IS THE FED ON THE BOND MARKET'S NAUGHTY OR NICE LIST?

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Once again, no surprises on the outcome for the Fed Funds target following the December FOMC meeting. As widely expected, the policy makers implemented their fourth rate hike of 2018, pushing the upper band of the Fed Funds range up a quarter point to 2.50%. This part of the Federal Reserve (Fed) outlook was the easy part of the equation; now comes the more challenging aspect: What will the FOMC do in 2019?

Until relatively recently, there seemed to be a consensus among market participants about Fed policy for next year. While the Fed's own projections for Fed Funds (blue dots) prior to the December convocation centered on three additional hikes, the money and bond markets seemed to be geared more toward two moves, with the chance for a third increase potentially.

And then … it hit! Fed Chairman Powell decided to walk back his comments from October 3, when he stated that Fed Funds were a "long way" below neutral, updating his stance to rates being "just below neutral." Needless to say, the U.S . Treasury (UST) market interpreted this shift in language as a potentially new tilt toward the dovish side. In other words, perhaps the Fed will be done raising rates sooner rather than later, with the timing and magnitude of any future moves being reduced accordingly. Throw in a rather noticeable risk-off trade in stocks and credit, and one can see a visible shift in Fed expectations. As a result, heading into the December meeting, Fed Funds Futures had priced in only one rate hike for 2019, and barely at that. In fact, at one point earlier this month, it looked as if the market could actually be thinking of a rate cut in 2020.

Back in September, the FOMC had already removed the phrase "the stance of monetary policy remains accommodative," so really, Powell's shifting comments were just stating the obvious. In my experience, Fed leaders usually are entitled to a mulligan, and this was Powell's. More importantly, let's focus on what the Fed is looking at going forward. There is no doubt the economy continues to be a positive factor for the outlook, even if a slowdown of sorts is looming. Based upon both the Fed's and consensus forecasts, a recession is not part of the equation for the next year or so, if not longer. Admittedly, headwinds (strong dollar, drop in inflation expectations, increases in nonfinancial corporate debt, U.S./China trade fears) exist. These are the forces that will be watched.

Conclusion

So for 2019, get used to a data-dependent Fed. Welcome back to how the Fed normally operates. This is policy norm; telegraphing each and every move that will occur every three months is not the norm. Add in a new wrinkle as well: There will be press briefings following each FOMC meeting beginning in January. In other words, the markets will have to get used to the notion that each Fed meeting will be live (i.e., policy moves could potentially occur at any given convocation). The primary focus on future decision making will be on both economic/inflation and financial conditions. Given this new climate, the policy makers did reduce their blue dots for only two rate hikes next year, but it appears as if the tug-of-war between the Fed and the money and bond markets has only just begun.

Unless otherwise stated, all data source is Bloomberg, as of December 13, 2018.

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DEFINITIONS

Fed fund futures : A financial instrument that let's market participants determine the future value of the Federal Funds Rate.

Federal Open Market Committee (FOMC) : The branch of the Federal Reserve Board that determines the direction of monetary policy.

Rate Hike : refers to an increase in the policy rate set by a central bank. In the U.S., this generally refers to the Federal Funds Target Rate.

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Treasury : Debt obligation issued by the U.S. government with payments of principal and interest backed by the full faith and credit of the U.S. government.

Dovish : Description used when stimulation of economic growth is the primary concern in setting monetary policy decisions.

Risk-on/risk-off : refers to changes in investment activity in response to perceived risk. During periods when risk is perceived as low, investors tend to engage in higher-risk investments. When risk is perceived as high, investors tend to gravitate toward lower-risk investments.

Monetary policy : Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

Inflation : Characterized by rising price levels.