Weekly Market Commentary
March 25, 2019

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The Federal Reserve took center stage this week, filling a void left by a virtually empty data calendar. Most thought this week's policy meeting would elicit a collective yawn, as no one expected the Fed to raise (or lower) interest rates at the confab. As expected, it didn't. But it was hardly a sleepy affair, as the outcome hit the financial markets like a bombshell. This was a case of "look what we say, not what we do," and both the post-meeting policy statement and Chairman Powell's comments at the press conference spoke volumes. The loudest message was that there would be no more rate increases, at least for the rest of this year, and no further shrinking of balance sheet holdings after September.

Simply put, the U-turn towards a more dovish strategy suggested at the January meeting was solidified at this week's meeting, which presented the quarterly estimates of where Fed officials expect the federal funds rate to be this year and next, as well as their projections for economic growth, inflation and unemployment. The focus of attention was on the federal funds rate, captured by the so-called dot plots. At the December policy meeting, the last one to include the summary estimates of economic projections (the SEP), Fed officials expressed concerns about headwinds stemming from global crosscurrents and other sources but still believed the economy was on a solid growth path that warranted two rate increases in 2019. No projections were made at the January meeting, but the tone of the policy statement and in the post-meeting press conference turned more dovish, signaling that the Fed would be more patient before raising rates again depending on how incoming data evolved.

Apparently, the Fed saw enough by the time of this week's meeting, as data on the books are tracking a significant slowdown in the first quarter, even as inflation remains below the 2 percent target. Heading into the meeting, the financial markets thought the Fed would lower the number of projected rate increases for 2019 from 2 to 1. But it did one better, as the majority of Fed officials expect no hikes this year and only one more in 2020 – and that's only if inflation rises to the 2 percent target. If it's one and done, or quite likely, none and done, the endgame for the federal funds rate this cycle would be considerably below the peak rates seen in every other postwar expansion.

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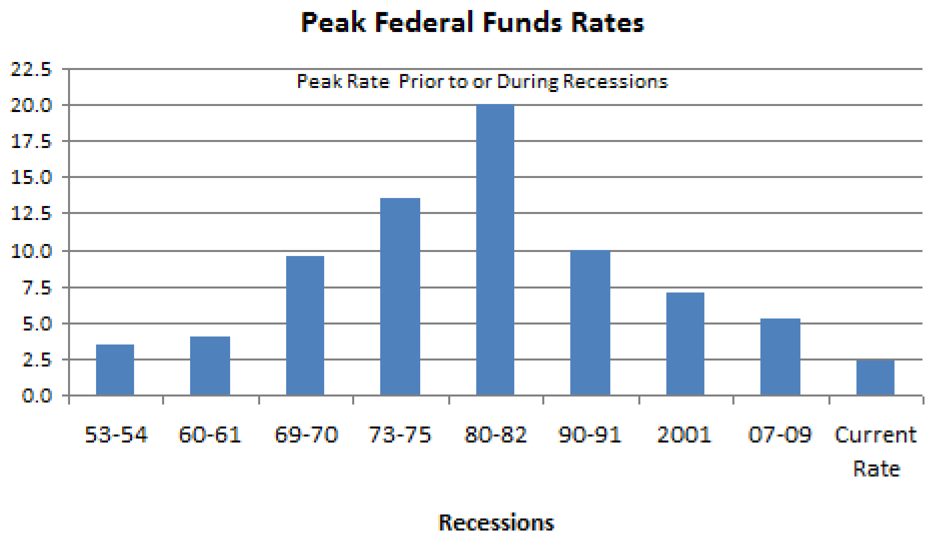
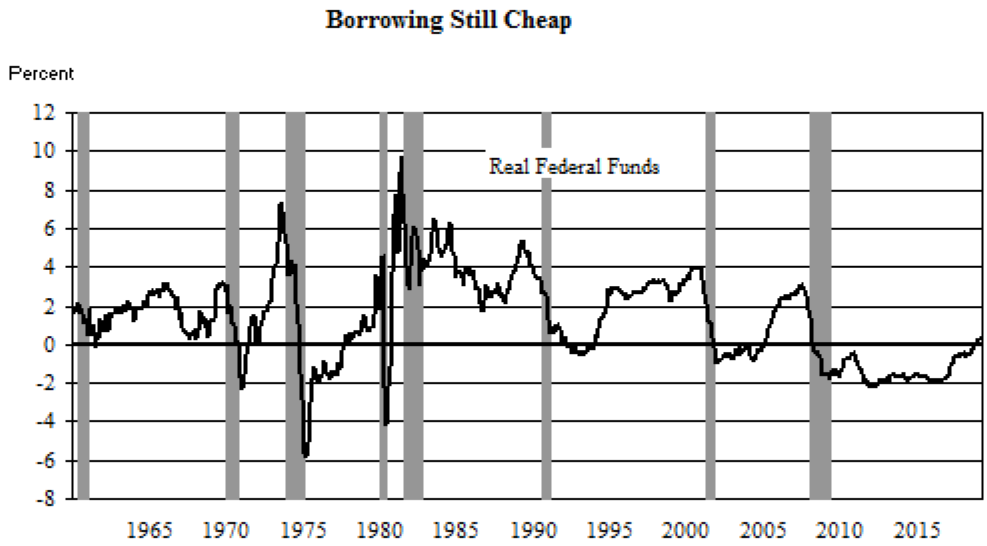


