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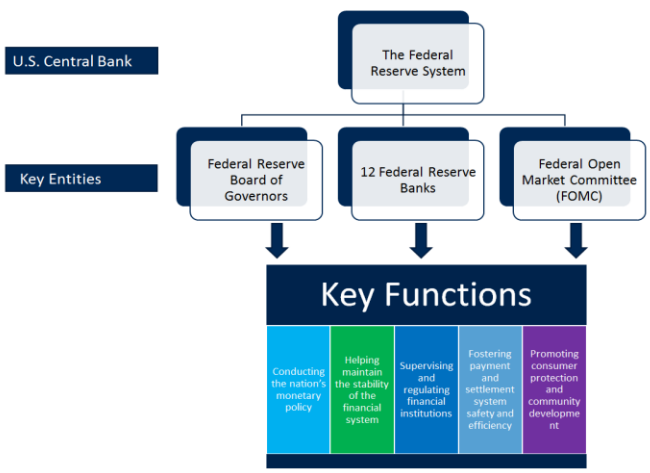
The Fed: A Primer

The Federal Reserve ("the Fed" for short) plays a crucial role in the US economy, acting as its central bank with a mandate of maximizing employment and ensuring price stability. Given its most recent rate cut, we examine the Fed's role to have a greater understanding of how they make important decisions for the economy and how such choices impact equity markets. With US/China trade tensions, a slowing global economy, stocks at all-time highs, employment at lows, and inflation benign, such conditions beg the question, how will the Fed respond to all of these factors in its upcoming meetings? In this piece, we offer an overview of the Fed's structure, how they operate and how their conclusions impact the markets.

Structure of the Fed

The Fed is independent from the United States government despite President Trump offering his opinions via tweets. Its independence, however, does not mean that its goals are different than those of the government since, together with the Department of the Treasury, the Fed aims to maintain macroeconomic stability and protect the financial health of the US. Independence here means their monetary decisions are made on their own and do not have to be approved by the President (or anyone in the Executive Branch), they are not funded by Congress and their Board of Governors can serve 14-year terms compared to the President's four.

Federal Reserve Composition and Duties



Source: Federal Reserve, Raymond James

Those that follow the Fed's outcome have also heard of the Federal Open Market Committee (FOMC). The FOMC is a sub-division of the Fed, which decides on monetary policy by raising or lowering interest rates, buying and selling treasuries and managing reserve requirements. The FOMC is composed of 12 members, seven on the Board of Governors, the President of the Federal Reserve Bank of New York and four of the other 11 Federal Reserve Bank presidents from each of the following categories:

- Boston, Philadelphia, and Richmond
- Cleveland and Chicago
- St. Louis, Dallas, and Atlanta
- Kansas City, Minneapolis, and San Francisco

Current FOMC Members

Member	Leaning
Jerome H. Powell, Board of Governors, Chair	Centrist
John C. Williams, New York, Vice Chair	Centrist
Michelle W. Bowman, Board of Governors	Centrist
Lael Brainard, Board of Governors	Dovish
James Bullard, St. Louis	Dovish
Richard H. Clarida, Board of Governors	Centrist/dovish
Charles L. Evans, Chicago	Centrist/dovish
Esther L. George, Kansas City	Hawkish
Randal K. Quarles, Board of Governors	Hawkish
Eric Rosengren, Boston	Centrist/hawkish

