Market Bulletin

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The Fed in 2018: Five things to know

Alexander Dryden, CFA
Global Market Strategist

John C. Manley
Market Analyst

In brief

- The composition of the Federal Reserve (the Fed) will be different in 2018 and likely moving in a more hawkish direction.
- During this economic expansion, the Fed has made significant progress towards hitting its dual mandate of price stability and full employment. However, the Fed's shadow mandate – avoiding asset bubbles – remains a concern.
- How will Fed policy shift in 2018? We believe there will be three to four rate hikes in 2018, which is significantly more than what the market is currently pricing in. Meanwhile, the balance sheet should continue its gradual decline.

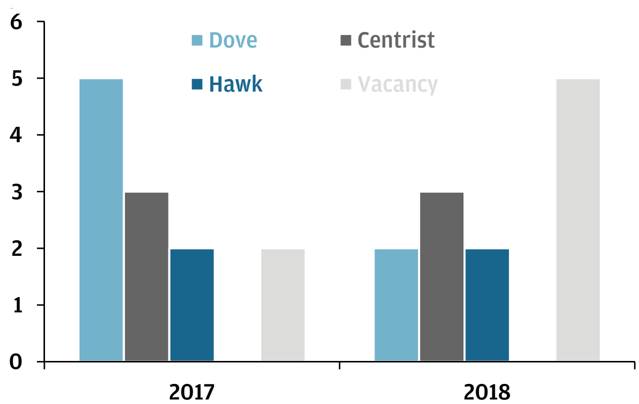
1. The Fed will be different in 2018

The Fed is in the midst of a transition period, and its composition has changed. That said, policy first set in place in 2015 should remain unaltered.

Most notably, Janet Yellen's tenure as Chair is over. She will be replaced by Jerome Powell, a trained lawyer and current member of the Fed's Board of Governors. This leadership exchange is a headline event, but it should not be overestimated. Mr. Powell is a consensus builder, having not dissented in any decision since becoming a Governor in May 2012; moreover, his lack of experience as an economist should position him to rely heavily on his Board. The continuation of monetary policy under Powell would also have historical precedence, with no leadership transition in the last 40 years resulting in an immediate change in direction of interest rates.

The broader composition of the FOMC is also changing, with procedure dictating a rotation of non-Board committee members. The committee will lose two prominent doves, in addition to a handful of other bank presidents, with their replacements being decidedly less-dovish, as shown in **Exhibit 1**. A number of vacancies will be open, too – not unusual, particularly in the last 20 years. These vacancies will likely be filled with policy hawks, again suggesting tighter monetary policy.

EXHIBIT 1: FOMC COMPOSITION BY VOTING BIAS



Source: Federeal Reserve, J.P. Morgan Asset Management. Data are as of January 25, 2018.

2. The dual mandate is being achieved

Per the Federal Reserve Reform Act of 1977, maximum employment and price stability are the Fed's dual mandate. With inflation close to 2% and unemployment at 4.1%, it appears that the mandate is being achieved.

The unemployment rate currently sits near a record-low, with only two instances in the last 50 years of sustained levels lower than present. The Fed, in its most recent forecasts, predicts the unemployment rate to fall to 3.9% by the end of 2018. More likely, it will fall further. Fiscal stimulus through tax reform should add incrementally to 2018 GDP. Accelerating GDP growth, particularly in the absence of productivity gains, will necessitate a more dramatic decrease in unemployment than the Fed predicts: the lower-bound is likely closer to 3.4%, the lowest level seen in over 60 years.

On inflation, recent weakness does not preclude future price growth. A base case of benign inflation has upside risk in 2018, particularly if the labor market tightens more than already anticipated in response to fiscal stimulus. Moreover, the roll-off of transitory weak spots like cellular bill and airfare prices should relieve some downward pressure on inflation, resulting in a gradual but upward movement that should ultimately satisfy the FOMC.

