Northern Trust | A Monumental Fed Shift

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The Federal Reserve meeting last week represented for investors a monumental outlook shift compared to just six weeks ago. The Fed decided to leave rates on hold, and pivoted substantially on where they see the economy heading. As we see it, the Fed may not only pause for an extended period of time, the next interest rate shift could just as likely be a rate reduction. Let's explore the issue.

What happened for the Fed to alter its view so dramatically? We don't think it has anything to do with tweets or pressures from US President Donald Trump. After the FOMC meeting, Chairman Powell spoke of trade wars, slowing economies around the world, and data, which may be coming in weaker than expected from the US and elsewhere.

But in our opinion, the crucial point is the Fed's uneasiness with the trajectory of inflation and inflation expectations. The Fed now sees inflation as central to future decision making, and they realize that inflation is simply stuck, a theme we call stuckflation. This makes it extremely difficult for the Fed to justify rate hikes in the near or medium term, unless there is a noticeable sustained increase in inflation.

The slightly uncomfortable news is that it took the Fed so long to figure this out. We've had differing views as to why the Fed previously had been so resistant to understand headwinds to global economies and stuckflation. The Fed's four rate hikes last year proved too many. Two increases would have been the right number in 2018, then maybe two more for 2019.

We don't think this is a hole that the Fed can't dig out of. But four rate hikes last year was too close for comfort. One more may have inverted the yield curve across the board, which could have been dire for a slowing global economy. Since the Fed has raised rates four times already, investors should count on zero rate hikes in 2019. If the Fed does make a move, we think there's a much higher chance of easing rather than tightening.

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