Money Markets

The Fed Raises Interest Rates as U.S. Economy Strengthens, with More Hikes to Come

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Key Takeaways

- In June, the Federal Reserve made its second interest rate hike of 2018.
- The Fed also increased the interest rate on excess reserves by 20 bps to 1.95% to help return the effective fed funds rate back to the middle of its range.
- The European Central Bank plans to end its quantitative easing at the end of 2018, thanks to an improved eurozone economy, higher inflation, and increased wages.
- Inflows into U.S. money market funds surged above trend in the second quarter due to higher rates and the repatriation of offshore corporate cash.

Economic growth remains healthy

The Federal Reserve (Fed) raised short-term interest rates by a quarter of a percentage point at its June Federal Open Market Committee (FOMC) meeting, lifting the fed funds target range to 1.75%–2.00%. The primary drivers of the Fed's rate increase were the continued decline of the unemployment rate and a quicker-than-expected increase in inflation. The U.S. unemployment rate stood at 3.8% in May, its lowest level in 18 years,[1] while inflation climbed to the Fed's 2% target rate.[2]

In its June Summary of Economic Projections (SEP), the Fed updated its forward guidance regarding future monetary policy (Exhibit 1). More than half (8 of 15) of the Fed officials expect an additional 2 rate hikes in 2018, along with 3 more increases in 2019. That projects to a 3.125% policy rate by the end of 2019, which is higher than the 2.875% rate forecasted in March. The projected rate forecast for 2020 remained unchanged at 3.375%.

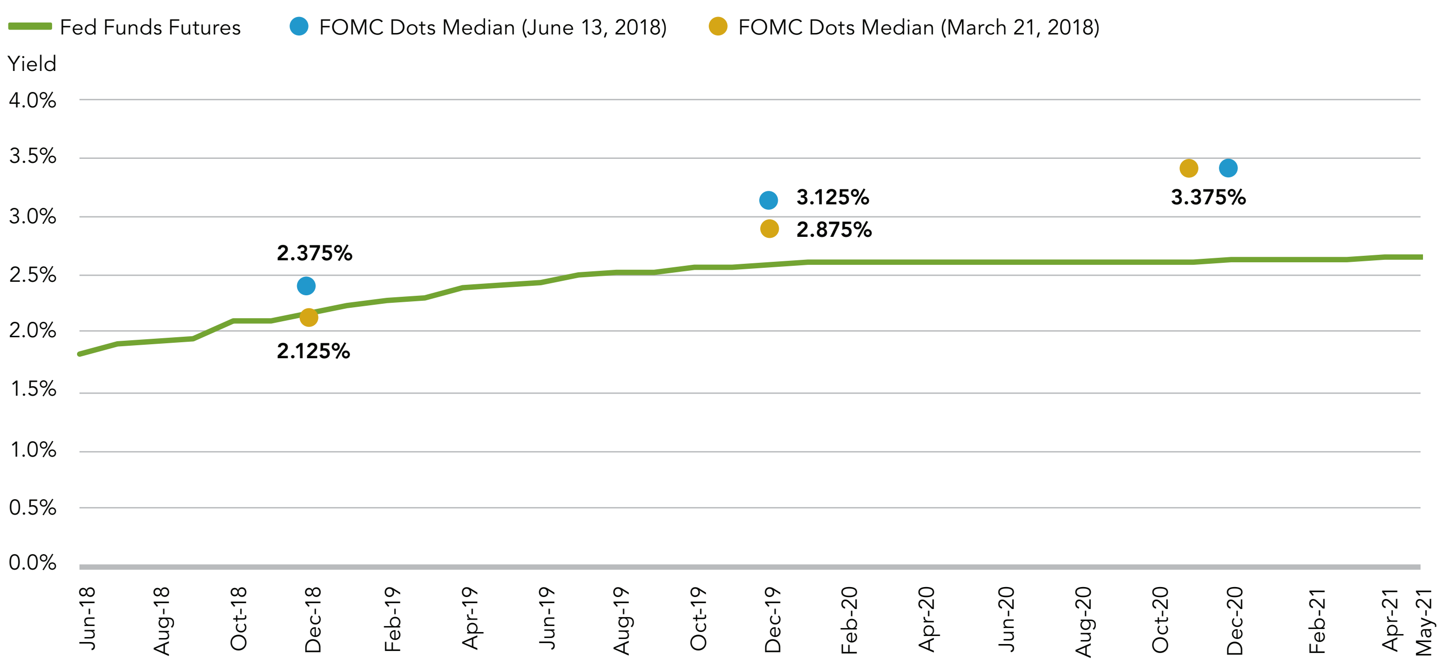
The June rate increase was the second this year and the seventh hike in this cycle, dating back to December 2015. The vote to raise rates was unanimous. New Fed Chairman Jerome Powell stated that "the decision you see today is yet another sign that the U.S. economy is in great shape. Growth is strong. Labor markets are strong. Inflation is close to target." Powell also stated that "We've been very, very careful not to tighten too quickly . . . We had a lot of encouragement to go much faster and I'm really glad we didn't."[3]

