q4	2.1	2.0	2.1	2.1	2.0
June Forecast	2.1	2.1	2.1	-	2.0
Federal Funds Rate, end of year	2.4	3.1	3.4	3.4	3.0
June Forecast	2.4	3.1	3.4	-	2.9

Source: Federal Reserve, J.P. Morgan Asset Management. Data as of September 26, 2018 *Forecasts of 16 FOMC participations, median estimate. **Green denotes an adjustment higher, red denotes an adjustment lower.

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