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MARKETS

Federal Reserve Not Likely Swayed by Recent Stock Market Declines

Central bank officials have indicated they plan to proceed with a December rate hike

The Federal Reserve has signaled that it plans to proceed with an interest-rate increase in December. PHOTO: ANDREW HARNIK/ASSOCIATED PRESS

By Nick Timiraos and Gregory Zuckerman

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Market turbulence is leading some investors to call on the Federal Reserve to halt its campaign of interest rate increases, but the selloff in stocks and corporate bonds that accelerated Tuesday is unlikely to stop the central bank from raising rates when it meets again next month.

Fed officials have signaled in recent days they plan to proceed with another quarter percentage point increase in their benchmark short-term interest rate when they meet Dec. 19, marking their fourth rate increase this year. The market pullback does underscore however the uncertain outlook for what the Fed will do after that.

Fed officials are divided over how many times the central bank will raise rates next year. Projections released after the Fed's meeting in September showed officials are roughly equally split over whether the economy will require two, three or four rate rises next year.

Officials will update their projections when they meet in December. Some officials could reduce their estimates for the number of rate increases required next year if the market rout continues, or if their expectations for growth or inflation next year recede.

The Dow Jones Industrial Average fell sharply Tuesday to its sixth drop in eight trading days, a move that has wiped out its gains for the year.

For the Fed to change its December plan, the market selloff would likely need to signal some broader deterioration in the U.S. outlook. Recent economic data shows few signs of a slowdown outside of the rate-sensitive housing sector. A continued run of strong labor-market data, in particular, would make it difficult for the Fed to justify a pause.

"Interest rates are still very low. We've raised them, but they are still at a very low level," said New York Fed President John Williams on Monday. He reiterated the Fed's plans to pursue a "gradual path" of rate rises.

Some investors worry that recent troubles in stocks and bonds could portend more economic weakness in the U.S. and abroad than Fed officials are counting on, and that a rate increase in that environment would be dangerous.

"I would pause and see if the market knows something we don't," said Stanley Druckenmiller, who once ran George Soros's hedge fund and today manages his own money. He has been a vocal critic of the Fed's reluctance to boost rates in recent years and other efforts to stimulate the economy. But he points to a number of signs of trouble in the market as reasons to hold off on a rate increase next month.

In recent weeks, Ray Dalio, founder of $160 billion hedge-fund firm Bridgewater Associates LP, has argued that the Fed's interest-rate hikes will hurt asset prices, and that such share weakness will in turn undercut the economy. He's also spoken of the risks of boosting rates, partly because the Fed is in an unusually weak position to aid the economy if a downturn results and such help becomes needed, partly because interest rates remain quite low.

Complicating matters for the Fed is the fact that President Donald Trump has been calling on the central bank to halt interest rate increases. Some investors might interpret a central bank decision to stop now as a bend to political pressure, which would hurt the Fed's inflation-fighting credibility.

Mr. Trump continued his pressure campaign on Tuesday. "I'd like to see the Fed with a lower interest rate," he told reporters outside the White House. "We have much more of a Fed problem than we have a problem with anyone else." A Fed spokeswoman declined to comment.

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Though the U.S. economy looks strong – especially the job market – financial markets are sending some worrying signals. Among them, retail stocks have experienced especially heavy selling lately, a possible indicator that consumers – who powered the expansion in 2018 – could be faltering. On Tuesday, shares of Target Corp. and Kohl's Corp. dropped 11% and 9%, respectively, after releasing quarterly results.

Credit spreads, reflecting the difference in yields between corporate bonds and safe Treasury securities, have jumped lately, a shift that in some past instances has foreshadowed a weakening economy. Interest rates on speculative-grade U.S. corporate bonds were on average 4.18 percentage above comparable Treasury securities Monday, up from a multiyear low of 3.03 percentage points in early October, according to Bloomberg Barclays data.

Still, these spreads aren't yet at alarming highs. They remain well below levels reached in a 2016 market rout, when they exceeded 8 percentage points above Treasurys, or during the financial crisis, when they hit nearly 20 percentage points above Treasurys.

Rising mortgage rates are another potential trouble spot for the economy. They have exacerbated affordability problems in the housing market, weighing on the interest-sensitive sector. Building permits for new housing units, a leading indicator of construction activity, stood 6% below their year earlier level in October, the Commerce Department said Tuesday.

Speaking in Dallas last week, Fed Chairman Jerome Powell acknowledged the recent market selloff could reduce growth by tightening financial conditions, but he did not suggest it had been enough for the Fed to change its policy plans.

Market conditions are "one of many factors" the Fed considers when deciding where to set its benchmark rate, he said.

He also said the Fed would carefully watch credit spreads, which have been narrow recently

Federal Reserve Chairman Jerome Powell says market conditions are "one of many factors" the Fed considers in raising rates.
PHOTO: ALEXANDER DRAGO/REUTERS

because investors have been optimistic about the economy's prospects.

"When credit spreads are low they can sometimes move up quickly and that can have negative effects," said Mr. Powell.

Mr. Powell will have ample opportunity to clarify how the Fed's outlook has changed if the market rout deepens. He is scheduled to speak in New York next week and to testify on Capitol Hill on Dec. 5.

The Fed's forecasts already incorporate some slowdown in the economy's growth rate next year, to 2.5% from 3.1% this year. The Fed sees the unemployment rate dropping to 3.5% next year from 3.7% in October and inflation remaining near its 2% target. Without the interest rate increases, the Fed's forecasts imply, inflation would be moving above its goal.

How many rate increases is a matter of great debate on Wall Street and inside the Fed itself. Economists at Goldman Sachs and JPMorgan Chase expect the Fed will raise rates four times next year. This camp sees inflation pressure building as unemployment drops.

Forecasters at Morgan Stanley and Nomura Securities see the Fed raising rates only twice in 2019, in part due to headwinds from trade disputes and the fading boost from tax cuts and federal spending increases.

Interest rate increases are meant to make the financial system a little less accommodating toward borrowing, spending and growth, to prevent the economy from overheating.

Mr. Williams pointed to another benefit of rate increases last month, noting it reduced the risk of another financial bubble. The last two expansions were upended by bubbles in tech stocks in the late 1990s and home prices in the 2000s.

The Fed responded to the last crisis by accumulating a large portfolio of Treasury and mortgage bonds, to help lower long-term interest rates in addition to short-term interest rates. It has been slowly reducing those holdings as the economy heals.

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Scott Bessent, who runs hedge fund Key Square Group, which manages about $4 billion, argues that the Fed's simultaneous effort to raise rates while shrinking its holdings "is a science experiment that they have no way of knowing the outcome."

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