Assuming we've seen the last rate hike for the foreseeable future, the median funds rate at 2.40 percent would pale in comparison to the 9.1 percent average peak seen over the previous eight business cycles. To be sure, the disparity over those previous Fed-tightening episodes is extremely wide, ranging from 20 percent in the early 1980s to 3.5 percent in the 1950s. The common variable driving the wedge between the two extremes is inflation, which hurtled towards runaway territory in the late 1970s and was relatively tame in the 1950s and early 1960s. As the chart shows, the trend since the 1980 peak is the mirror image of the trend leading up to that peak, as disinflationary forces replaced the upsurge in inflation and inflation expectations that characterized the period from the mid-60s to the early 1980s.

Yet even accounting for the low inflation environment in recent decades, the real cost of money is hardly expensive. Adjusting for the annual change in the core consumer price index, which excludes volatile food and energy prices, the real funds rate stands at just 0.3 percent in February, well below the levels usually prevailing this late in a business cycle. Hence, Fed policy is anything but growth stifling, although the reduction in Fed asset holdings even at a scaled-back pace over the next few months is the equivalent of a few basis points of tightening. Importantly, Chairman Powell in explaining the Fed's dovish turn stressed the fact that the solid growth last year failed to lift inflation to the 2 percent target. With the economy hitting a speed bump in recent months and growth expected to moderate this year, he is understandably concerned that it might be even more of a challenge to meet that target.



That concern is clearly reverberating through the financial markets, particularly in the fixed income sector where the 10-year Treasury yield on Friday tumbled to the lowest level since December 2017. Quite possibly, Treasuries are benefiting from a safe-haven bid, as news about overseas economies took a turn for the worse this week. But recent U.S. data are also pointing to more weakness than thought. Indeed, the final quarter of last year looks to have lost more momentum than indicated by the 2.6 percent growth rate shown in the preliminary GDP report. That report was calculated with incomplete data and subsequent releases on construction and trade and, most recently, spending on services, indicates that the next revision, due out on March 28, will pull down growth to under 2.0 percent for the period. If so, growth for the year will fall below the much ballyhooed 3.1 percent pace, dipping back to a 2 handle.