Meanwhile, Fed officials modified their economic forecasts slightly, projecting modestly stronger growth and inflation this year and lower unemployment. "Economic activity has been rising at a solid rate," the FOMC said in its statement. "Recent data suggest that growth of household spending has picked up, while business fixed investment has continued to grow strongly."[4]

The Fed's median estimate for U.S. economic growth in 2018 rose from 2.7% to 2.8% in March (Exhibit 2), with projections unchanged for 2.4% and 2.0% in 2019 and 2020, respectively. Currently, the U.S. economy is getting a boost from $1.5 trillion in tax cuts and a $300 billion increase in federal spending. The FOMC's forecast for the sustainable growth rate of the economy held at 1.8%, suggesting policymakers are skeptical of the long-term effect of tax cuts on the economy's capacity for growth. The Fed also noted that shifts in trade policy could weigh on economic activity, with several members saying it could pose downside risks to their growth forecasts. However, while trade policy is an emerging risk, the Fed does not seem to be overly concerned about it at this point.

EXHIBIT 1: In Q2, the Fed upped its forward guidance on interest rates in 2018 and 2019.

Fed Funds Futures vs. Fed Forward Guidance



Source: Federal Reserve, Bloomberg Finance L.P., as of 6/28/18.

Inflation on the rise

On inflation, policymakers forecast a slight overshoot of their target. The Commerce Department's Personal Consumption Expenditures (PCE) Index rose to the 2% level, after spending most of the past six years below it. The core PCE index, which excludes volatile food and energy and is the Fed's preferred price gauge, is forecast to reach 2% this year and 2.1% in 2019 and 2020. The index rose to 1.8% in April from a year earlier.

U.S. central bankers emphasized that the goal is "symmetric," and stated in the May meeting minutes that "a temporary period of inflation modestly above 2%" would help anchor long-run inflation expectations around the target. The Fed also stated that "indicators of longer-term inflation expectations are little changed."

