



## HOW TIGHT IS THE FED'S MONETARY POLICY?

NOVEMBER 2018

Ken Orchard

*Portfolio Manager, Diversified Income Bond Strategy*



Conventional wisdom is that U.S. monetary policy is currently somewhere between loose and neutral. In its August statement, the Federal Reserve removed the “accommodative” description of its monetary policy, which was initially interpreted as meaning that the Fed believed that it had reached a “neutral” stance. But then Fed Chair Jerome Powell said in a recent interview that the central bank is “a long way from neutral,” which implies that he believes that policy is still loose. Moreover, the Fed has continually emphasized that its tightening of policy has been, and will continue to be, gradual.

But what if the Fed’s monetary policy is tighter than everybody thinks?

Typically, monetary policy stances are measured with reference to a “real” policy rate—in other words, a central bank’s nominal policy rate adjusted to remove the effects of inflation. In the U.S., both the fed funds rate and core inflation are currently 2.20%, giving a real policy rate of zero.

There is no commonly agreed level of a neutral policy stance. Pre-financial crisis, Fed research suggested that it was +1.5% to +3.5%, but according to the Fed’s current dot plot, the central bank seems to think it is about +1%—in other words, around 100bps above the current level. This backs up Jerome Powell’s view that policy is still loose.

But these measurements are all based on current policy rates. What if, instead, we look at swap rates, which give a more accurate picture of companies’ borrowing costs? The two-year swap rate provides a rough guide to where high-quality companies can borrow in the short term. The nominal two-year swap rate is currently 3.07%, meaning the real rate is just under 0.9%—just below the 30-year median swap rate of 1.1%. This implies that today’s real swap rate is close to its historical norm and, therefore, that current policy may be tighter than commonly thought.

It’s also worth considering the change in rates over time. Since January, current real swap rates have been around 1.9% higher than they were two years ago, which is roughly the same level as when Fed tightening peaked in 2000 and 2005–06. To take another example, current home affordability indices imply that there is no affordability problem by historical standards. However, a closer examination shows that 30-year conventional mortgage rates have increased by about 140 basis points over the past two years, which translates into roughly 18% higher annual payments with no adjustment for higher home prices. Perhaps it’s no surprise that new home sales have disappointed over the past few months.

This all suggests that monetary policy may be tighter than commonly thought, which logically implies that the Fed may pause its hiking cycle much earlier than it originally planned. Interestingly, the market may be already recognizing this—the difference between five-year and one-year forward cash rates has been negative for much of the past three months, which means the market is pricing that the Fed will stop hiking rates from the middle of

next year. The last time the five-year and one-year forward cash rate differential was negative was in the first quarter of 2006—just before the Fed stopped hiking in June of that year.

The Fed may even pause sooner than the market thinks. Market commentators tend to focus on equities, but the Fed is probably more concerned about interest rate spreads. If the equity sell-off continues and corporate bond spreads widen, then the Fed is likely to become concerned about the ability of companies to fund themselves. It's therefore possible that the December hike could be the last before the pause—which feels very soon given that recent Fed commentary has continued to emphasize that rates need to rise.

But it should not be ruled out.

---

### **Important Information**

This material is being furnished for general informational purposes only. The material does not constitute or undertake to give advice of any nature, including fiduciary investment advice, and prospective investors are recommended to seek independent legal, financial and tax advice before making any investment decision. T. Rowe Price group of companies including T. Rowe Price Associates, Inc. and/or its affiliates receive revenue from T. Rowe Price investment products and services. **Past performance is not a reliable indicator of future performance.** The value of an investment and any income from it can go down as well as up. Investors may get back less than the amount invested.

The material does not constitute a distribution, an offer, an invitation, a personal or general recommendation or solicitation to sell or buy any securities in any jurisdiction or to conduct any particular investment activity. The material has not been reviewed by any regulatory authority in any jurisdiction.

Information and opinions presented have been obtained or derived from sources believed to be reliable and current; however, we cannot guarantee the sources' accuracy or completeness. There is no guarantee that any forecasts made will come to pass. The views contained herein are as of the date written and are subject to change without notice; these views may differ from those of other T. Rowe Price group companies and/or associates. Under no circumstances should the material, in whole or in part, be copied or redistributed without consent from T. Rowe Price.

The material is not intended for use by persons in jurisdictions which prohibit or restrict the distribution of the material and in certain countries the material is provided upon specific request.

It is not intended for distribution to retail investors in any jurisdiction.

**Australia**—Issued in Australia by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 50, Governor Phillip Tower, 1 Farrer Place, Suite 50B, Sydney, NSW 2000, Australia. For Wholesale Clients only.

**Canada**—Issued in Canada by T. Rowe Price (Canada), Inc. T. Rowe Price (Canada), Inc.'s investment management services are only available to Accredited Investors as defined under National Instrument 45-106. T. Rowe Price (Canada), Inc. enters into written delegation agreements with affiliates to provide investment management services.

**DIFC**—Issued in the Dubai International Financial Centre by T. Rowe Price International Ltd. This material is communicated on behalf of T. Rowe Price International Ltd. by its representative office which is regulated by the Dubai Financial Services Authority. For Professional Clients only.

**EEA**—Issued in the European Economic Area by T. Rowe Price International Ltd, 60 Queen Victoria Street, London EC4N 4TZ which is authorised and regulated by the UK Financial Conduct Authority. For Professional Clients only.

**Hong Kong**—Issued in Hong Kong by T. Rowe Price Hong Kong Limited, 21/F, Jardine House, 1 Connaught Place, Central, Hong Kong. T. Rowe Price Hong Kong Limited is licensed and regulated by the Securities & Futures Commission. For Professional Investors only.

**New Zealand**—Issued in New Zealand by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 50, Governor Phillip Tower, 1 Farrer Place, Suite 50B, Sydney, NSW 2000, Australia. No Interests are offered to the public. Accordingly, the Interests may not, directly or indirectly, be offered, sold or delivered in New Zealand, nor may any offering document or advertisement in relation to any offer of the Interests be distributed in New Zealand, other than in circumstances where there is no contravention of the Financial Markets Conduct Act 2013.

**Singapore**—Issued in Singapore by T. Rowe Price Singapore Private Ltd., No. 501 Orchard Rd, #10-02 Wheelock Place, Singapore 238880. T. Rowe Price Singapore Private Ltd. is licensed and regulated by the Monetary Authority of Singapore. For Institutional and Accredited Investors only.

**Switzerland**—Issued in Switzerland by T. Rowe Price (Switzerland) GmbH, Talstrasse 65, 6th Floor, 8001 Zurich, Switzerland. For Qualified Investors only.

**USA**—Issued in the USA by T. Rowe Price Associates, Inc., 100 East Pratt Street, Baltimore, MD, 21202, which is regulated by the U.S. Securities and Exchange Commission. For Institutional Investors only.

© 2018 T. Rowe Price. All rights reserved. T. ROWE PRICE, INVEST WITH CONFIDENCE, and the Bighorn Sheep design are, collectively and/or apart, trademarks of T. Rowe Price Group, Inc.