US - JANUARY FED MEETING REVIEW

FED SIGNALS END OF RATE AND LIQUIDITY TIGHTENING IS NEAR

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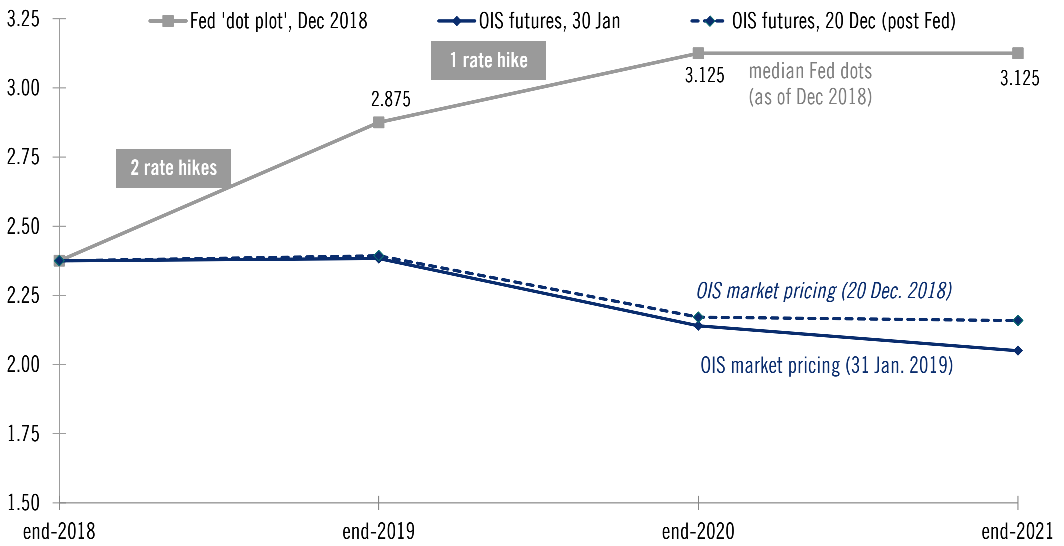
SUMMARY

- Dovishness was on full display at the Fed meeting on 30 January. The Fed removed its rate tightening bias, and emphasised its "patience" until the next rate move.
- Chairman Powell seemed particularly anxious about the global growth backdrop and explained the more dovish stance is just "common sense risk management".
- Another key focus was the balance sheet reduction as Powell hinted that a decision about ceasing the Fed's balance sheet runoff – a key concern for markets in recent weeks – would be taken "soon".
- This dovish view is in sharp contrast to Powell's ebullient optimism about US growth a few months ago, when he expressed wariness about accelerating wage growth and the possibility of the Fed having to overshoot the 'neutral rate'.
- Our big picture view has long been that 2019 would mark the end of the Fed tightening cycle and Powell's comments only reinforce this view.
- In more detail, our rate scenario this year has been for one final, and mostly symbolic rate hike in June with the risk of no rate hike at all; the risk of no move is rising.
- That said, our still constructive view on the US outlook in coming months makes it difficult to contemplate a rate cut at this stage, especially if there is no recession.
- In fact, the Fed is helping to sustain the US growth cycle with its dovish rhetoric.
- Regarding the balance sheet, we would have expected a decision in the second half of this year, for a balance sheet plateau from the first half of 2020, but Powell's comments suggest the decision could come earlier, perhaps as soon as next summer.

CHART 1: CHAIRMAN POWELL'S DOVISH GUIDANCE SIGNIFIED DECEMBER'S 'DOT PLOT' IS NO LONGER VALID



Source: PWM - AA&MR, Factset

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The Powell Put

While Powell resisted journalists' attempts to call the Fed's dovish turn a "Powell Put", it remains what stood out as Powell emphasised his responsiveness to the recent wobbles in markets, as well as additional sensibility to macro developments abroad (citing Europe, China and even Brexit in the UK).