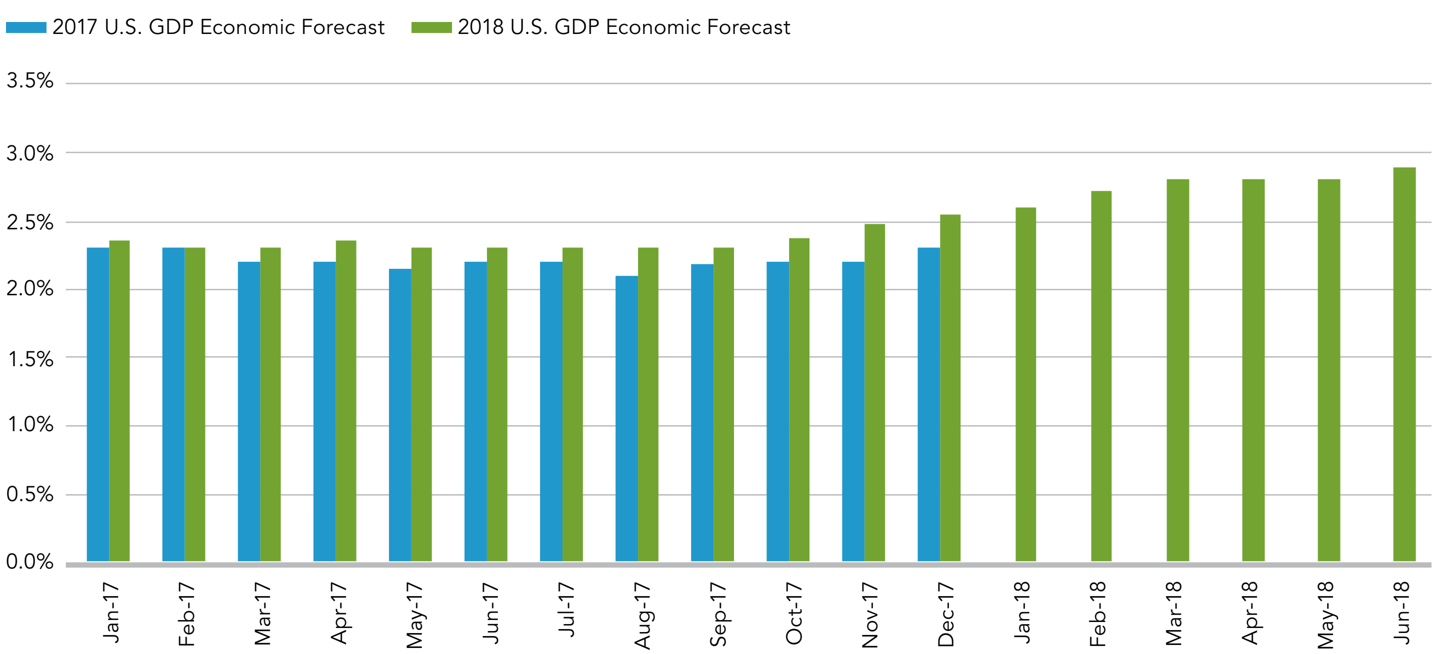
Unemployment at a multiyear low

Fed officials lowered their year-end jobless-rate estimates to 3.6% after unemployment fell to 3.8% in May. This matched the 3.8% rate in April 2000 as the lowest unemployment reading since 1969. This spring, for the first time on record, the number of job openings in the U.S. exceeded the number of unemployed Americans, compared to the end of the Great Recession in July 2009, when there were on average 6.6 unemployed people for each job opening.[5]

Longer term, unemployment is now expected to drop to a 50-year low of 3.5%, a full percentage point below the estimated long-run non-accelerating inflation rate of unemployment (NAIRU) estimate of 4.5%. U.S. payrolls expanded by more than one million workers in the first five months of 2018, reaching that milestone faster than in the previous two years.

EXHIBIT 2: The Fed's forecast for economic growth has climbed modestly but steadily during the past year.

FOMC's Forecast for Economic Growth



Source: Federal Reserve, Bloomberg Finance L.P., as of 6/28/18.

Fed announces changes

Beginning in January, the Fed will hold a press conference after every one of its eight meetings, compared with the current schedule of four quarterly meetings. "This change is only about improving communications," Powell said, adding that holding more press conferences does not signal a faster pace of rate hikes. However, the Fed removed longstanding statement language that discussed how rates would remain, for some time, "below levels expected to prevail in the long run," suggesting the Fed no longer views the economy as fragile. The language shift may also partially reflect that the policy rate is getting closer to the FOMC's estimate of neutral, in which it neither stimulates nor restrains the economy. Other changes included referring to potential rate hikes as "further gradual increases" instead of "adjustments."

While every meeting will have a press conference starting in 2019, the Fed's SEP will still only be published every other meeting. The Fed's June statement also retained language in place since late 2015 that states "policy remains accommodative," and officials repeated their assessment that "risks to the economic outlook appear roughly balanced."

