The Fed Pivots on Interest Rates

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Ben Pace, Chief Investment Officer
Cerity Partners

The Federal Open Market Committee (the Committee) decreased the federal funds rate by 0.25% (25 basis points) yesterday to a range of 2.00%-2.25%. In somewhat of a surprise, it also announced the end to the balance sheet reduction program two months earlier than initially indicated. As always, the statement accompanying the announcement and Chairman Powell's press conference provided more insight into the Committee's long-term strategy.

The Fed described an economic backdrop of continued moderate expansion and low inflation, but also cited the potential negative impact global developments (e.g., trade frictions) could have on the economic outlook. The vote to cut rates was not unanimous. Kansas City Fed President Esther George and Boston Fed President Eric Rosengren preferred to keep rates unchanged. Chairman Powell called the rate cut a "mid-cycle adjustment" and stressed that it should not be viewed as the beginning of an extended easing cycle.

The markets viewed this reduction as a more hawkish cut and reacted accordingly. U.S. equities sold off as the market had priced in a more dovish Fed, if not a .50% cut. Bond yields declined on the longer end and the closely watched spread between the two-year and ten-year Treasury note flattened somewhat. The dollar also rose sharply as several other central banks are expected to follow the Fed's lead. Finally, gold prices declined; this market had priced in more aggressive Fed easing.

Given the reasonably strong GDP growth rate, it makes sense for the Fed to assess current conditions and monitor incoming data before committing to a prolonged tightening program. Earlier this year, it was important to remove Fed tightening as a market headwind. Powell's pivot in January away from tightening towards easing was arguably the most important driver of strong year-to-date returns in the equity markets.

Having begun the process of easing monetary policy, the Fed is now in a better position to react to any tangible slowdown in economic growth or heightened trade frictions. While investors may quibble over the magnitude of potential ease, monetary policy is now a clear tailwind and should support higher equity valuations in an environment of continued economic and earnings growth.

Ben Pace is the Chief Investment Officer and a member of the Investment Committee. Prior to joining Cerity Partners, Benjamin Pace was Chief Investment Officer and Head of Global Investment Solutions for Deutsche Bank Private Wealth Management in the U.S. Ben has more than 25 years of experience in investment management. Prior to joining Deutsche Bank in 1994, he managed equity income funds for two investment organizations.