Money Markets

The U.S. Economy Powers Ahead as the Fed Moves Interest Rates Closer to Neutral

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Key Takeaways

- The Federal Reserve (Fed) in September raised interest rates for a third time in 2018, with its Summary of Economic Projections (SEP) forecasting an expected December increase, three more rate hikes in 2019, and one in 2020.
- The Fed is continuing on its path toward a neutral rate of interest, and may move beyond it to sustain the health of the economy and maintain inflation at its target.
- Treasury bill supply is expected to increase in the fourth quarter. As a result, market participants are forecasting another possible technical adjustment to the interest rate on excess reserves (IOER) at the Fed's December meeting to better control the effective federal funds rate (EFFR).

U.S. economic growth—the envy of the world

The Fed raised short-term interest rates by a quarter of a percentage point at the September meeting of the Federal Open Market Committee (FOMC), raising the target range to 2.00%—2.25%. It was the third increase of 2018 and the eighth hike of this policy cycle. In its decision the Fed noted the continued health of the labor market and strong economic activity. Both household spending and business investment are expanding briskly, the Fed said, and the overall growth outlook remains favorable due to fiscal policy, ongoing job gains, and healthy financial conditions.[1]

Unemployment in September fell to 3.7%, its lowest level since 1969, with average earnings up 2.8% from a year ago. Hiring cooled somewhat as a result of Hurricane Florence, with 134,000 jobs added (versus an average monthly gain of 201,000 over the prior 12 months), but data for both July and August were revised significantly higher, for a combined addition of 87,000 more jobs than previously reported.

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The health of the U.S. economy, as evidenced by the jobless rate, reinforces expectations that the Fed will continue on its path of gradually increasing interest rates. Forward guidance in the Fed's September Summary of Economic Projections (SEP) regarding future monetary policy remains unchanged from its June assessment, with one more hike in 2018, three in 2019, and one in 2020. (Exhibit 1). That projects to a 2.375% policy rate by the end of December and a 3.125% policy rate by the end of 2019. The projected rate forecast by the end of 2020 remains at 3.375%, with a target range of 3.25% to 3.50%.

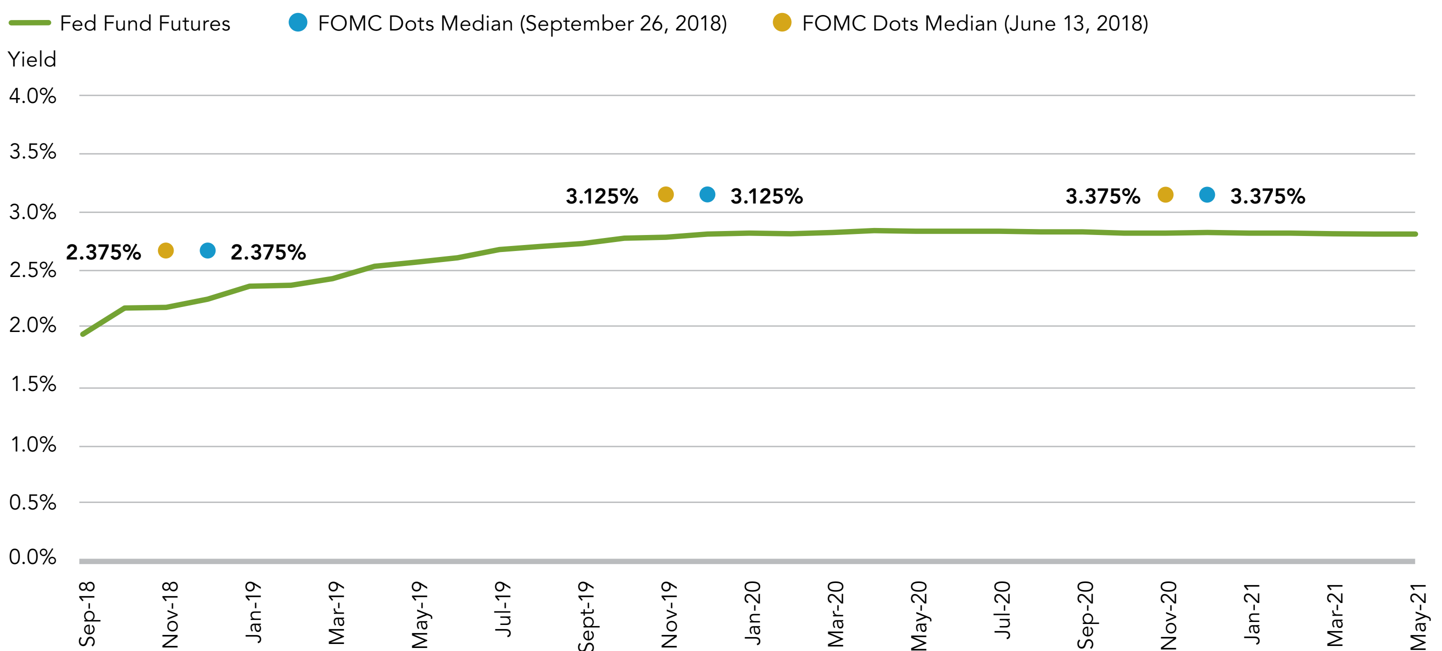
The FOMC removed "accommodative" from its statement, though Fed Chairman Jerome Powell pointedly noted that the change does not indicate a new policy direction but rather "a sign that policy is proceeding in line with our expectations." The Fed also ramped up its balance-sheet reduction program, as expected, raising its run-off caps to $50 billion per month, from $40 billion monthly. Shrinking its balance sheet is another way the Fed has been tightening monetary policy.