As forecasted, the Fed changed the balance-sheet reduction program, increasing its monthly run-off caps to $40 billion in July from $30 billion. The plan calls for quarterly increases until the caps reach $50 billion per month. Gradually removing accommodation by shrinking the Fed's balance sheet is another means of tightening monetary policy.

Fed increases the IOER rate

As mentioned in the May FOMC minutes, the Fed increased the interest rate on excess reserves (IOER rate) by 20 bps to 1.95%, in order to help return the effective fed funds rate (EFFR) back to the middle of its range. According to the minutes, this action "is intended to foster trading in the federal funds market at rates well within the FOMC's target range." The minutes flagged the possibility of such a move as a "small technical adjustment" in implementing monetary policy.

The day after the Fed upped the IOER rate, the EFFR rose by 20 bps to 1.90%, preserving the 5-basis-point gap between EFFR and IOER. The IOER rate adjustment shows that the Fed is watching money market developments closely, and remains willing to tweak its monetary policy tools to maintain adequate control over the policy rate. However, it remains too early to tell if the technical change to the IOER rate was a success; the federal funds rate has traded as high as 1.92% since the adjustment was made.

QE to end in Europe

The European Central Bank (ECB) started its quantitative easing (QE) program in 2015, when policymakers feared the eurozone economy was slipping into deflation. At its recent June meeting, though, the ECB announced plans to wind down its massive bond-buying program. ECB President Mario Draghi noted that increasing inflation, the underlying strength of the euro-area economy, and employment gains were contributing factors behind the decision. The remainder of the QE is scheduled to run at 30 billion euros per month through September, and then shift to 15 billion euros per month from October through the program's end in December.[6] This will leave the Bank of Japan as the only major central bank engaging in QE.

Nevertheless, the ECB is treading carefully regarding the phase-out of its accommodation given mounting evidence that the economy is slowing amid threats of internal trade conflicts, political turbulence in Italy, protectionism, and slowing Chinese consumption.

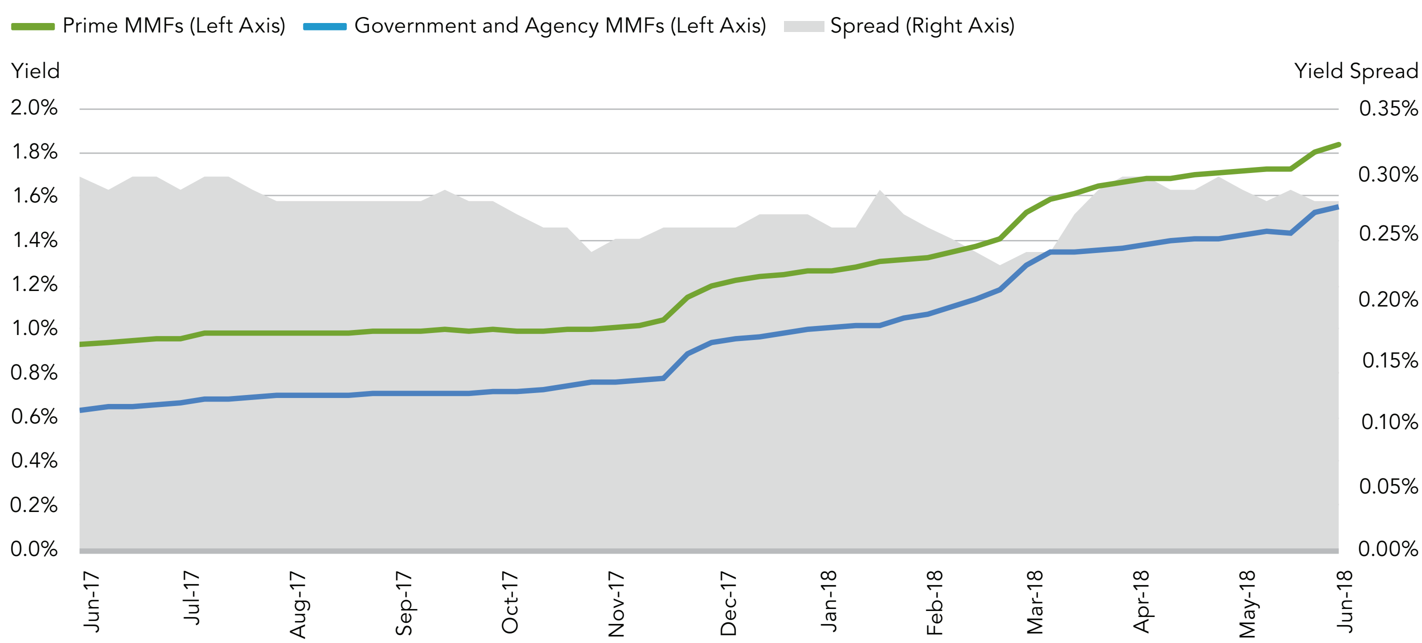
Eurozone growth was only 0.4% in Q1 2018, down from 0.7% in the fourth quarter of 2017, while Germany reported that factory orders dropped 2.5% in April.[7] In contrast, U.S. growth is ramping higher and is expected to top 4% in the second quarter, which would be the fastest growth rate in any quarter in almost four years.

