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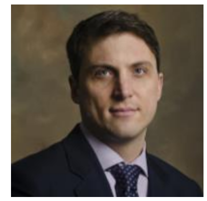
HOW TIGHT IS THE FED'S MONETARY POLICY?



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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

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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.

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