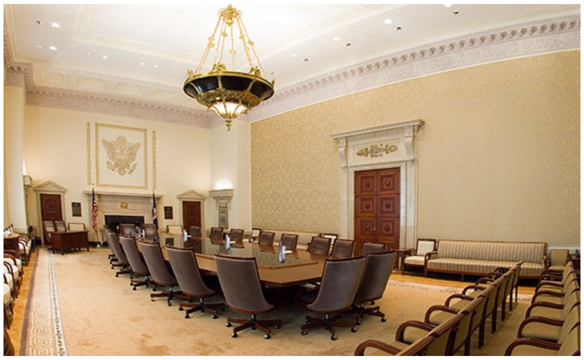
CenterState
CORRESPONDENT DIVISION

Market Update

Economic News

December 19, 2018



Not much of consequence will get done in the market today until the 2pm EST Fed rate decision and subsequent press conference. We delve into more detail below what we think will come from the meeting but suffice it to say here, the odds-on rate hike that was the play for weeks leading up to today has suddenly become a little more interesting as the combination of equity selling, decreasing inflation expectations, and general angst over the direction of the global and domestic economies has created more uncertainty for the Fed than they probably wanted less than one week before Christmas. While a rate hike is still the favorite play, the odds of a hike today have decreased from 78% when December began to 67% today. The rate forecast for next year will also get a good going over. The September forecast calling for three-hikes in 2019 could be reduced given the increasing market anxiety and economic uncertainty. But even if the Fed cuts its 2019 rate hiking forecast it's still not likely to match the fed funds futures market's 10bps of hikes in 2019. Thus, we expect some pressure on the short-end of the curve after the rate decision with longer maturities rallying further with more curve flattening the result.

Will they or won't they? That is the question. What was once a foregone conclusion that today's FOMC meeting would result in the fourth 25bps rate hike this year has become a bit more uncertain with the ugly equity selling that has seen most major indices eclipsing their February lows. If there is one reason to pause today it's the equity selling but while it has certainly tightened financial conditions the tightening is not off-the-chart by any stretch (see graph below).

The conundrum for the Fed is that, hewing strictly to recent economic results, a rate hike is warranted. Other than some softening in housing and autos, recent economic reports have been solid to strong with the November retail sales numbers pointing to another excellent quarter for consumer consumption and hence GDP. In fact, after Friday's release of the retail sales numbers the Atlanta Fed revised their fourth quarter GDP forecast from 2.5% to 2.9%. And with the bottom range of the neutral rate estimate beckoning at 2.5%, the Fed would love to get the funds rate into the range and then have some time in 2019 to assess the lay of the land. Arguing against a hike today is the aforementioned equity selling and subsequent tightening of financial conditions. In that regard, in a November 28th speech Fed Chair Powell laid out the Fed's first Framework for Monitoring Financial Stability. In that work he noted that asset price levels, including equity valuations, are one of the four potential vulnerabilities to financial stability. That's a clear admission that the Fed does indeed watch equity markets as another input in their policy decisions.

The other aspect arguing against a hike is the level of inflation and inflation expectations. The latest CPI prints was rather docile with most of the core increase owing to housing-related equivalent rents. If the softening in housing activity continues to spread that will likely take the edge off those equivalent rent numbers. Also, inflation expectations have been trending lower with the most recent 10-year TIPs breakeven inflation rate at 1.8% versus 2.2% on October 5th. The drop in oil is the major impetus behind those decreasing inflation expectations as West Texas Intermediate has declined from $76/barrel on October 3rd to $46/barrel yesterday. The drop is ostensibly due to a concern about the pace of growth next year and hence demand. The Fed pays a lot of attention to inflation expectations so hiking when those expectations are not "well-anchored" and, in fact, are decreasing will make some members a little nervous.

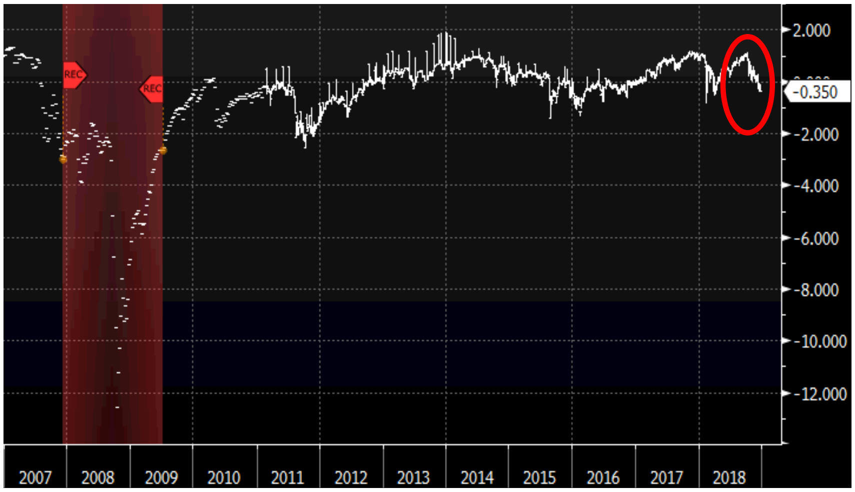
The other wild card in this meeting is the pressure being applied by President Trump in tweets asking the Fed not to hike at today's meeting. In order to maintain the appearance of independence some on the Fed may feel it necessary to hike even though a pause could be logically justified. We think Fed Chair Powell will rise above such concerns and decide based on the data and not on pressure from the president.

Also entering the equation is the change in format for Fed meetings next year. Each meeting in 2019 will be followed by a press conference allowing the chairman to more fully explain the committee's actions. Thus, some have promoted the scenario where the Fed pauses today, and then hikes in January. That still gets the fed funds rate to the bottom edge of neutral and also proves that every meeting is "live" and not just the quarter-end months.

While we wouldn't be surprised if the Fed were to pause today, overall economic and labor market strength still justifies a hike but with a downgrading of rate-hiking expectations in 2019. A hike today gets the fed funds rate into the lower range of neutral, an accomplishment the Fed dearly wants to check-off in 2018.

However, with increasing global uncertainty stemming from Brexit, to trade wars, to a soon-to-be expiring debt ceiling, not to mention increasing political friction with the new Democratic House majority, global and domestic uncertainty is higher than when the Fed was forecasting rates back in September. That seems to warrant a slower and lower pace of rate hikes going forward. In any event, we'll be back this afternoon with a recap of the meeting and any changes to policy.

Financial Conditions Index Only Moderately Tighter



The bloodbath in equities this month has seen most major indices move below their February lows and that opened the discussion of where the next level of support might be found. That selling, and resultant tightening of financial conditions, has been one of the rallying cries for those arguing the Fed should pause today. The Bloomberg Financial Conditions Index graph, however, reveals the tightening in financial conditions isn't extreme. In fact, the tightening is not to the levels reached in February and certainly is well above levels reached in 2015, 2011 and during the Great Recession. The Fed is likely to view the move circled in red as somewhat concerning but still shy of warranting a pause in and of itself.

Agency Indications— FNMA/FHLMC Callable

Maturity (yrs)	2 Year	3 Year	4 Year	5 Year	10 Year	15 Year
0.25	2.87	3.02	3.16	3.29	3.66	3.89
0.50	2.84	2.99	3.13	3.25	3.64	3.87
1.00	2.75	2.90	3.04	3.17	3.52	3.77
2.00	-	2.73	2.88	3.01	3.47	3.64
3.00	-	-	-	-	3.33	3.52
4.00	-	-	-	-	3.20	3.43
5.00	-	-	-	-	3.09	3.36
10.00	-	-	-	-	-	NA