Amid this backdrop, the ECB lowered its growth forecast for 2018 from 2.4% to 2.1%, and raised inflation projections to 1.7% for 2018 and 2019, noting that uncertainty around inflation is receding. It also committed to retaining its negative rate policy (currently -0.4%) through the summer of 2019. Draghi stated that the central bank does not want to "underplay the existing risks" and that "policies could change if the outlook darkens."

Strong asset growth, demand for money markets

U.S. money market funds (MMFs) benefited from higher interest rates and a tax cut on repatriated foreign profits in President Trump's tax plan. In May, assets under management (AUM) rose sharply in taxable MMFs, increasing $53 billion on a month-over-month basis. Meanwhile, government and agency MMFs rose $39 billion, Treasury funds increased by $7 billion, and prime funds grew $6 billion. Most of the increase ($48 billion) was concentrated in institutional funds (Exhibit 3). While June's flows through the first half of the month have been negative, the migration back into U.S. MMFs is in full swing as market-based products outperform bank-administered deposits and as repatriated cash returns home.

EXHIBIT 3: The spread between prime MMFs and government and agency MMFs widened in Q2 relative to Q1.



Note: Prime MMFs and government and agency MMFs include institutional share classes only. Source: iMoneyNet, as of 6/26/18.

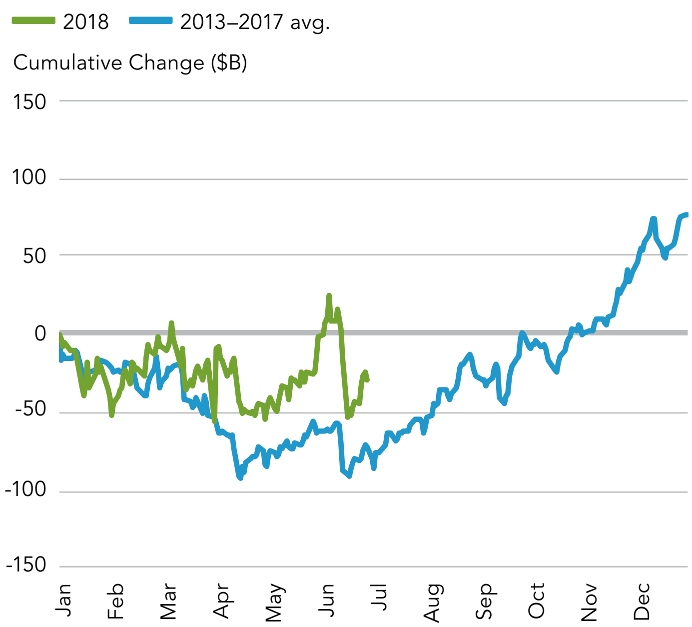
Taxable MMFs actually saw positive year-to-date inflows in June, leading to cumulative net outflow of $29 billion by the end of the quarter, versus the $73 billion in outflow that has been typical by this point in recent years (Exhibit 4). The somewhat unusual demand for MMFs so far this year has primarily been driven by the combination of increasingly attractive market-based yields and corporations building onshore liquidity (and, in some cases, transferring cash from offshore). Concerns about the stability of the eurozone economy and looming trade wars have also contributed to stronger inflows into retail MMFs, which have reached their highest level in nearly five years.[8]