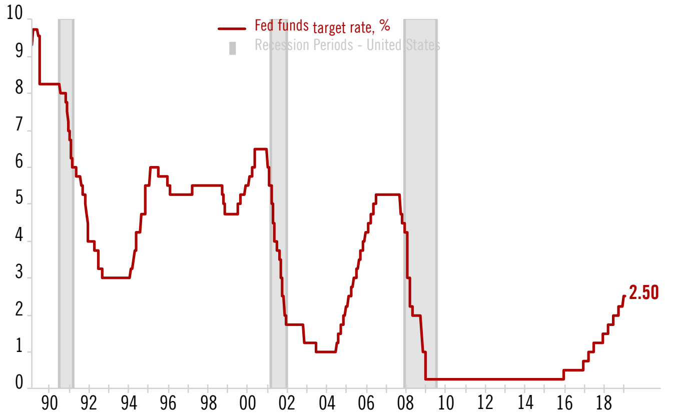
The dovish stance was particularly characterised by (1) Powell's insistence about "patience" until the next rate move (2) the removal of the tightening bias from the wording (The Fed removed "further gradual increases") (3) the upcoming halt to the Fed's balance sheet reduction, not just for technical reasons but also guided by macro and financial market factors.

As an aside, Powell dismissed journalists' questions that his arm had been twisted by President Trump – who vehemently criticised the Fed for keeping the balance sheet on auto pilot reduction – but the impression is still that there might have been some indirect influence there.

As a reminder the balance sheet reduction is currently operating on auto pilot in the background with monthly runoff caps at USD 50 billion. Powell confirmed that such reduction would come to an end soon. The decision will be taken at "upcoming meetings", suggesting potentially a decision this summer. That said, Powell did not specifically say the monthly cap would be adjusted imminently, although he said that was part of the debate the Fed is having at the moment. Powell seemed more focused on announcing a target level for the balance sheet rather than tweaking the monthly caps.

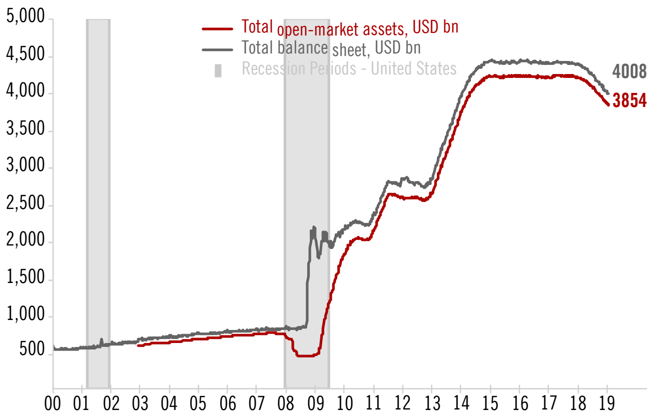
While this announcement on the balance sheet already transpired after Powell's speech on 4 January at the economics conference in Atlanta, this still marked a U-turn from his indifferent attitude at December's meeting, when he hinted he was happy about letting it shrink in the background, a fact that ultimately caused much market anxiety, and the recent reversal.

CHART 2: FED FUNDS TARGET RATE, %



Source: PWM - AA&MR, Factset

CHART 3: FED BALANCE SHEET, USD BILLIONS



(Note: monthly data) Source: PWM - AA&MR, Factset

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Slow inflation and recent market volatility support a patient stance

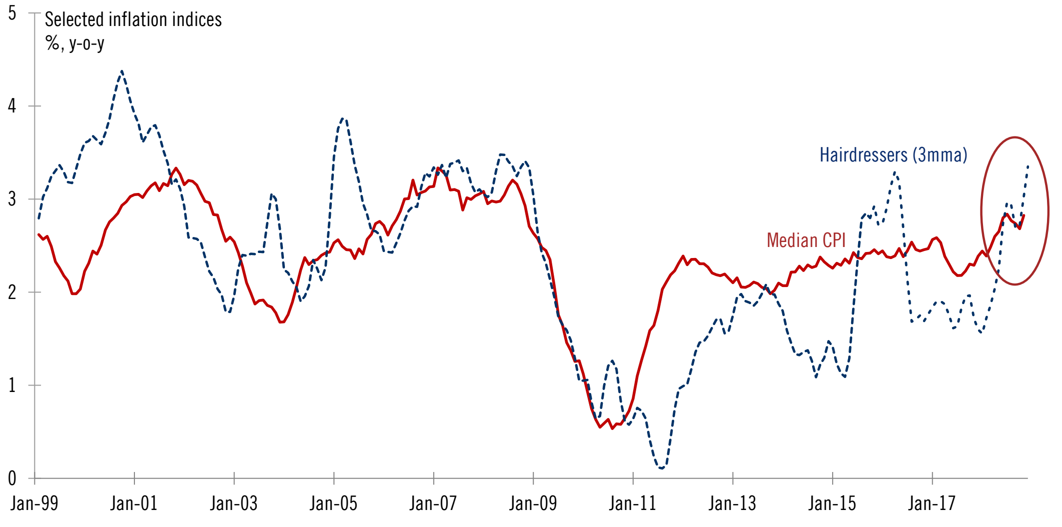
Powell gave two reasons for this new dovish stance and the fact that the case for raising rates has "weakened". First, the risk of high inflation has diminished. Second, the risk of financial imbalances has receded (a subtext is that financial valuations came down considerably in December).