Source: Federal Reserve, Raymond James

The Key Decisions and their Impacts

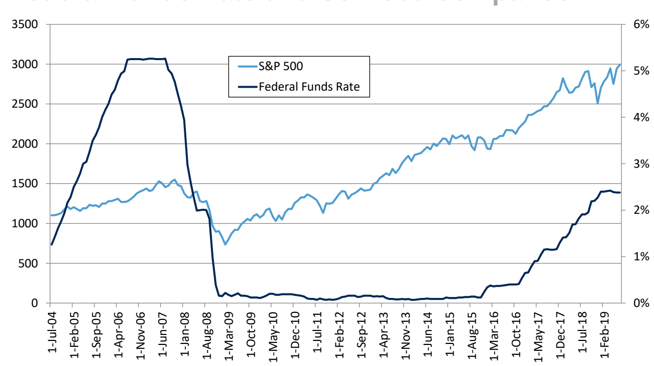
Throughout the year, eight confidential scheduled meetings are held where the FOMC examines data to form their decision on whether to change monetary policy. After their two-day meeting concludes, they publish their results of whether they will raise, cut or keep interest rates as is. Commentaries ahead of a rate decision also have a major impact on markets. For instance, the current Fed Chair, Jerome Powell, can impact markets when speaking at conferences. An unexpectedly hawkish or dovish tone can cause wild swings in both the equity and bond markets. Most recently, Powell's overly hawkish tone towards the end of last year sent the S&P 500 to its lowest level since early 2017. Shortly after in early 2019, the Fed's tone dramatically changed to being more dovish, boosting equity markets and sending the S&P 500 Index on its strongest quarterly rallies since 2009.

Terms Explained

Since the FOMC's releases are filled with economics jargon, we provide some of the most important terms to keep in mind. While the following terms are framed in a US context, the Bank of Canada (BoC) also uses similar terms.

- **Hawkish/dovish** is the lingo used by many market participants when discussing the direction of interest rates. When the Fed is being hawkish, they intend to tighten monetary policy by raising rates. Just like a hawk, the central bank is exhibiting dominance and control, similar to when a hawk firmly grips its prey with its claws. Being dovish means the Fed is cutting rates, loosening monetary policy. Doves are a symbol of peace, so cutting rates allows consumers to borrow money at lower rates to fund big purchases.
- The **discount rate** is the interest rate that is charged to banks and financial institutions when they borrow from the Federal Reserve. The banks borrow funds from the Fed in order to fulfill liquidity concerns, bankruptcy, or short-term operating requirements as a last resort or "bail out" when they are struggling. This interest rate does not fluctuate with the market. Rather, it is set and approved by the board of the Fed.

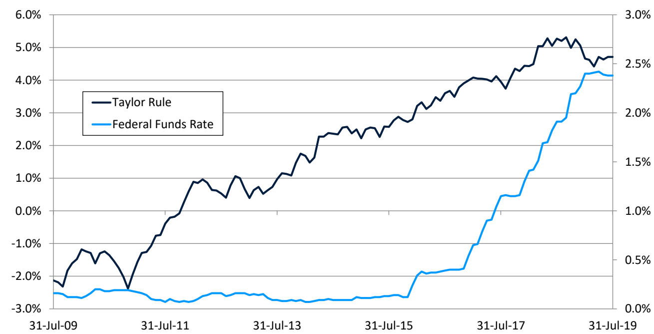
Federal Funds Rate and S&P 500 Comparison



Source: Bloomberg, Raymond James

- On the other hand, the **federal funds rate** is the interest rate that banks charge other banks and financial institutions for borrowing. Banks typically lend to other banks if they have excess reserves. The fed funds rate impacts short-term rates for consumer loans such as student, credit cards and car loans. For instance, by cutting the fed funds rate, the Fed expects to boost the economy by making it more affordable for consumers to buy a home or a car as they will pay less in interest.
- The **Taylor Rule** is a forecasting model. When the Federal Reserve is forming their decision, they examine targeted vs actual inflation levels and full employment vs actual employment levels, as well as ensure that short-term interest rates are consistent with full employment. Although the Taylor Rule is used often as a guideline for FOMC decisions, it can be controversial and may not be always followed due to many other factors that may cause deviations. Practically, the Taylor Rule may only be used as a reference point because this type of benchmarking tool only provides general guidance on how the federal funds rate is adjusted in response to the economy.