The increase in money market assets helped fund the $59 billion spike in Treasury repos. The growth was led by a notable increase in sponsored repo through Fixed Income Clearing Corp. (FICC),[9] which grew 135% to reach a new high of $47 billion (Exhibit 5), making FICC the sixth largest individual money market repo counterparty.

The London Interbank Offered Rate-Overnight Investment Swap (LIBOR-OIS) spread continued to narrow off its dramatic March widening (Exhibit 6). The spread decreased by 6 bps in the second half of April and another 9 bps in May as the supply/demand imbalances continued to work out of the system.

EXHIBIT 4: Asset growth in taxable MMFs is well above its historical average through the first half of 2018.

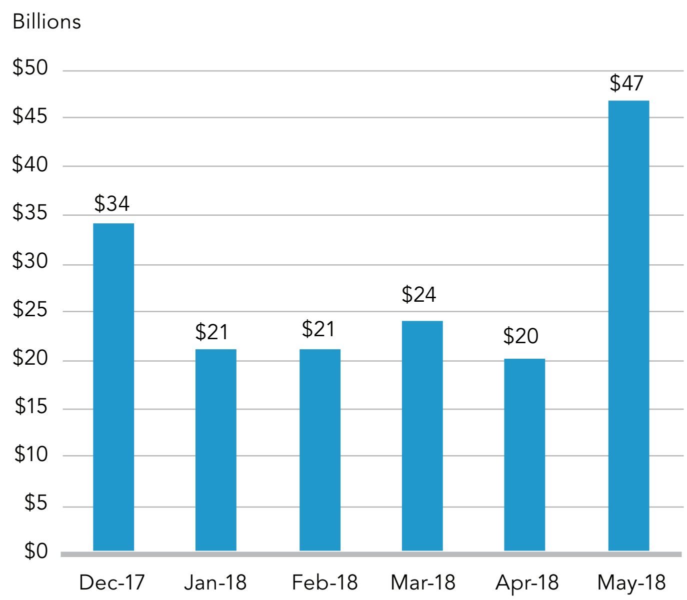
Cumulative Change in Taxable MMF AUMs throughout the Year, 2013–2018



Source: iMoneyNet, as of 6/28/18.

EXHIBIT 5: In May, sponsored repo through FICC soared to an all-time high.

FICC Sponsored Repo Volume



Source: J.P. Morgan Markets, as of 5/31/18.

Fidelity money market funds well positioned

Fidelity's MMFs continue to be well positioned with short weighted average maturities to take advantage of heightened supply conditions which may include the introduction of a two-month Treasury bill (Exhibit 7) and further Fed rate hikes expected later this year.

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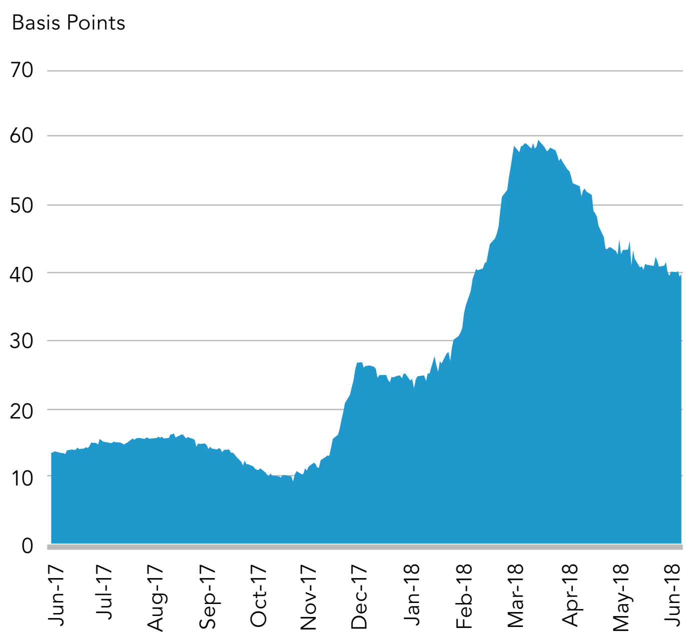
Fidelity Thought Leadership Vice President Martine Costello provided editorial direction for this article.