Powell seemed to put a lot of importance on the global macro picture, noting that some "cross currents" may persist "for a while", without being more specific about these. Still reading between the lines, it seemed that Powell is taking a more sombre view about upcoming trade negotiations with China and on the functioning of federal bureaucracy in Washington DC. He hinted specifically at the risk of another federal shutdown after mid-February, a threat that President Trump maintains.

The longer term picture: Fed "normalization" no more

The Fed's dovish rhetoric at the January meeting and in recent speeches throughout January also belie the fact that the Fed is increasingly realising that its long-hoped "normalization" in monetary policy is not going according to the initial plan, and in fact that such normalisation is a mostly elusive concept.

CHART 4: POWELL REMAINED COOL-HEADED ABOUT THE INFLATION RISK, EVEN IF SOME DATA GO OPPOSITE



Source: Pictet WM - AA&MR, Bloomberg

It is clear that the Fed will now not return to the small balance sheet world of the pre-Global Financial Crisis years; it is also clear that it will be unable to hike rates back to peaks seen during previous business cycles.

This is partly because the Fed's entrenched low rate policy has help to fuel a sharp increase in federal and corporate debt, in turn narrowing its room for manoeuvre. The longer term question remains whether such a persistent low rate policy is healthy for the economy in the future, especially given its artificial help to highly indebted (and often unproductive) companies at the expense of entrepreneurship and "destructive creation", its implicit boost to ongoing widespread financial engineering and complacent market behaviour and ultimately whether all this does not help to fuel the populist forces that

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could sharply destabilise the economic system. The risk is that the Fed becomes “trapped” in a low-rate environment for longer, especially if at the same time his political independence gradually erodes.

Fed scenario: Case for a June rate hike weakening

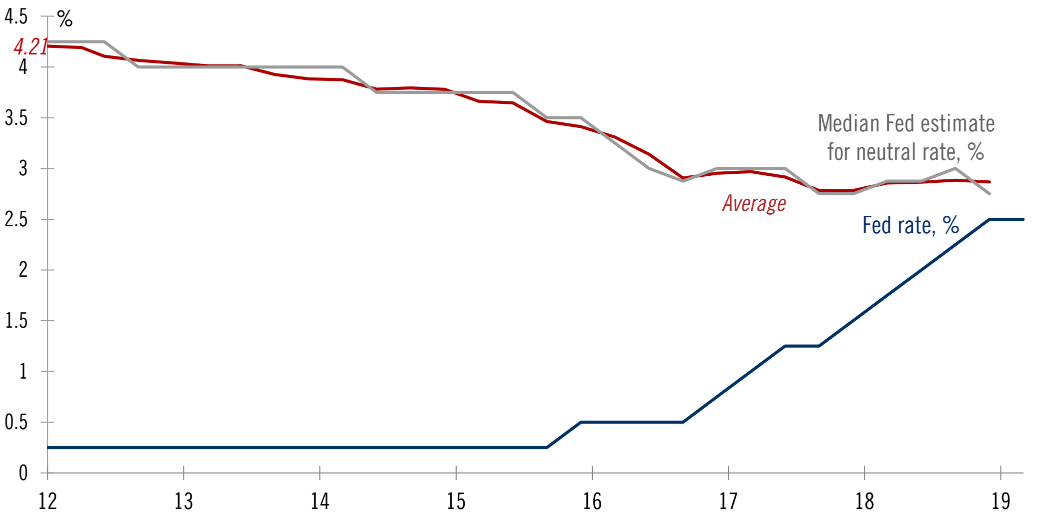
Our Fed scenario remains built on the two pillars of data, and Fed rhetoric (i.e. how the Fed interprets this data). It is clear that the rhetoric is now leaning to the dovish side, and the Fed seems less anxious about an inflation build-up than in recent months. Rather, it seems to have put a lot of importance on the stock market gyrations.

