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# Is the Rate Hike Cycle Over?

## MARCH 2019

**Snapshot**

- The Federal Reserve's (Fed) latest projections depicted a softer assessment of the economic outlook.
- In a more concrete statement, the central bank said it plans to begin slowing its balance sheet reduction this May.
- Fed Chairman Jerome Powell confirmed that rate hikes will remain on hold until a consistent pattern or trend emerges.

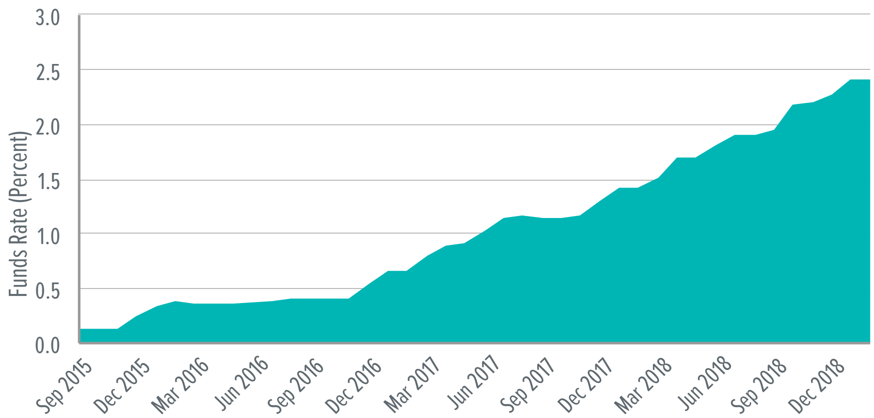
Yesterday's release of the Federal Reserve's (Fed) latest projections depicted a softer assessment of the economic outlook for 2019 and 2020 compared to its December report—with lower projections for overall economic growth and inflation, and higher projections for the unemployment rate.

Market observers and the media focused much of their attention on whether the Fed anticipated more increases in the funds rate over the next few years. The so-called dot plot revealed a more dovish outlook, with zero expected rate increases for 2019 (down from two in December) and one in 2020 (no change from December).

It's fair to say that market pricing—which implied zero interest-rate increases in 2019 last year—was ahead of the Fed in calling for an end to the rate-hike cycle. Market probabilities now foresee a 33% chance that the funds rate will actually be cut by 25 basis points this year[1].

Exhibit 1 depicts the multi-year climb of the Fed funds rate, which began in earnest at the end of 2016 and may have effectively concluded with the last hike in December 2018.

**Exhibit 1: From Low to Plateau?**




Source: Board of Governors of the Federal Reserve System

## The New Normalization

Dot-plot projections for the Fed's rate path may have dominated headlines following Wednesday's announcement, but the most concrete development centered on the Fed's balance-sheet normalization plans.

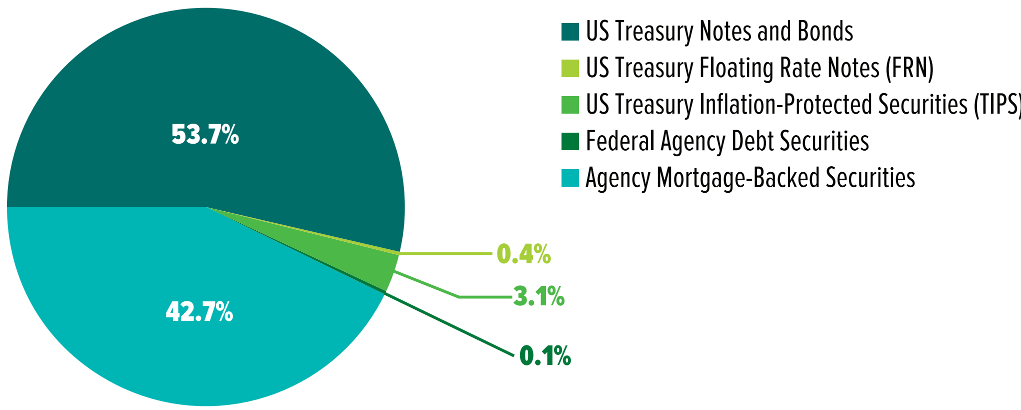
[1] CME FedWatch Tool

Starting this May, the roll-off cap—that is, the amount of securities that can mature without having their principal proceeds reinvested—will be reduced from $30 billion to $15 billion for the Fed's holdings of U.S Treasurys. Roll-off is expected to conclude altogether for Treasurys at the end of September.

The central bank's holdings of agency mortgage-backed securities (and, to a much lesser extent, agency debt) will continue to decline at a pace of $20 billion per month. In fact, starting in October, the Fed plans to begin re-investing up to $20 billion per month in principal proceeds into Treasurys. This will effectively tilt the Fed's balance sheet away from mortgages and toward Treasurys over time.

Exhibit 2 provides a breakdown of the Fed's balance sheet holdings.

**Exhibit 2: Treasurys Set to Come Full Circle**




Source: Federal Reserve Bank of New York. As of March 14, 2019.

## SEI's View

The Fed is unlikely to reverse course on the tapering of its balance-sheet normalization plan. On rates, however, Chairman Jerome Powell has continuously emphasized a patient, data-dependent approach.

His statement yesterday confirmed that the central bank will remain on hold until a consistent pattern or trend emerges. He said "the data are not currently sending a signal that we need to move in one direction or another."

Within equities, we began to see the market anticipating the Fed's policy-path change months ago. The decline in long-term interest rates tends to benefit "bond substitutes" like utilities and real estate with higher borrowing costs, while pressuring sectors like financials at the margin.

To the extent that the Fed's revised outlook reflects concerns about the global economy, we expect this to be a positive development for defensive sectors relative to growth-oriented stocks.

Within fixed income, our core strategies were long duration for much of last year as our managers saw more value in the market's assessment of economic conditions than that of the Fed. We accurately anticipated a cooldown from last year's peak growth to more moderate levels, with the Fed subsequently taking a less aggressive stance.

The Fed's latest turn should represent an opportunity for our managers to reduce duration—some are already considering yield-curve steepening trades.

## Glossary of Financial Terms

Duration: Duration is a measure of a security's price sensitivity to changes in interest rates. Specifically, duration measures the potential change in value of a bond that would result from a 1% change in interest rates. The shorter the duration of a bond, the less its price will potentially change as interest rates go up or down; conversely, the longer the duration of a bond, the more its price will potentially change.

Steepener position: A steepener position reflects the expectation that the difference between shorter-term and longer-term bond yields will increase. This position is typically expressed through an overweight to the shorter-end of the curve and an underweight to the longer-end.

Yield curve: The yield curve represents differences in yields across a range of maturities of bonds of the same issuer or credit rating (likelihood of default). A steeper yield curve represents a greater difference between the yields. A flatter curve indicates the yields are closer together.

## Important Information

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