Slowing growth outside of the U.S.

The Fed noted at its July 31–August 1 meeting that real gross domestic product (GDP) growth was strong in the first half of the year, compared with moderate or slowing growth in the euro area and many emerging-market economies.[3] Policymakers said they expect the U.S. economy would continue to expand at an above-trend pace due to fiscal policy, a strengthening labor market with job gains and low unemployment, and robust household spending and business fixed investment. Projected GDP growth rates, indexed to account for

EXHIBIT 1: In September, the Fed maintained its forward guidance on interest rates for 2018, 2019, and 2020.

Fed Funds Futures vs. Fed Forward Guidance



Source: Federal Reserve, Bloomberg Finance, as of 9/30/18.

size disparities, show that the U.S. is forecasted to lead the way in growth for both 2018 and 2019 (Exhibit 2). Growth in developing markets will flatten, while growth in other advanced economies will actually decline.

On a 12-month basis, both overall inflation and inflation for items other than food and energy remain near 2%. Indicators of longer-term inflation expectations are little changed, on balance. Tax cuts, fiscal stimulus, and deregulation continue to drive consumer confidence despite relatively tepid wage gains and ongoing trade concerns. Continued economic confidence caused U.S. dollar and Treasury yield fluctuations, with the 10-year Treasury yield reaching a seven-year high in October.

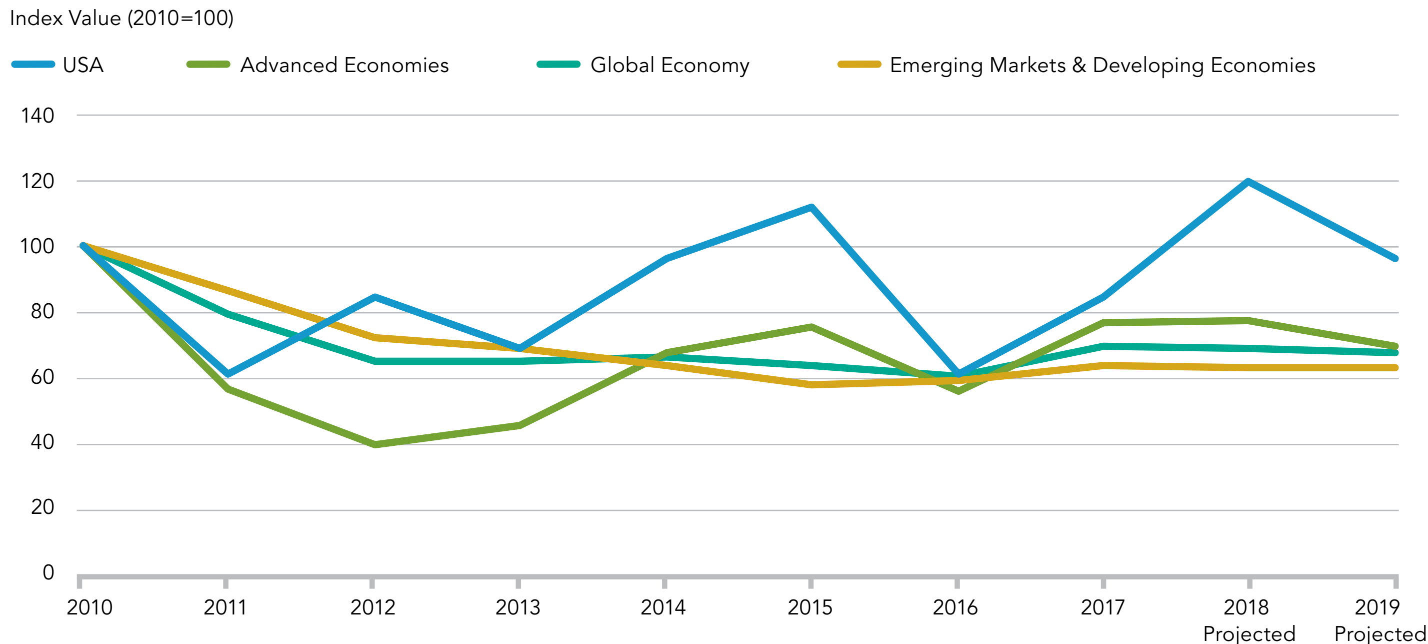
The march to neutrality (and perhaps beyond)