The main question is whether the Fed would have to change tack again if stock markets rebound. Perhaps not completely, as we are left with the feeling that there is indeed a Powell Put, if not a clear desire to see some reflation in financial assets. In other words, it is now the opposite of taking the ‘punchbowl’ away.

Powell emphasised that the timing and extent of future tightening would depend principally on inflation, but even here he gave the impression of moving the goalposts. He downplayed the ongoing strength in core inflation, focusing rather on the more volatile oil prices that are dampening headline inflation.

Conspicuously absent was the ongoing risk of strong domestic, demand driven pressures, including wage growth that is still trending up and the positive output gap the US economy is now operating in (also echoed by an unemployment rate below ‘full employment’ levels). But overall, it seems the Phillips curve relationship linking the two is completely out of favour at the Fed, a big change from the Yellen years. Powell did not mention US wage growth during the press conference.

CHART 5: THE RHETORIC OF BRINGING RATES TO “NEUTRAL” DISAPPEARED RECENTLY



Source: Pictet WM - AA&MR, Bloomberg

The bottom line is that we’ve long seen 2019 as marking the end of the Fed’s tightening cycle, and Powell’s comments during the press conference only buttress this point. Rate hike wise, we had pencilled in one rate hike in June, with the risk of zero given recent Fed dovishness. The risk of no hike has indeed risen after this meeting.

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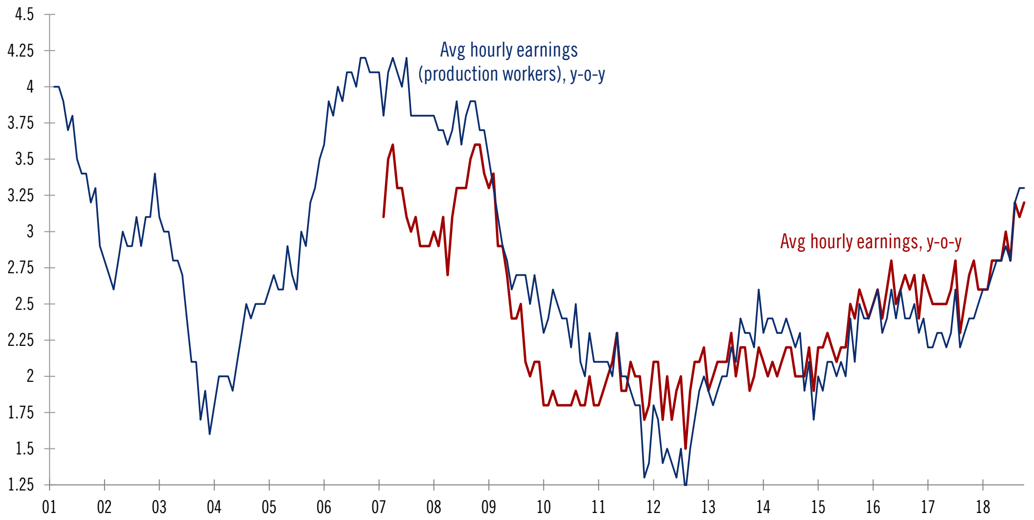
Still, we remain constructive about US data in coming months, and we are aware that the pendulum could swing back, especially if international data improves (e.g. a stimulus in China or a trade truce in the current US China trade negotiations). The current situation strongly echoes the Fed under Greenspan in 1998-99 with similarly strong anxiety about the global backdrop.

By being very dovish now, the Fed is implicitly buttressing the US business cycle's longevity. This is one reason why we see the near-term risk of recession as still moderate; for this reason as well, we see the possibility of a rate cut as premature.

On the balance sheet side, there is now a growing possibility that the Fed will announce a halt to its monthly balance sheet reduction, perhaps as soon as this summer. This would then mean stabilisation of the Fed's balance sheet a few months later, perhaps by end-2019 or early 2020. While Powell gave no particular signal, it still seems that the Fed is targeting a balance sheet size of around USD 3.5 trillion, versus 4.0 trillion at the present.

