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## Are we there yet?

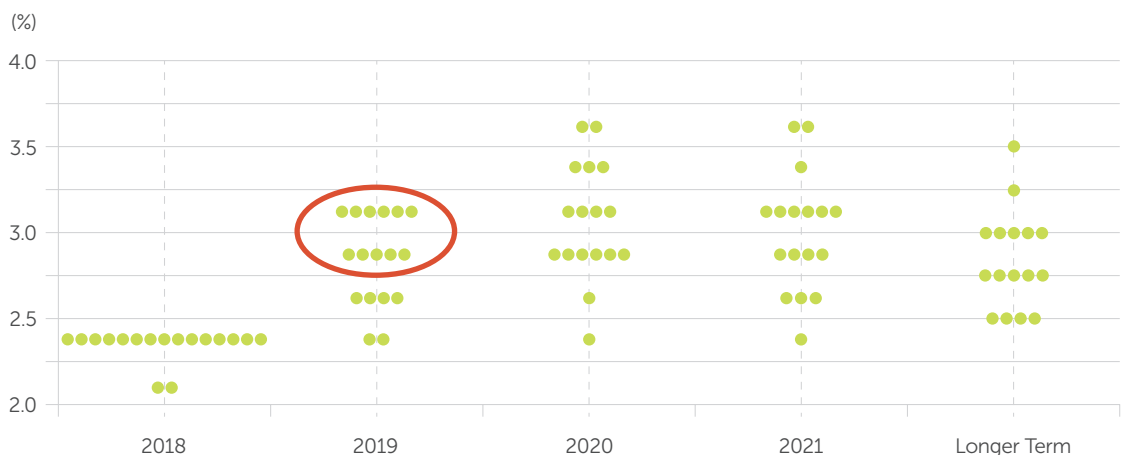
### Key highlights:

- The Federal Reserve (Fed) mindset regarding interest rates looks to have changed since the end of last year.
- The 2-year U.S. Treasury's yield suggests that financial markets think the Fed may be done raising rates for this economic cycle.
- Riskier assets may start to appear less risky in the days ahead.

### "We are data dependent"

Since the Federal Reserve (Fed) met in December, raised its benchmark federal funds rate and intimated that four hikes were likely in the next 12 months, there has been a noticeable change in its views. This shift has been hinted in comments from key Fed officials and is aptly captured in the phrase "We are data dependent" which Chairman Powell stated following December's Federal Open Market Committee (FOMC) meeting. *Exhibit 1*, from the FOMC's end-of-year meeting, is the often referred to "dot plot" that the Fed provides following its periodic deliberations. The circled area suggests that their policymakers were leaning towards more rate hikes ahead in 2019. However, this aggressive sentiment has lessened in the new year.

### Exhibit 1: In December, the Fed suggested that more rate hikes were coming

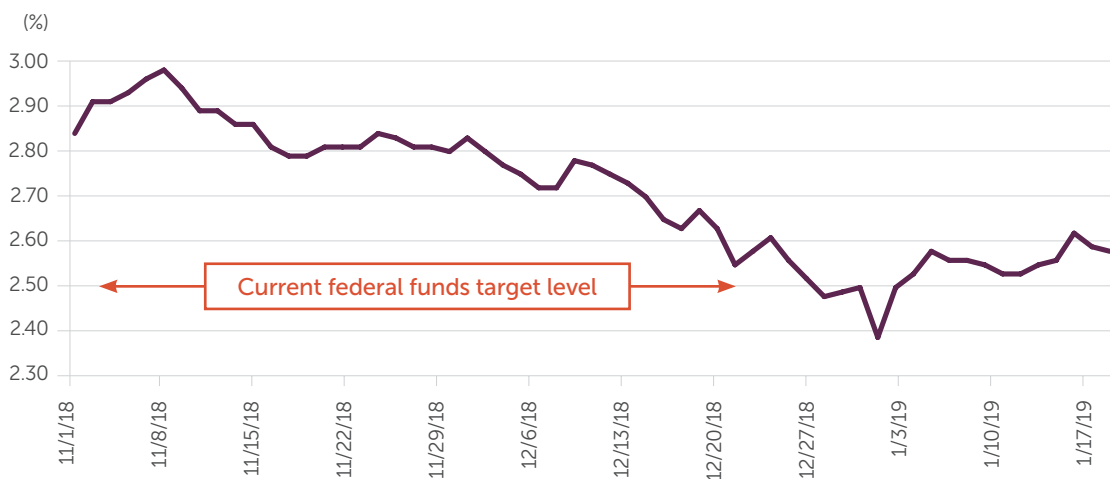


Source: Federal Open Market Committee (FOMC), meeting minutes, 12/18/18. FOMC participants' assessments of appropriate monetary policy: Midpoint of target range or target level for the federal funds rate.

### What a difference a month makes

Today, as illustrated in *Exhibit 2*, interest rates have fallen, specifically the 2-year U.S. Treasury note yield which has decreased 40 basis points since its November 2018 high of 2.98%. That level is roughly equal to the Fed's 2.50% fed funds target. Such a downward move suggests that the wider market has now shifted its thinking about potential rate hikes and the necessity of the Fed continuing on its current path. Also on investors' minds, no doubt, is the Fed's approach to its balance sheet management. Following the quantitative easing measures imposed since the Great Financial Crisis to stimulate the economy, the Fed is now shrinking the size of its mortgage and U.S. Treasury portfolio ("quantitative tightening"). Like raising the fed funds rate, reducing the Fed's balance sheet tightens monetary policy. Last year, Chairman Powell stated that reduction of the balance sheet was on "automatic pilot". Now, Fed speakers have indicated that quantitative tightening also will be data dependent.

## Exhibit 2: Market expectations have changed 2-year U.S. Treasury yield (November 2018 – January 2019)



Source: Federal Reserve Bank of St. Louis, FRED, 1/22/19.

### What does this mean for investors?

The shift by the Fed from a path of gradual and steady tightening of monetary policy to a data dependent policy has supported risk markets which have rallied nicely following December's substantial sell-off. Investors now believe the Fed is "on hold" through the first half of the year, after which it may resume raising interest rates. A Fed that may be taking an extended pause offers one source of short-term predictability. In fact, it's very possible that we may have seen the last Fed interest rate hike in this interest rate cycle. If so, the market has likely seen the high in interest rates for this cycle. Regardless, the coming months should be very interesting.

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The dot plot is published after each Fed meeting and shows the projections of the 12 members of the Federal Open Market Committee (FOMC), the rate-setting body within the Fed. Each dot represents a member's view on where the fed funds rate should be at the end of the various calendar years shown, as well as in the long run—the peak for the fed funds rate after the Fed has finished tightening or "normalizing" policy from its current levels. The dot plot represents the Fed's ongoing effort to become more transparent with respect to its policies.

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