For some time, investors have been watching to see when interest rates will reach neutrality, in which rates neither stimulate nor restrict growth. When interest rates are at neutral, the economy is in equilibrium (e.g., growing at full potential with stable inflation). Views on the neutral rate are an important consideration for monetary policy, and may impact how far the Fed will go in raising interest rates. Chicago Fed President Charles Evans said recently that estimates for the neutral rate are around 2.75%. He believes the economy will likely need to see interest rates rise above that—to between 3.0% and 3.25%, which he termed "slightly restrictive" for growth.[4]

Indeed, with the U.S. economy above its long-run potential growth rate and unemployment below its own neutral rate, the Fed has significant latitude to continue

EXHIBIT 2: The U.S. is forecasted to lead the way in GDP growth for 2018 and 2019.

Annual Growth Rates Since 2010, Indexed



Source: Bloomberg, World Economic Outlook database, as of 10/2018.

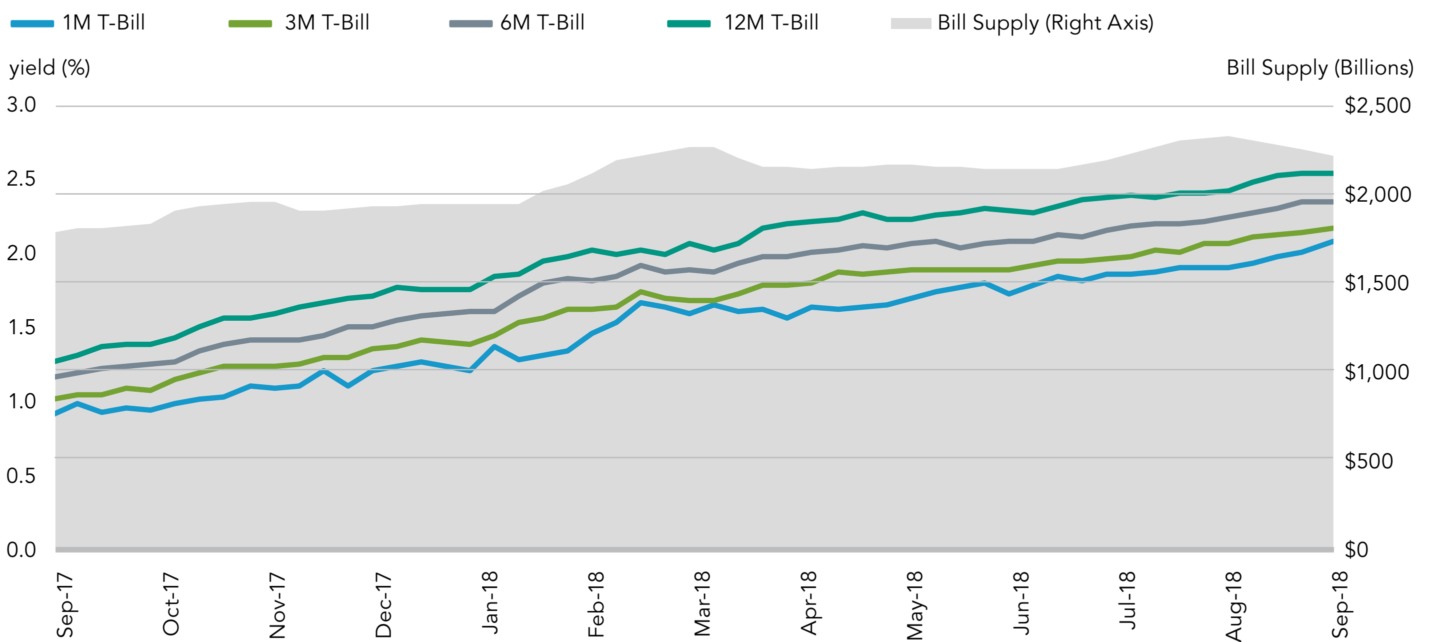
lifting rates. Economists may conclude that the Fed sees the U.S. economy as far less fragile than in 2015 and 2016, when global financial conditions caused the FOMC to pause for long stretches. Futures markets are pricing in a greater than 80% chance of a December hike, a likelihood that may drift even higher as policymakers continue to speak publicly about their views. All of the above suggests that the Fed will reach the neutral rate of 2.75% to 3.00% next year.