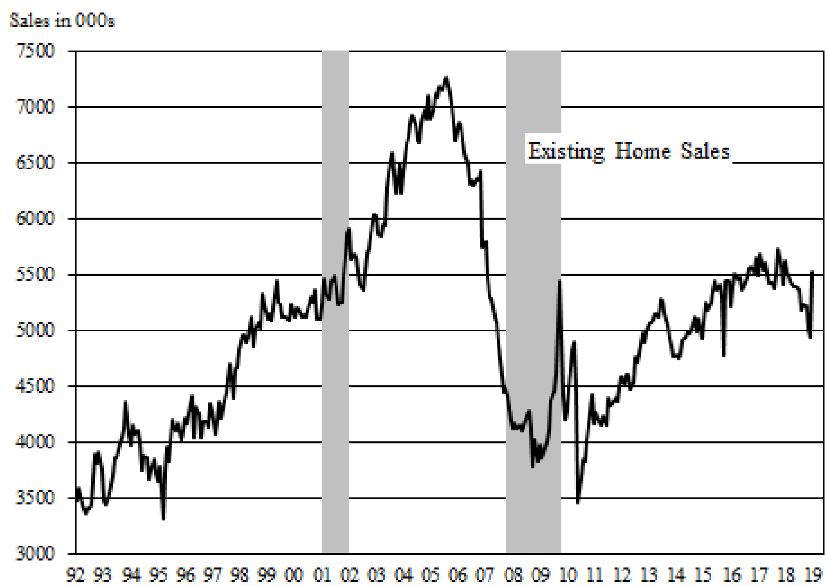
Indeed, with the stock market also tanking on Friday, the heightened anxiety among investors is not just an inflation story. Global growth concerns, which have been simmering for months, may be reaching a boiling point, as manufacturing activity in Europe plunged in March, signaling a soft end to the first quarter. That follows tepid growth over the second half of 2018, when the region's growth powerhouse, Germany, barely escaped a recession. The global growth slowdown is sending yields on sovereign debt tumbling, with rates on German bunds falling into negative territory on Friday. Capital goes to where the better risk-adjusted yields are, and the U.S., even with its grimmer outlook, is still an attractive destination for foreign funds, underpinning the strong demand for U.S. Treasuries.

But the slide in long-term interest rates sends a dual message about the economy. For the first time since the recession, the 10-year Treasury yield fell below the 3-month Treasury bill yield on Friday, an inversion that is often seen as a precursor to a recession. Indeed, financial markets are pricing in greater odds of a recession sooner than later; if that downbeat mind-set permeates households and businesses, it could well become a self-fulfilling prophecy. However, we caution against reading too much into a slight inversion of the 10-year/3-month yields. For one, the more widely watched 10-year/2-year spread is still positive, albeit narrowing to a slim 12 basis points this week. For another, in a low-yield, low inflation environment, tighter spreads are much more common and an inversion is more likely to occur without an ensuing recession.

What's more, while lower long-term rates may signal a weakening economy, it also sows the seeds for a recovery in credit-sensitive sectors. We may be seeing signs of that already, as sales of previously owned homes surged nearly 12 percent in February to a 5.51 million annual rate. Importantly, existing home sales reflect closings on contracts signed a month or two earlier than the month the transaction is recorded. In December, the rate on 30-year fixed mortgages published by Freddie Mac averaged 4.64 percent and the median price on existing homes stood at $254,700. Both are considerably lower now. In the last published week, ending March 20, the 30-year fixed rate fell to 4.28 percent. Since then, it has fallen further, alongside the 15 basis point drop in the 10-year Treasury yield over the past week. Meanwhile, the median sales price fell to $249,500 in February, although it is still up 3.6 percent from a year ago.

That combination of lower mortgage rates and moderating price increases makes a home purchase more affordable to a larger swath of the population. In a housing market that has been moribund throughout 2018, this might be a welcome shot that revitalizes sales. A limiting factor has been the slim volume of homes on the market, but here too some encouraging signs are emerging. The supply of homes available for sale increased 2.5 percent in February and is up on a year-over-year basis for the seventh consecutive month. Importantly, the demand fundamentals remain solid, reflecting the still-sturdy job market and accelerating wage growth.

Home Sales Rebound



That said, a one-month rebound in home sales does not make a trend. That cautionary note is particularly apt for the month of February, which is one of the weakest sales months of the year. And while inventories are rising compared to a year ago, they are still historically low. At the current selling rate, there is only a 3.5-month supply on the market, which is considerably below a normal 6.0-month supply. The trend over the upcoming spring and summer months, which are traditionally stronger for sales, will be a better gauge of the health of the housing market.

We suspect that a modest recovery in home sales and construction will contribute to a modest rebound in overall economic activity in the second quarter. While we don't dismiss the rising recession concerns that are reverberating through the financial markets, they are probably overblown, reflecting increasing global headwinds and recent downbeat economic data. That sentiment may well receive more validation in the coming week with the release of the second estimate of fourth-quarter GDP, which, as noted, will likely be revised down a notch. But just as the fourth quarter ended on a weaker note than it began, the first quarter should provide a stronger handoff to the second, helped in part by lower interest rates and backstopped by a Fed that is now more inclined to stimulate growth than restrain it.