Are the July and September Federal Fund rate cuts and renewed expansion of the Federal Reserve (the Fed) balance sheet signs that the policies led by Chairman Powell are falling into place? Or, are these adjustments a sign that it is falling behind?

At his final press conference in 2018, despite having just implemented the fourth rate hike of the year, Fed Chairman Powell noted fourth quarter market volatility was part of a backdrop, which included tighter financial conditions, which were less supportive of growth going forward. In that context, he stated that "Many [Federal Open Market Committee] FOMC participants had expected that economic conditions would likely call for about three more rate increases in 2019. We have brought that down a bit and now think it is more likely that the economy will grow in a way that will call for two interest rate increases over the course of next year."

Fast forward seven months from that statement and the Powell Fed had implemented zero additional rate hikes and, instead, made the first of two rate cuts so far in 2019. In July, and again in September, Chairman Powell noted that the Fed's policy evolution was driven by weak global growth, trade policy uncertainty and muted inflation.

The view that the Fed's policy has caught up to market expectations and, therefore, its policy is falling into place, is supported by Federal Funds futures pricing as of September 30, which reflected just a 40% chance of a rate cut at the upcoming October Fed meeting. Standing pat at the October meeting would also be consistent with the FOMC median 'dot plot', which projects the year-end rate expectations of each of the Fed's 17 voting members.

However, a mismatch between futures market pricing and the dot plot could support the idea that Fed policy is falling behind. Federal Funds futures pricing on September 30 also reflected a 70% chance of a rate cut by year-end (at either the October or December meeting). Furthermore, as of the September FOMC meeting, less than half the voting members, specifically seven of seventeen, project a lower rate by year-end, and five of the seventeen project a rate hike at one of the two remaining meetings of 2019. In short, it appears that a significant portion of bond futures market participants have assessed Fed policy as behind and in need of additional evolution.

While the Fed may or may not be playing catch-up with respect to its policy rate, for three days in September it appeared the Fed was behind the curve with respect to a different policy tool. After more than a year of allowing its balance sheet to shrink as the government bonds it owned matured, the Fed restarted asset purchases to address a lack of liquidity in the overnight lending market. From September 16 through 18, the effective Federal Funds rate (the interest rate at which overnight borrowers within the Federal Reserve system actually pay) spiked well above the mid-point of the target range and even went above the upper bound of the targeted range on September 17. The spike was driven by a shortage of liquid reserves that could be lent within the system. To remedy the situation, the Fed was compelled to conduct market operations involving the purchase of longer-term assets from lending institutions, thus supplying them with liquid reserves that could be used to satisfy demand for overnight loans. The Fed had not enacted such transactions since the financial crisis 11 years ago.

Though the Fed's action brought the effective Federal Fund's rate back to the mid-point of its target range and helped calm markets that had been unnerved by the overnight reserves rate spike, the change in policy is a potentially troubling sign. This is because Chairman Powell had earlier indicated that the policy approach was such that open market operations, like September's, would not be needed. Specifically, when pressed for clarification on its balance sheet policy during a post-meeting press conference in January, Chairman Powell explicitly articulated that the "ample reserves" policy approach of the Fed would entail setting the Federal Funds rate "without managing the supply of reserves actively." He went so far as to say that their approach would provide "good control of short-term money market rates in a variety of market conditions and effective transmission of those rates to broader financial conditions." In mid-September the market sent a clear signal that reserves were not "ample" enough and a resumption in the growth of the Fed's balance sheet ensued.

Whether the Fed policy evolution is ahead, behind or right on-time remains uncertain. What is more certain is that, if the Fed fails to continue meeting market expectations, there is significant potential for an increase in volatility and a possible disruption of the strong returns posted by both equity and fixed income markets so far this year. As we wrote in our May and August Market Perspectives, we see the differing responses to upticks in uncertainty from implied volatility markets and interest rate markets as an indicator that many market participants are counting on the Fed to be effective managers of investment risk. Recently, at the same time there has been a strong downtrend in interest rate markets in response to negative developments and increasing uncertainty, there has been a muted response from markets that price future equity volatility, like the Chicago Board Options Exchange Volatility Index.

The combined signals from interest rate and implied volatility markets send the message that if interest rates go down, equity market volatility is likely to be low. As investors ponder the contingency in that statement, consider that the mandate of the Fed is to manage employment levels and price stability (inflation). Investors counting on the Fed to perform a function not explicitly part of its mandate may be setting themselves up for disappointment.

IMPORTANT INFORMATION

Sources: Morningstar Direct[SM], Bloomberg, L.P.

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