Healthy T-bill supply may again cause the Fed to modify the IOER rate

An increased supply of Treasury bills and related repos pushed the effective federal funds rate (EFFR) to the top of its range during the quarter. T-bill issuance has been generally strong in 2018 because of the resolution of the debt ceiling in February, the allocation of debt, and the increase in the deficit, with yields rising across maturities (Exhibit 3). The outlook for the T-bill supply for the rest of the year is forecasted to be fairly robust, with net bill supply estimates totaling $175 billion in the fourth quarter. This would mark the largest upswing in T-bill issuance since the outsized period of February and March, following the suspension of the federal debt limit, though valuations will likely not be as disruptive as they were in the first quarter. This time, the increase in supply will be smaller, spread out over a longer time period, and more diversified. A new two-month T-bill debuting in October will provide the Treasury with more diversification in its issuance so it will need to rely less on three- and six-month maturities. The new two-month bills will also settle on Tuesdays versus Thursdays, which should benefit Treasury-only money market funds seeking access to maturity-based liquidity.

EXHIBIT 3: Treasury bill supply was high as yields climbed across the maturity spectrum in 2018.

Treasury Bill Supply and Yields



Source: J.P. Morgan Markets and Bloomberg as of September 30, 2018.

A continued narrowing of the spread between the EFFR and the interest rate on excess reserves (IOER) suggests that the Fed might make another small technical adjustment to the IOER to help move the EFFR back to the middle of its range, as it did in June. As mentioned in the June FOMC minutes, the Fed said the increase was to "foster trading in the federal funds market at rates well within the FOMC's target range." The Fed's August minutes noted that the EFFR rose around 20 bps after the June adjustment, and traded well within the target range throughout the period.

The London Interbank Offered Rate-Overnight Indexed Swap (LIBOR-OIS) spread continued to narrow from its steep widening earlier in the year (Exhibit 4). The spread decreased in the third quarter by 20 bps as supply/demand imbalances continued to work their way out of the system. New Treasury issuance may cause the spread to widen out toward the end of the year.

