RBC ECONOMIC RESEARCH

Financial Markets Monthly Update

January 24, 2019

Fed rate hikes: all in good time

In January's Financial Markets Monthly we noted growing risks around our long-held call for the Fed to continue raising interest rates in March, with a brief pause in their tightening cycle looking increasingly likely. Ahead of next week's FOMC meeting we are taking this opportunity to push back our forecast—we now see the Fed's next move coming in June rather than March. We still expect two rate hikes this year, but with a second increase being put off until December. This more gradual pace reflects a patient approach espoused by a number of Fed officials, as well as several downside risks to the outlook that are likely to keep investors on edge in the near-term.

With fed funds now at the lower end of its neutral range, monetary policy is becoming more data dependent and "patience" has become the Fed's watchword:

December FOMC minutes: "*Many participants expressed the view that, especially in an environment of muted inflation pressures, the Committee could* ***afford to be patient*** *about further policy firming.*"

Chairman Powell: "*We're in a place where we can be* ***patient and flexible*** *and wait and see what does evolve, and I think for the meantime we're waiting and watching.*"

Vice Chairman Clarida: "*With inflation muted, I believe that the Committee can* ***afford to be patient*** *as we see how the data evolve in 2019.*"

Chicago Fed President Evans: "*I feel we have* ***good capacity to wait*** *and carefully take stock of the incoming data and other developments.*"

Boston Fed President Rosengren: "*I believe we can* ***wait for greater clarity*** *before adjusting policy.*"

Market jitters and tightening financial conditions have been key in the Fed's dovish shift. While volatility has largely subsided, equities and corporate bonds haven't fully recovered from their end of year swoon. A number of issues continue to worry investors. The partial US government shutdown, now into its second month, shows no sign of being resolved and its impact on economic activity (while temporary) is growing by the day. Trade risks remain elevated—the tone on US-China talks has been positive, but the threat of a March 1 tariff hike can't be dismissed. Escalating trade tensions and a slowdown in China were among the downside risks noted by the IMF when they lowered their global growth forecasts this week. The recent improvement in market sentiment is encouraging, but given these concerns, we doubt the Fed will want to test investors' resilience by raising rates in Q1.

Updated fed funds and yield curve forecast:

	18Q1	18Q2	18Q3	18Q4	19Q1	19Q2	19Q3	19Q4	20Q1	20Q2	20Q3	20Q4
Fed funds (upper bound)	1.75	2.00	2.25	2.50	2.50	2.75	2.75	3.00	3.00	3.00	3.00	3.00
Three-month	1.73	1.93	2.19	2.45	2.40	2.65	2.65	2.90	2.90	2.90	2.90	2.90
Two-year	2.27	2.52	2.81	2.48	2.75	2.95	3.05	3.10	3.10	3.10	3.05	3.05
Five-year	2.56	2.73	2.94	2.51	2.80	3.00	3.10	3.15	3.15	3.15	3.10	3.10
10-year	2.74	2.85	3.05	2.69	2.95	3.15	3.25	3.30	3.25	3.25	3.20	3.15
30-year	2.97	2.98	3.19	3.02	3.20	3.30	3.40	3.45	3.40	3.40	3.35	3.30

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