Taylor Rule and Federal Funds Rate Comparison

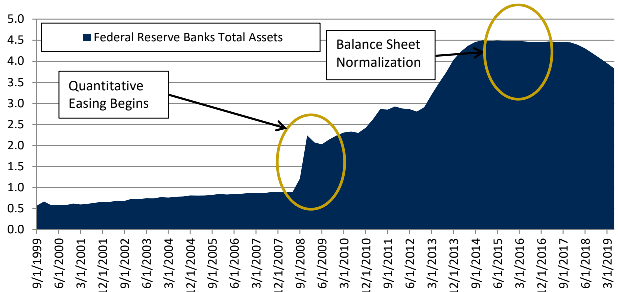


Source: Bloomberg, Raymond James

- An **inverted yield curve** (when long-term rates are lower than short-term rates) is generally considered a good predictor of an economic downturn. In order for this to occur, investors will buy long-term bonds, which indicate that they are bearish about the market. Once the majority of investors follow this trend, the yield on each bond declines and the curve begins to invert. Currently, long-term yields are lower than short-term yields and may signal the economy is entering a slowdown or outright contraction.
- **Balance sheet normalization** is the selling of assets (long-term Treasuries, debt and mortgage-backed securities) the Fed purchased during the financial crisis over a decade ago in order to keep the economy afloat. This was called quantitative easing, or QE.
- **Quantitative easing** is where governments can purchase or sell securities to control the money supply in the economy. When the central bank purchases these securities from the market, they aim to encourage lending and investment by increasing the money supply. This is typically used

when interest rates are close to or at 0% because there are less traditional options available to stimulate the economy. If it fails to be effective, other methods may be explored. A large drawback with quantitative easing is the potential to cause stagflation (inflation without corresponding economic growth). This can result in devaluing the currency as well.

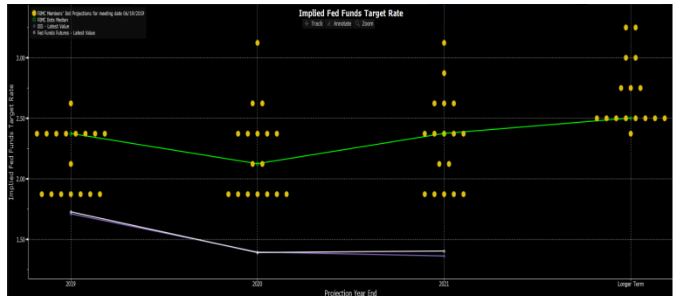
Federal Reserve Balance Sheet Normalization



Source: Bloomberg, Raymond James

- The Fed has also become increasingly **data dependent**, which guides the interest rate hikes and cuts. They use several metrics such as the 5-year breakeven inflation rate, core PCE (the Fed's preferred measure of inflation), unemployment rate differential, average hourly earnings, financial conditions index, 10- to 2-year treasury yield spread, and the S&P 500 Index.
- An **"insurance" interest rate cut** is designed to maintain economic growth and extend the current expansion amid evidence growth is decelerating. When the Fed decides on a rate cut, it is generally good for risk assets (such as equities) and can help create a soft-landing for the economy.
- The **dot plot** is a widely used tool by investors, which shows the FOMC's outlook for the target Federal Funds Rate. Each dot on the grid represents a member of the committee's projections for interest rate adjustments in the future. This tool helps investors anticipate interest rate changes for future meetings.

Federal Reserve Dot Plot



Source: Bloomberg

Federal Reserve Meeting

The Federal Reserve met this past Wednesday to determine policy changes for the economy. Many of the indicators that were forecasted at the last meeting remain the same. Previously, the Fed reported that labour markets were strong and economic growth was maintained at a steady, increasing rate. Household growth was growing faster than last year, but business investment was softer than usual. Based on these continued trends, the Fed has decided to lower the Federal Funds Rate by 25 bp to 2.25%. Instead of allowing the economy to plateau and/or contract, the FOMC has taken a dovish view to maintain economic growth, a strong labour market and stable inflation by deciding on an insurance interest rate cut.

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