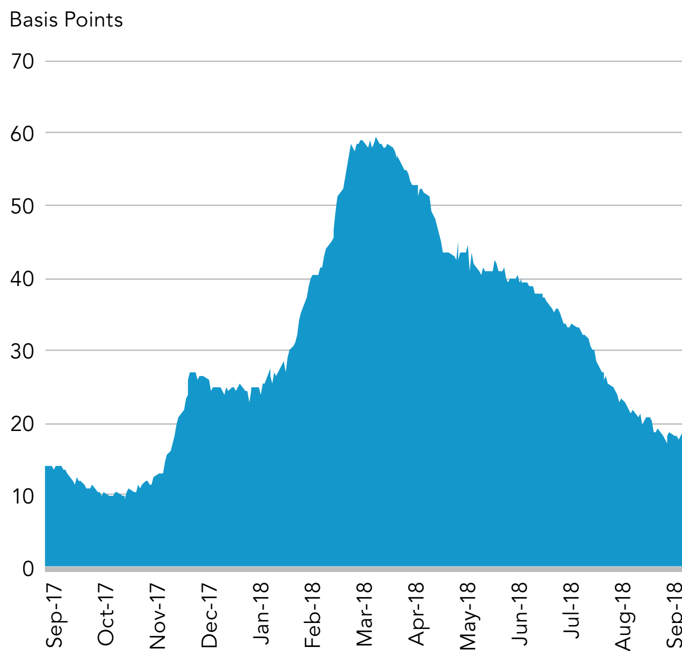
U.S. prime money market funds see a boost from higher rates, repatriation

U.S. taxable money market funds (MMFs) have generally benefited this year from rising interest rates and the repatriation of U.S. corporate cash via a tax cut on repatriated foreign profits in President Trump's tax plan. Taxable MMFs had net inflows of $23 billion by the end of the third quarter, compared with average outflows of $7.5 billion by this point in recent years (Exhibit 5).

Most of those gains were in prime funds, where assets grew by $75 billion year to date, including $38 billion for institutional prime funds. Government and agency MMFs saw assets shrink by $52 billion, while assets in

EXHIBIT 4: The LIBOR spread continued to narrow in the third quarter, but remains above its levels from a year ago.

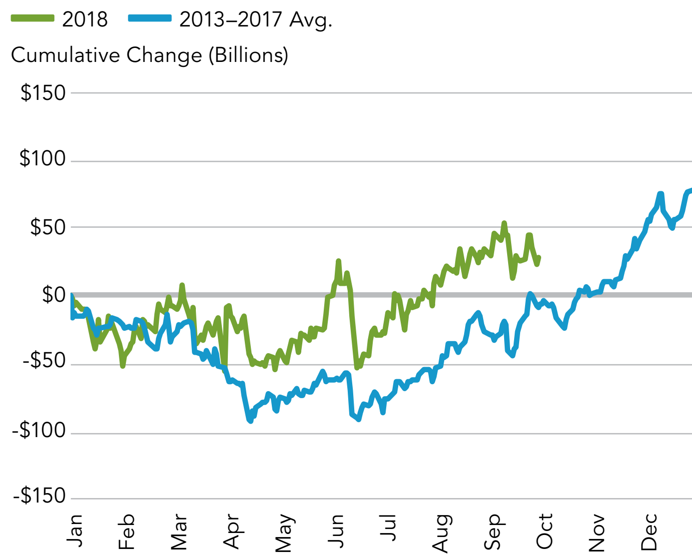
Three-Month U.S. LIBOR-OIS Spread



Source: Bloomberg, as of 9/30/18.

EXHIBIT 5: Taxable money market funds have seen strong asset growth in 2018, well above the historical average, with prime funds benefiting from higher interest rates and repatriated cash.

Cumulative Change in Taxable MMF AUMs throughout the Year (2018 vs. Average)



Source: iMoneyNet, as of 10/1/18.

Treasury MMFs fell by $1 billion during the same time. Institutional MMFs have seen significant asset growth in 2018 over a year ago, with almost all of it coming from prime funds. (Exhibit 6).

