



The Fed changes its game plan

Weekly Market Review: The Fed signals a major change in approach at its January meeting

Feb 4, 2019 | Kristina Hooper, Chief Global Market Strategist

The biggest American football game of the year was played last night, and for the first three quarters, it looked as if both teams forgot how to score a touchdown. But great teams find a way to win, even when their tried-and-true game plan seems to be faltering.

The Federal Reserve (Fed) has been in a similar place, sticking to its playbook of rising rates and balance sheet normalization, and causing market jitters in the process. But last week, we saw the strongest indications yet that the game plan may be changing. The Fed released its January statement and held a press conference last Thursday. The Fed made it clear that “the case for raising rates has weakened,” citing a variety of factors from a slowing global economy to policy uncertainty surrounding trade conflicts and Brexit, and relatively low inflation.

The Fed’s January statement said it would be “patient” as it “determines what future adjustments to the target range for the federal funds rate may be appropriate.” This promise of “patience” was a welcome change from what felt like a brisk series of systematic quarterly rate hikes in 2018. Powell made a dramatic about face when he said last week that the Federal Open Market Committee (FOMC) might already be at neutral: “Our policy stance is appropriate right now. We also know that our policy rate is in the range of the [FOMC’s] estimates of neutral.” This was a significant change from Powell’s comments in October, when he said the Fed was a long way from neutral (which of course helped catalyze the fourth-quarter sell-off). Now this doesn’t mean the Fed won’t raise rates this year, but it certainly means the Fed will be far more unhurried, measured and thoughtful about any more rate hikes.

But the big news from last week was about the Fed’s balance sheet. As recently as December, Powell had insisted that the balance sheet normalization process would remain on “autopilot,” stoking market concerns. However, since then, FOMC participants including Powell have suggested the Fed could be more flexible. And then came the January FOMC meeting, when the Fed signaled a major change in its approach to the balance sheet. While the FOMC was clear that the balance sheet will not be the “active tool” of monetary policy operations, it assured that the balance sheet could be altered depending on conditions: “The Committee is prepared to adjust any of the details for completing balance sheet normalization in light of economic and financial developments,” according to the FOMC’s statement.

From my perspective, that was a very important change – being essentially data dependent (rather than operating on autopilot) is a good thing. And I believe this change in perspective will help to support risk assets going forward, regardless of whether or not the Fed actually alters its normalization plan.

What are we hearing from the Fed?

What is the data telling us now?

The FOMC decision and press conference seemed strange given how significant a departure it was from the Fed's decision just six weeks ago. It seems even more bizarre when it is juxtaposed with the US jobs report released two days later. The US employment situation report for January was another blockbuster, with nonfarm payroll growth of more than 300,000 and average hourly earnings growth above 3% year-over-year.¹ (Now, the caveat is that the previous month's nonfarm payrolls had to be revised down significantly, but this was still a strong report.)

But despite the strong US jobs report, we have been seeing signs of a global slowdown - which helps explain the Fed's decision (it even cited a slowing global economy as a reason for its newfound patience).

- **Europe.** Italy's economy contracted for the second consecutive quarter, putting it into a technical recession, and the eurozone in general is under pressure. And Eurostat reported that euro area gross domestic product (GDP) growth rose 0.2% for the fourth quarter and 1.2% for the year.²
- **China.** The Caixin/Markit Purchasing Managers' Index (PMI) for Chinese manufacturing clocked in at 48.3 for January, indicating contraction.³ This is similar to the official PMI statistics from the Chinese government, and it reflects what we heard from companies such as Caterpillar and Nvidia that mentioned Chinese weakness in earnings calls.
- **Japan.** Another sign of a global slowdown came from Japan, where manufacturing PMI also dropped to a level not seen in several years - although it is still in expansion territory.
- **Asia.** Manufacturing PMIs for Taiwan and South Korea are in contraction territory, another indication of a global slowdown.

What are we watching going forward?

Below, I highlight seven issues to watch in the coming week:

1. US-China trade talks. Another big issue hanging over the stock market is, of course, the US-China trade situation. We have received varying assessments of last week's talks from those involved in them, although it is a positive sign that the talks actually continued despite the Huawei indictments.⁴ However, it seems clear that very little in the way of material progress has been accomplished thus far. Talks are expected to resume in mid-February, which gives very little time to get anything accomplished before the US' March 1 deadline, when it says it will raise tariffs. As I have been saying, I expect China will not make any major concessions - I can think of no compelling reason why it would. And so the question is whether the US will extend the deadline for raising tariffs and continue negotiations, or whether it will take "easy wins" from China in the form of promises to buy more US goods. Even that will be difficult to get nailed down by the end of February, so I think an extension is most likely - which I expect would have no significant impact on stocks. My alternate scenario is that the US may quickly accept China's offer of reducing the trade deficit, despite having ironed out all the details, and spin it as a big win, and the stock market would likely react very positively.

2. Brexit. The plot thickened on Brexit last week with two key Parliamentary votes. UK Prime Minister Theresa May has been given the mandate to go back to the European Union and re-negotiate a deal. However, that seems to be a fool's errand as a spokesperson for European Council President Donald Tusk said last week that the agreement was "not open for renegotiation." The likelihood of a "crash out" from the EU is increasing, which is concerning, as more economic policy uncertainty is likely, which is not good for business spending or hiring plans. For example, Nissan has just decided that it will shift production of its X-Trail vehicle out of the UK, explaining that "The continued uncertainty around the UK's future relationship with the EU is not helping companies like ours plan for the

future.”⁵ I am hopeful that if enough companies make decisions like this in coming days, it will force the prime minister to become more flexible and entertain another Brexit referendum. If Jay Powell can change his game plan, I hold out hope that Theresa May can too.