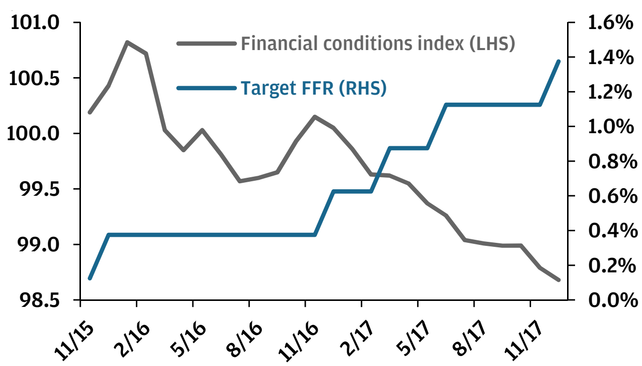
3. Asset bubbles are a worry

Despite success in achieving its dual mandate, there remains concern about the Fed's unofficial "shadow" mandate: preventing excess asset price appreciation. This concern is well-warranted.

Since the beginning of the U.S. recovery, the S&P 500 has appreciated by roughly 300%, the longest bull market on record. Home prices, too, have appreciated dramatically, with the average sales price of a new home increasing by nearly 40% in the recovery, significantly faster than the pace of inflation. The recent rise in crypto currency speculation is further proof of asset price inflation.

Asset prices have dramatically appreciated because of the extended period of ultra-low interest rates, which both allowed for cheap borrowing and encouraged investment in risk assets. Typically, rising interest rates should help deflate asset bubbles, but so far have not. In fact, it has been the opposite: financial conditions, which measure Treasury yields, credit spreads, equity prices and currency strength, have become easier over the course of this hiking cycle (**Exhibit 2**), mostly due to a recent collapse in the value of the dollar. Should conditions continue to loosen and asset prices continue to rise, the Fed will likely be forced to more aggressively tighten monetary policy.

EXHIBIT 2: FINANCIAL CONDITIONS ARE LOOSENING DURING THIS RATE HIKING CYCLE



Source: Bloomberg, FactSet, Federal Reserve, Goldman Sachs, J.P. Morgan Asset Management.

4. Expect more rate hikes in 2018

So what does this mean for actual monetary policy in 2018? A slightly more hawkish Fed, continued progress towards hitting the dual mandate and worries about asset bubbles should see the Fed raise rates three to four more times in 2018.

Our view is slightly more hawkish than the one to two interest rate hikes that is currently priced into the markets. This means that as investors adjust to a slightly more hawkish Fed, bond prices are likely to fall and yields are likely to grind higher. This will hurt fixed income investors.

5. Balance sheet policy is unlikely to change

Despite some debate over the pathway for rates in 2018, the reduction in the balance sheet looks to be on a preset course. Last year, the Fed announced that it would begin reducing its balance sheet, allowing up to USD 10 billion of bonds to mature each month. It would increase this cap by USD 10 billion each quarter until reaching a cap of USD 50 billion per month. So far, the Fed appears to be sticking to this plan, having increased the cap to USD 20 billion at the start of 2018.

In terms of using monetary policy to combat a negative shock to the economy, Janet Yellen has made clear that interest rates, rather than balance sheet manipulation, will be the Fed's primary tool. Barring a severe economic shock, therefore, we believe that the Fed will continue to wind down its balance sheet over the course of 2018, and will likely increase the caps as outlined last year. This will see the balance sheet shrink by USD 370 billion, from USD 4.45 trillion at the end of 2017 to USD 4.08 trillion by end of the year.

Investment implications

- The changing composition of the Fed, coupled with the fact that the dual mandate is being achieved and asset prices are becoming worrisome, means investors should expect slightly more hawkish monetary policy in 2018.
- We believe the Fed will raise interest rates three to four more times in 2018 while continuing to reduce the size of its balance sheet in line with the pathway released last year.
- The continued reduction in the balance sheet, combined with more interest rate hikes than what the market is expecting, will likely see bond prices fall and yields rise over the course of 2018.

MI-MB_Fed in 2018

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