EXHIBIT 6: The LIBOR spread narrowed in Q2, but it is still well above its June 2017 level.

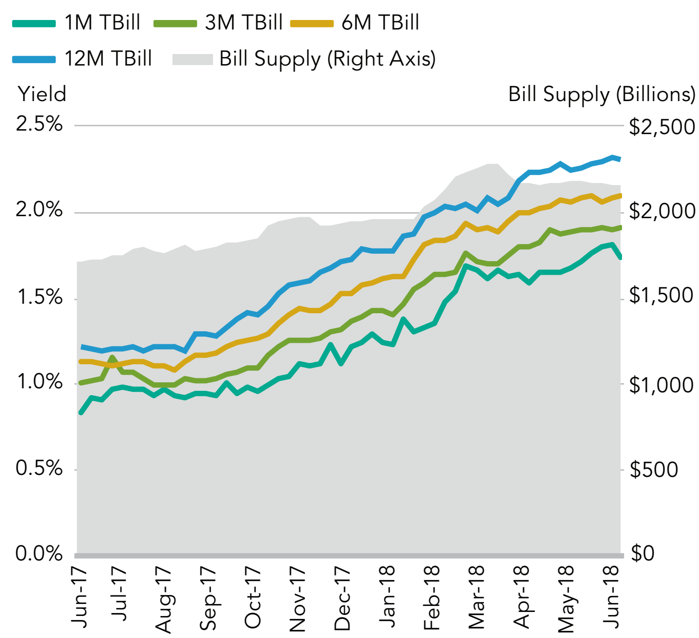
Three-Month U.S. LIBOR-OIS Spread



Source: Bloomberg Finance L.P., as of 6/28/18.

EXHIBIT 7: Treasury bill supply continued to be high as yields rose in the second quarter.

Treasury Bill Supply and Yields



Source: J.P. Morgan Markets, Bloomberg Finance L.P., as of 6/28/18.

Endnotes

[1] Trading Economics, United States Unemployment Rate 1948–2018. tradingeconomics.com/united-states/unemployment-rate

[2] Bloomberg Finance L.P., as of 5/31/18.

[3] FOMC press conference, 6/13/18. www.federalreserve.gov/mediacenter/files/FOMCpresconf20180613.pdf

[4] Source: U.S. Federal Reserve FOMC Statement, 6/13/18. www.federalreserve.gov/newsevents/pressreleases/monetary20180613a.htm

[5] Bureau of Labor Statistics, Job Openings and Labor Turnover Survey, May 2018. www.bls.gov/web/jolts/jlt_labstatgraphs.pdf

[6] All ECB data from ECB press conference, 6/14/18. www.ecb.europa.eu/press/pressconf/2018/html/ecb.is180614.en.html#qa

[7] Source: Bloomberg.com, 6/7/18. www.bloomberg.com/news/articles/2018-06-07/german-factory-orders-extend-slide-as-economic-worries-build

[8] Source: iMoneyNet, as of 6/22/18.

[9] Since 2005, the FICC Sponsored Repurchase Agreement Program has offered a service that allows well-capitalized bank members to sponsor their eligible clients into Government Securities Division (GSD) membership. Sponsored GSD membership offers eligible clients the ability to lend cash or eligible collateral via FICC-cleared delivery vs. payment (DVP) throughout the day. Member banks facilitate their sponsored clients' GSD trading activity and act as processing agents on their behalf for all operational functions, including trade submission and settlement with the CCP. As of June 12, 2018, there were over 1,700 sponsored members listed.

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