3. The price of oil. Venezuela has been coming under greater civil strife. Major European nations and the US have recognized the opposition leader as the new interim president of Venezuela, as the humanitarian situation worsens and Nicolas Maduro shows little inclination to back down. As this situation becomes more chaotic, I expect continued reduction in oil production, which should, all else being equal, support a slightly higher oil price. In addition, there are growing concerns that the US might attempt military action against Iran – another geopolitical risk that could drive oil prices higher.

4. Euro area retail sales and the Sentix Investor Confidence survey. We want to get a sense of how significant the slowdown is in the eurozone, and these two readings – one actual data and one sentiment – should give us a sense of the current state of the economy. I expect we will continue to see a material slowdown in growth, but that we will not see a recession this year, but we will need to monitor data closely. I am optimistic that consumers in some European countries such as Germany will actually increase spending in coming months.

5. Discussions around the successor to Mario Draghi. It has been reported that the candidacy of monetary hawk Jens Weidmann as the next president of the European Central Bank is becoming more likely, as Italy’s finance minister is reportedly not opposed to him as the next ECB president. This is concerning to me, given that Weidmann has advocated for the ECB to end extraordinary stimulus measures and tighten monetary policy. Given how important Draghi has been in reducing systemic stress in European markets, I worry about what a Weidmann presidency will do. I expect markets will react negatively if Weidmann is appointed.

6. Japan Leading Economic Indicators Index. Given that we are seeing signs of a slowdown in Asia, we will want to follow Japanese economic data closely – especially leading indicators. However, I expect economic growth to remain relatively solid.

7. US State of the Union Address. US President Donald Trump has suggested that he might declare a national emergency during this speech, scheduled for Feb. 5. From my perspective, that might actually be a positive, as it means the US would avoid another shutdown. Shutting down the government again would not only be negative for the economy, creating more economic policy uncertainty, but would jeopardize the US’ credit rating.

Finally, I would like to wish everyone a happy Chinese New Year. I look forward to seeing what the Year of the Pig has in store.

Source

US Bureau of Labor Statistics, as of Feb. 1, 2019

Eurostat, as of Jan. 31, 2019

Reuters, as of Feb. 1, 2019

On Jan. 28, US authorities issued indictments against Chinese tech firm Huawei. Allegations include violating US sanctions on Iran as well as attempted theft of trade secrets.

The Guardian, "Nissan warns of Brexit concerns as U-turn at Sunderland confirmed," Feb. 3, 2019

Important information

The Federal Open Market Committee (FOMC) is a 12-member committee of the Federal Reserve Board that meets regularly to set monetary policy, including the interest rates that are charged to banks.

The federal funds rate is the rate at which banks lend balances to each other overnight.

The Caixin/Markit Purchasing Managers' Index (PMI) for China is considered an indicator of economic health for the Chinese manufacturing sector. It is based on survey responses from senior purchasing executives.

The Sentix Investor Confidence Index measures the economic outlook for the eurozone, based on a survey of investors and analysts.

The Japan Leading Economic Indicators Index measures 12 leading indicators for the Japanese economy.

In a "no-deal" or "crash out" Brexit, the UK would leave the EU in March 2019 with no formal agreement outlining the terms of their relationship.

Gross domestic product is a broad indicator of a region's economic activity, measuring the monetary value of all the finished goods and services produced in that region over a specified period of time.

The opinions referenced above are those of Kristina Hooper as of Feb. 4, 2019. These comments should not be construed as recommendations, but as an illustration of broader themes. Forward-looking statements are not guarantees of future results. They involve risks, uncertainties and assumptions; there can be no assurance that actual results will not differ materially from expectations.

This document has been prepared only for those persons to whom Invesco has provided it for informational purposes only. This document is not an offering of a financial product and is not intended for and should not be distributed to retail clients who are resident in jurisdiction where its distribution is not authorized or is unlawful. Circulation, disclosure, or dissemination of all or any part of this document to any person without the consent of Invesco is prohibited.

This document may contain statements that are not purely historical in nature but are "forward-looking statements", which are based on certain assumptions of future events. Forward-looking statements are based on information available on the date hereof, and Invesco does not assume any duty to update any forward-looking statement. Actual events may differ from those assumed. There can be no assurance that forward-looking statements, including any projected returns, will materialize or that actual market conditions and/or performance results will not be materially different or worse than those presented.

The information in this document has been prepared without taking into account any investor's investment objectives, financial situation or particular needs. Before acting on the information the investor should consider its appropriateness having regard to their investment objectives, financial situation and needs.

You should note that this information:

- may contain references to amounts which are not in local currencies;
- may contain financial information which is not prepared in accordance with the laws or practices of your country of residence;
- may not address risks associated with investment in foreign currency denominated investments; and
- does not address local tax issues.

All material presented is compiled from sources believed to be reliable and current, but accuracy cannot be guaranteed. Investment involves risk. Please review all financial material carefully before investing. The opinions expressed are based on current market conditions and are subject to change without notice. These opinions may differ from those of other Invesco investment professionals.

The distribution and offering of this document in certain jurisdictions may be restricted by law. Persons into whose possession this marketing material may come are required to inform themselves about and to comply with any relevant restrictions. This does not constitute an offer or solicitation by anyone in any jurisdiction in which such an offer is not authorised or to any person to whom it is unlawful to make such an offer or solicitation.