While Powell seemed eager to announce an end to the balance sheet reduction both for technical (high demand for bank reserves in the post-Global Financial Crisis years) and market-pleasing reasons, the technical arguments about the future of the Fed's balance sheet as well as its relationship with the rate policy leave the profound impression that the Fed does not seem to really understand how all this works.

CHART 6: CHAIRMAN POWELL WAS CONSPICUOUSLY SILENT ABOUT RECENT STRONG WAGE GAINS



Source: Pictet WM - AA&MR, Bloomberg

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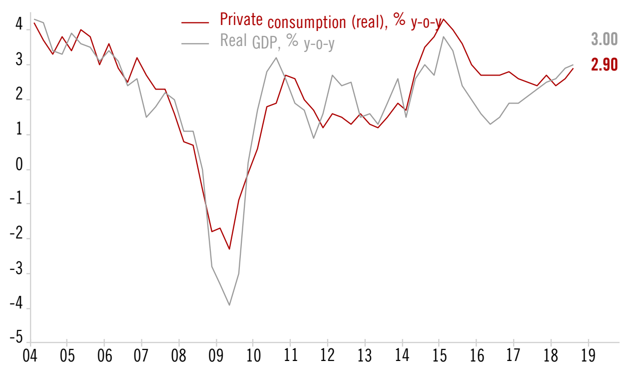
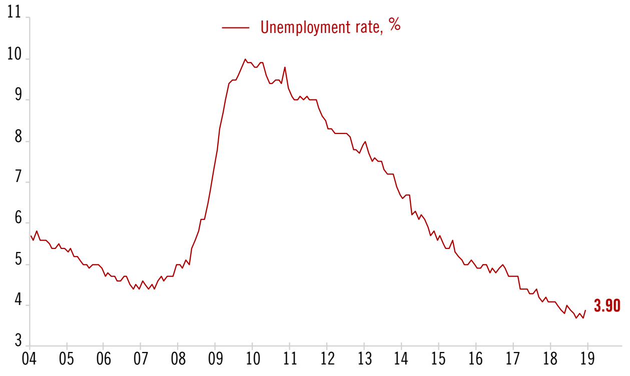
REAL GDP AND PRIVATE CONSUMPTION GROWTH, % Y-O-Y