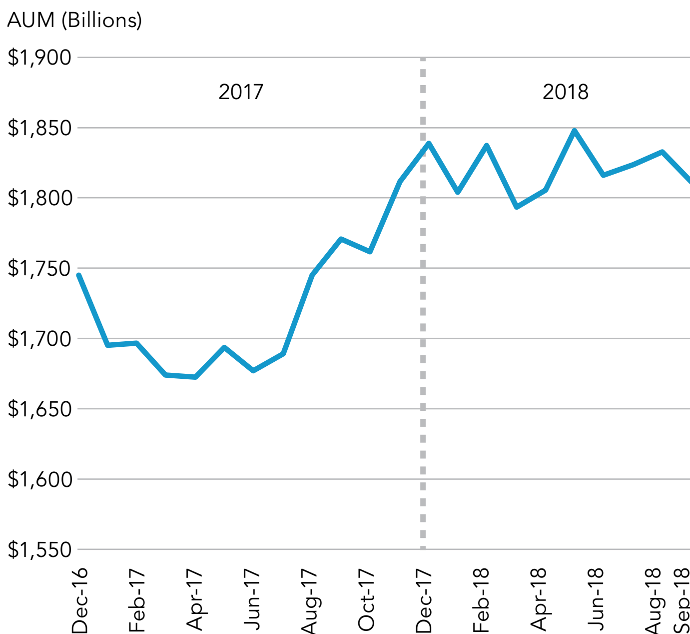
Prime funds experienced outflows following new rules that took effect in 2016 from the U.S. Securities and Exchange Commission requiring a floating NAV, potential liquidity fees, and redemption gates in periods of market stress. Now, rising interest rates are prompting corporate clients to further focus on their liquidity, with the net yield spread between prime and government/agency funds at 21 basis points at the end of the third quarter (Exhibit 7). As market rates have trended higher, institutional and corporate investors are seeing value in segmenting their liquidity portfolios between government funds for immediate operating needs and prime funds for short-term strategic needs.

Fidelity's 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 and further Fed rate increases, including an expected hike in December. Fidelity's prime institutional money market fund maintains higher levels of overnight and weekly liquidity to provide a buffer over the SEC's liquidity thresholds that, if breached, could result in a liquidity gate or fee.

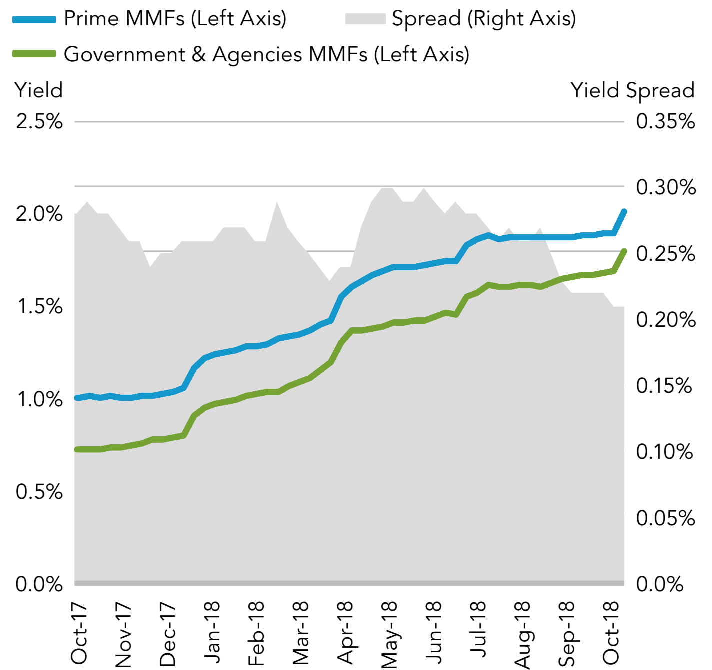
EXHIBIT 6: Institutional MMFs—primarily prime funds—were significantly higher in 2018 over the previous year.

Institutional MMF AUMs



Source: iMoneyNet, as of 9/30/18. Note: September 2018 AUM is preliminary and subject to change.

EXHIBIT 7: The spread between prime MMFs and government/agency MMFs ended the quarter at 21 bps.



Source: iMoneyNet, 10/2/18. Note: Prime and government/agency MMFs include institutional share classes only.

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

Endnotes

[1] FOMC press conference and statement, 10/26/18, https://www.federalreserve.gov/newsevents.htm.

[2] Bureau of Labor Statistics, "The Employment Situation—September 2018," https://www.bls.gov/news.release/pdf/empsit.pdf. Unemployment data by year: https://data.bls.gov/timeseries/LNU04000000?years_option=all_years&periods_option=specific_periods&periods=Annual+Data.

[3] Minutes of the FOMC, 7/31/18-8/1/18. https://www.federalreserve.gov/monetarypolicy/files/fomcminutes20180801.pdf.

[4] Bloomberg, "Fed's Evans Says He's Comfortable with Prospect of December Hike," 10/3/18, https://www.bloomberg.com/news/articles/2018-10-03/fed-s-evans-says-he-s-comfortable-with-prospect-of-december-hike.

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