

THE FED: POISED TO PAUSE IN MARCH

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With the effective fed funds rate now only slightly below the range of estimates for neutral monetary policy and few signs of economic or financial market overheating, we believe that the Federal Reserve is likely to hold rates steady in March, interrupting its pattern of quarterly interest rate hikes.

Against this backdrop, U.S. Treasury bond markets have recently started to price in a higher probability that the Fed will cut its policy rate in late 2019 or 2020. While the downside risks to the outlook have increased over recent months, we believe it's too early to forecast the next easing cycle with a high degree of certainty. Slowing global growth and tighter financial conditions over the last several months have negated the need for restrictive monetary policy, in our view, but don't yet argue for rate cuts. Indeed, a prolonged period where interest rates remain at or close to current levels is very possible.

Arriving at 'not too hot, not too cold'

After modest downgrades to their growth and inflation forecasts at the December Federal Open Market Committee (FOMC) meeting, Fed officials will likely need to again downgrade their 2019 growth expectations and revise lower their forecasts for the appropriate policy path when the Fed's updated Summary of Economic Projections is released in March. We estimate that the cumulative tightening in financial conditions since the [December FOMC meeting](#), if sustained, will slow U.S. economic growth in 2019 by an additional 0.2 percentage points, reducing the need for the Fed to tighten monetary policy to avoid overheating.

Still, it's important to keep in mind that the magnitude of the recent tightening hasn't been enough to warrant an outright easing in monetary policy, and absent a further deterioration in global economic fundamentals, we do not think a recession in the U.S. is imminent.

Despite the recent turmoil in financial markets, significant sectors of the U.S. economy remain healthy. After deleveraging in the wake of the 2008 financial crisis, household balance sheets remain robust, and savings rates are high. Consumption, which makes up a sizable portion of U.S. GDP, continues to be supported by tight labor markets, lower energy prices and the recent tax cuts. Furthermore, post-financial-crisis regulations have strengthened the U.S. banking sector, which should mitigate the risk that contagion exacerbates an economic slowdown. We think the financial sector demonstrated its broad stability and its ability to act as a buffer against shocks in 2014–2015 when credit dislocations after the global energy price collapse did not materially spill over into other markets.

Can the Fed extend the cycle?

In recent speeches, Fed Chair Jerome Powell and other Fed officials have expressed concern over the risks to global growth and have tempered the tone set by last month's 25-basis-point policy rate increase.

Overall, we believe the Fed is right to be cautious in the face of rising global economic risks. With the policy rate now at 2.4% – within the 2%–3% range that PIMCO has long associated with The New Neutral level – and little evidence of domestic economic or financial market imbalances, the central bank can afford to be flexible and patient, and see how these risks evolve. We view this approach as consistent with a balanced risk management strategy that should ultimately lengthen the cycle.

For more on our economic views, please see our outlook for 2019, "[Synching Lower](#)."

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