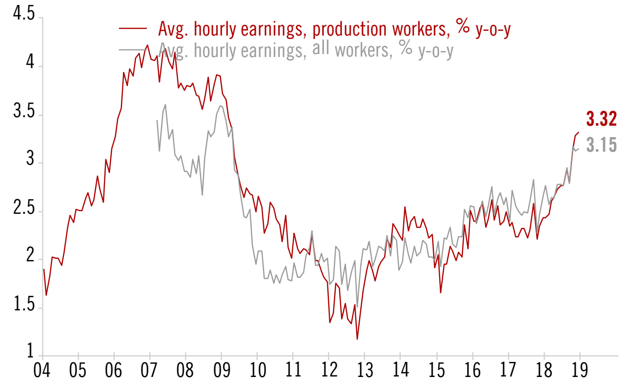
Source: Pictet WM – AA&MR, Factset

UNEMPLOYMENT RATE, %



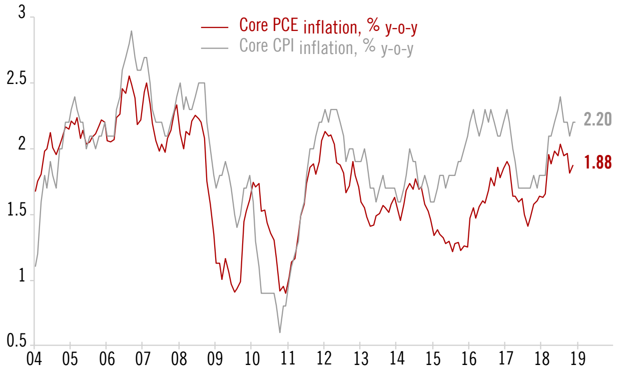
Source: Pictet WM – AA&MR, Factset

AVERAGE HOURLY EARNINGS (WAGE GROWTH), % Y-O-Y



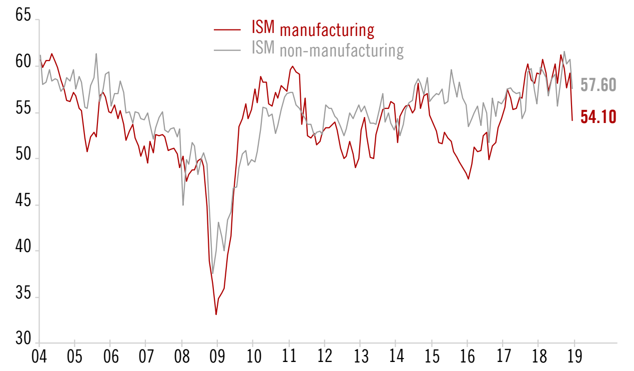
Source: Pictet WM – AA&MR, Factset

CORE INFLATION (PCE AND CPI), % Y-O-Y



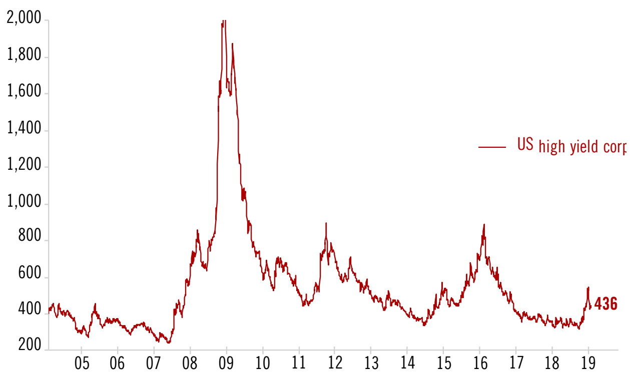
Source: Pictet WM – AA&MR, Factset

ISM BUSINESS SURVEYS



Source: Pictet WM – AA&MR, Factset

HIGH-YIELD CORPORATE BOND SPREAD, BASIS POINTS



Source: Pictet WM – AA&MR, Factset

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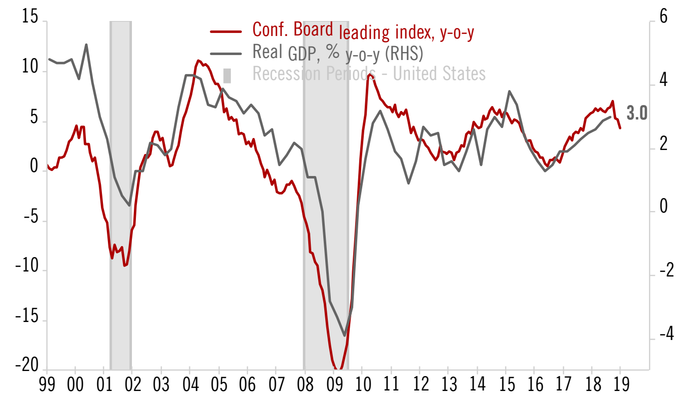
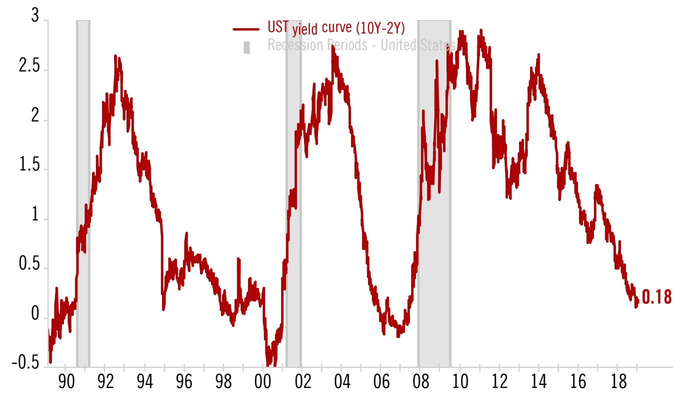
CONF. BOARD LEADING INDEX, % Y-O-Y VS GDP GROWTH, % Y-O-Y



