CIBC PRIVATE WEALTH MANAGEMENT

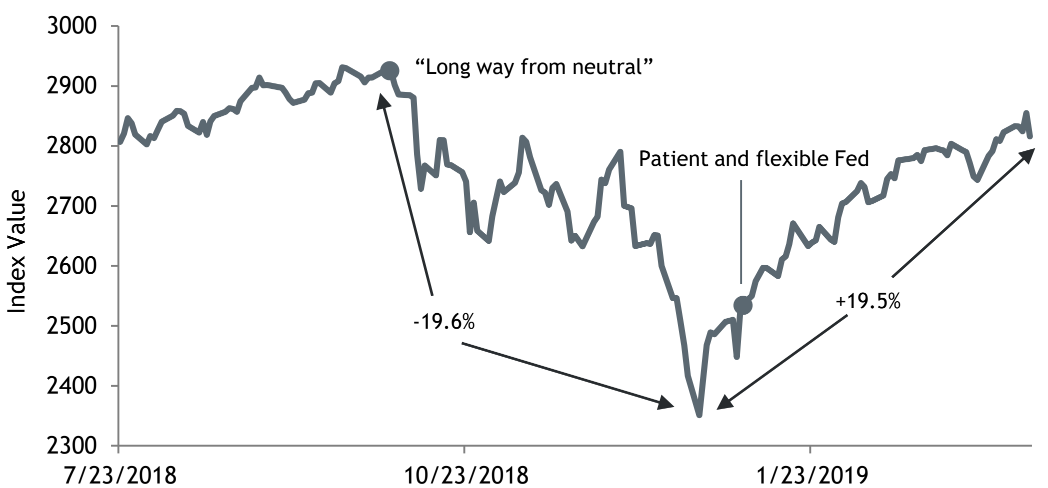
THE BOND MARKET

What Has Changed at the Fed?

A U-TURN FOR MARKETS

Equity markets have experienced a significant amount of volatility over the last six months. The near 20% drop in value of the S&P 500 from early October to late December was followed by a 20% appreciation through late March.

Market Rebound, S&P 500 – Q4 2018 -13.5%, January 2019 +8.0%



Source: Bloomberg, as of 03.22.2019.

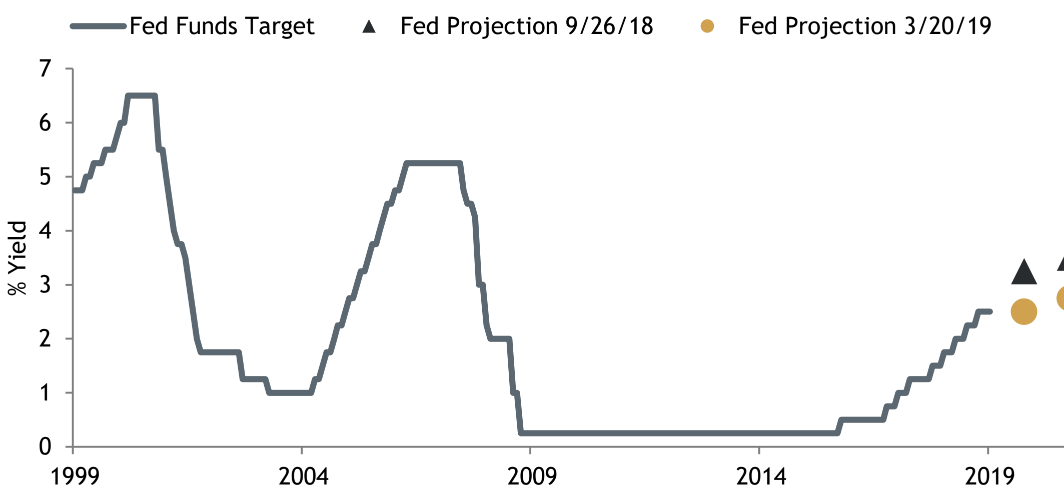
Market volatility of this nature is rarely due to a single factor, and this recent swing in prices could be a result of changes on several fronts, including: improving prospects for a trade deal with China, an adjustment in expectations for growth and earnings and an end to the government shutdown. Of course, if you look at a snapshot of most periods of market volatility you will see the Federal Reserve (The Fed) somewhere in the frame.

SO, WHAT HAS CHANGED AT THE FED?

While turning points in markets can be sharp and sudden, changes in Fed policy are usually more nuanced.

And unlike the market U-turn, **Fed policy has gradually shifted from the direction of higher rates toward something akin to a stand-still.** The median Fed participant projects there will be no change in short-term rates this year. This is a change from their September projection of three rate hikes of 0.25%. Chairman Powell has made it clear since the beginning of his term that the Fed is in the business of risk management. The inexact science of economics and monetary policy led Powell to compare rate setting to wandering through a dark room without tripping over the sofa. To the Fed's credit, when the room got dark, they slowed down.

Short-Term Interest Rates



Source: The Federal Reserve, as of 03.22.2019.

The Fed usually looks to three broad areas to assess where they are in the room: growth, inflation, and the markets. When we look at indicators in these areas, it appears that the risks have changed and the Fed is responding with an appropriate adjustment in policy.

1. **Growth is slowing.** As recently as September, the Fed expected 2019 to see slightly slower growth in the U.S. economy. Their models projected 2.5% growth, down from actual expansion of 3.1% in 2018. Fiscal policy is expected to be less supportive in 2019 and headwinds from trade policy will likely reduce contributions from the rest of the world to U.S. growth. Incoming data has softened since then, particularly retail sales and purchasing manager surveys. The Fed's models now project growth of 2.1% for the current year.

2. **Inflation is stable.** At its September meeting, the Fed worried that low unemployment—the lowest in nearly 50 years—would spark higher wages and eventually, higher inflation.

Wage gains had been slower than usual to that point, but several key wage indicators saw acceleration in 2018 in response to labor shortages in some areas of the economy. Increases in wage measures indicated that the low unemployment rate was not a mirage, but it was also not translating into broad increases in prices. Data on the Fed's preferred measure of inflation has been below its target of 2% since July.

3. **Markets recoiled at higher rate projections.** The Fed is sensitive to access to capital for consumers and businesses. Market disruption leads to gaps in financing and puts household and business purchasing decisions at risk. We have already highlighted the equity market reaction, but access to corporate debt markets was also constrained in the last quarter of 2018. When the Fed raised rates in December and sent a signal that it would likely have to continue raising them in 2019, the negative market reaction was an indication that the Fed had stubbed its toe.

Market behavior can force a policy response at times and the Fed's recent shift followed the market's lead in a call for stable rate policy. We see this as an appropriate adjustment in policy, supported by a slightly slower economic outlook and lack of evidence of inflation. At his last press conference, Powell indicated that policy will continue to respond to economic and market data, and whether the next move was a cut or a hike was equally likely. Markets are already discounting higher odds of lower rates in the coming quarters, but it may take further weakness for the Fed to make another shift toward easier monetary policy. ■

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