Economist's Weekly Market View

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Much uncertainty about path of US rates in coming year

There is a lot of uncertainty about the path of US interest rates this year, with a big divergence in the views of the Federal Reserve and the markets. The December meeting of the Federal Reserve saw rates hiked as expected by 25bps, with the target range for the key fed funds rate raised to 2.25-2.50%.

However, the Fed lowered its expected path for future rates, scaling back its rate hike projections for the coming year. It now expects two 25bps rate hikes in 2019 compared to three previously, although it still plans to also raise rates one more time in 2020. Thus, the Fed now sees rates peaking at 3.125%, rather than 3.375% previously. It also sees rates rising at a much slower pace than in 2017-18.

The lower guidance from the Fed is still well above the market's very benign outlook for interest rates. Over the past couple of months, the market has scaled back its rate hike expectations, amid signs of a softening in the global economy and increasing risk aversion on financial markets.

In the autumn, the market had been expecting two 25bps hikes from the Fed in 2019, taking rates up to near 2.9%. Futures contracts, though, now see no changes to rates this year, indicating that markets believe the Fed is finished with raising rates. Markets are even beginning to discount the possibility of a rate cut in 2020. It is worth noting, though, that markets significantly underestimated the extent of Fed tightening in both 2017 and 2018.

The Feds funds rate is now at the bottom of what is considered to be its neutral range, whereby rates are at a level that neither stimulate nor restrict growth. Hence, Fed Chair Powell has emphasised that the future path of interest rates is very much data dependent. The Fed will thus be examining incoming data very carefully in assessing what to do on interest rates this year.

The economy will slow this year as the fiscal stimulus fades, tighter monetary conditions impact and given slower global growth. However, the Fed still sees GDP growing by a solid 2.3% by end 2019 and 2% at end 2020, with inflation remaining around the 2% level. The course of the trade talks between the US and China could have a key role to play in this regard, as a trade deal would provide a big boost to business confidence and financial markets.

The markets, though, are increasingly worried about the outlook for the US economy and seem to be fearing a sharp slowdown in activity this year, as evidenced by the steep falls in stock markets over the final months of 2018, as well as declining bond yields. A concern in markets is that the Fed could tighten monetary policy too much, causing a sharp economic slowdown.

The focus, then, is going to be on US economic data this year. The Fed has raised rates at a steady pace over the past couple of years. However, it may keep them on hold in early 2019 while it awaits further data on the economy. If US growth remains solid, then markets will have to reassess their view that US rates have peaked, as they could well be hiked further this year.

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