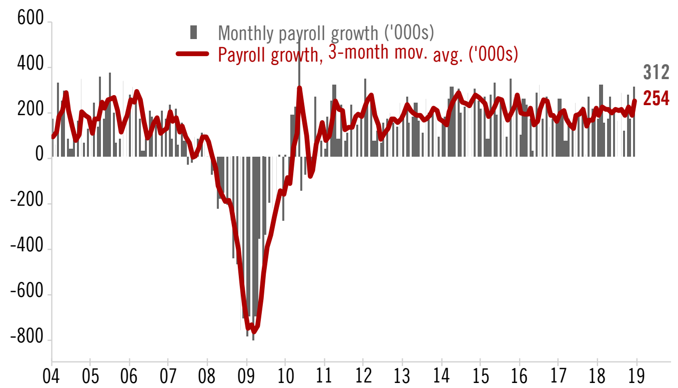
Source: PWM - AA&MR, Factset

US YIELD CURVE SPREAD (10-YEAR YIELD MINUS 2-YEAR YIELD)



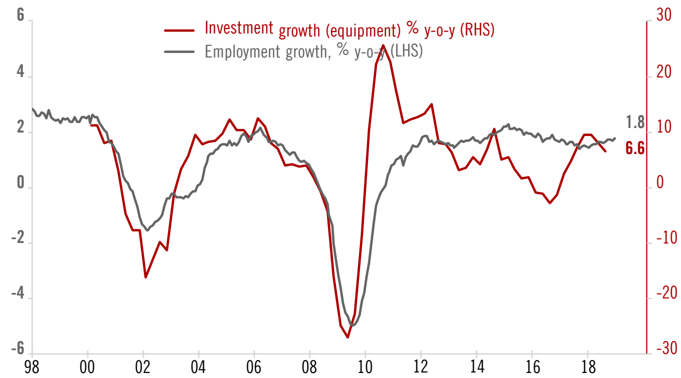
Source: PWM - AA&MR, Factset

EMPLOYMENT GROWTH, IN THOUSANDS OF PAYROLL ADDITIONS



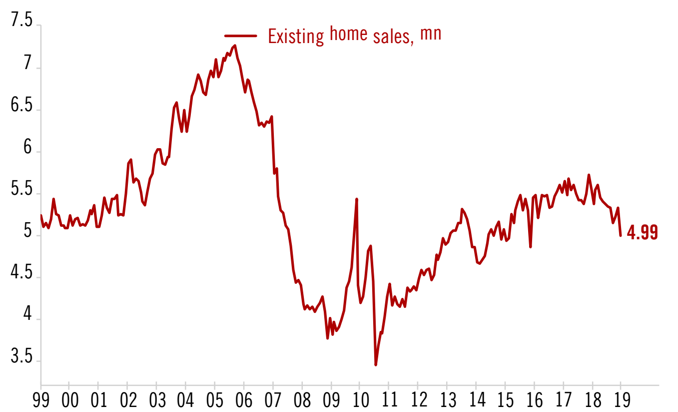
Source: PWM - AA&MR, Factset

US INVESTMENT VS EMPLOYMENT GROWTH, % Y-O-Y



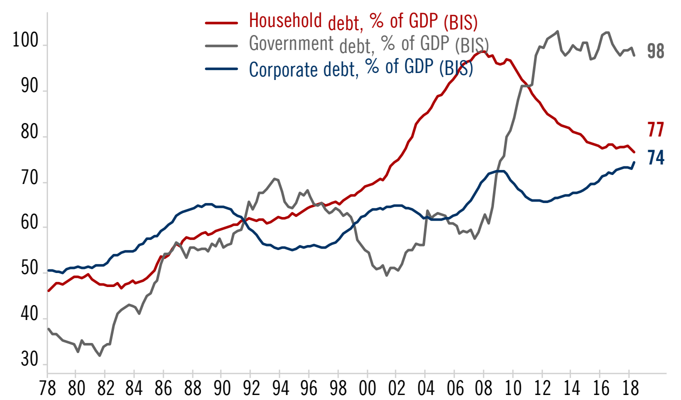
Source: PWM - AA&MR, Factset

EXISTING HOME SALES, MILLION UNITS (ANNUALISED)



Source: PWM - AA&MR, Factset

DEBT RATIOS (HOUSEHOLD, CORPORATE, GOVERNMENT), % OF GDP



Source: PWM - AA&MR, Factset

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