



DEVELOPMENTS IN FINANCIAL MARKETS AND OPEN MARKET OPERATIONS

The System Open Market Account's domestic securities holdings stood at \$3,874.2 billion as of December 12, 2018, essentially unchanged from the prior release on December 5, which recorded a week-over-week change of zero. The portfolio remained split between \$2,083.0 billion in Treasury notes and bonds and \$1,653.5 billion in agency mortgage-backed securities. The staff noted that this account covers SOMA holdings only — the total size, its composition across Treasury and agency securities, and the change from the prior week — and does not encompass the results of repo or reverse-repo operations, for which no point-in-time-safe data source is currently available to this Committee.

STAFF REVIEW OF THE ECONOMIC SITUATION

The staff reviewed the incoming data and characterized the expansion as continuing at a modest pace, though with signs that momentum had eased somewhat. The Beige Book reported downshifts or outright declines in activity across five distinct sectors, and several Districts described softening in housing demand even as other lines of business held firm. Labor markets remained tight throughout: the unemployment rate stood at 3.7 percent, well below the estimated natural rate of 4.61 percent, and initial jobless claims were low at 231,000. Districts consistently reported robust hiring demand constrained by a lack of qualified workers, with wage pressures described as widespread in some regions and moderate overall in others. The Chicago Fed National Activity Index registered a positive 0.24, consistent with growth somewhat above trend.

On the price side, core PCE inflation ran at 1.51 percent on a twelve-month basis, below the Committee's 2 percent objective. The Beige Book noted that input costs were rising strongly in several Districts, with contacts frequently attributing the pressure to tariffs as well as shipping and recruitment costs. Notably, selling prices were reported to be rising with less intensity than input costs, pointing to margin compression rather than broad-based consumer price acceleration. Overall, price growth was described as modest to moderate. The Employment Cost Index reading was 134.3, and M2 stood at \$14,270.4 billion.

STAFF REVIEW OF THE FINANCIAL SITUATION

Financial conditions presented a mixed picture. The broad financial stress index was low at 0.072, indicating no acute systemic strain, and this reading anchored the staff's assessment that markets remained functioning rather than distressed. At the same time, several forward-looking indicators pointed to rising caution. The VIX was elevated at 21.46, above levels typical of calmer periods, and the Baa corporate spread of 2.26 suggested some creeping in credit costs for lower-rated borrowers. The



most striking signal was the flatness of the yield curve: the 10-year/2-year spread had compressed to just 0.14, near inversion and a classic recession-risk warning. The 3-month T-bill spread relative to the current policy rate stood at 0.245, consistent with markets pricing in roughly one more near-term increase in the target range.

STAFF ECONOMIC OUTLOOK

The staff's forward-looking assessment drew heavily on the estimated neutral rate and the momentum measures embedded in the data. The estimated neutral real rate (r^*) of -0.5 percent implies that the neutral level of policy is far lower than the level-based reference rules assume, and that the current target range of 2.00 to 2.25 percent may already be at or above neutral rather than accommodative. This distinction proved decisive for interpreting the reference rules: the Taylor rule, the Balanced Approach rule, and the ELB-adjusted rule each pointed to 75 basis points of additional tightening, but all three rest on assumptions of near-target inflation and a higher neutral rate that the current readings do not support. With core PCE at 1.51 percent and inflation momentum negative at -0.055, the price pressures those rules presuppose are not materializing.

The First-Difference rule, which keys off changes in conditions rather than distance from an assumed neutral level, uniquely recommended -25 basis points. Both momentum inputs supported an easing direction: inflation momentum at -0.055 and unemployment momentum at -0.15 indicated cooling on both sides of the mandate, even as the level of unemployment remained low. The optimal policy engine's loss-minimizing recommendation was -25 basis points, reflecting the judgment that undershooting the inflation objective carries real cost and that a restrictive stance risks pulling inflation further below target while momentum fades. Taken together, the forward-looking quantities suggested that if current momentum persisted, conditions were more likely to soften than to overheat, and that the balance of risks around the projected path had shifted toward the downside relative to the prior median projection of 2.4 percent.

PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK

In their initial predictive positions, four of the five participants favored raising the target range by 25 basis points to 2.25 to 2.50 percent, with one favoring no change. Those supporting an increase converged on a common set of considerations: the Committee's own prior median projection of 2.4 percent implied room for one more move, prior guidance had emphasized further gradual increases, the labor market was tight with unemployment at 3.7 percent against a 4.61 percent natural rate, and the broad stress index at 0.072 signaled no crisis that would force a pause. The participant most focused on inflation risk framed the case as forward-looking: while core PCE at 1.51 percent removed any urgency, widespread wage pressures and tariff-driven input costs building down the supply chain



represented an accumulating risk that a measured hike would appropriately lean against, guarding against a scenario of falling behind.

The participant most attentive to employment dissented from the majority, arguing for a hold. This participant acknowledged that no labor deterioration was yet flashing — jobless claims were low and hiring demand robust — so there was no basis to cut. But the same participant strongly resisted tightening into a softening backdrop, pointing to sub-target inflation, the Beige Book's observation that activity had 'eased a bit' with downshifts in five sectors, and the near-flat 10y-2y spread of 0.14 as a recession-risk signal taken seriously precisely because recessions are what ultimately damage employment. The participants weighing financial stability and market signals most heavily identified the flat curve, the elevated VIX, and the widening Baa spread as genuine cautions, but resolved the balance toward a hike on the grounds that markets were already pricing one — the 3-month T-bill spread of 0.245 pointed that way — and that pausing against priced-in expectations could itself sow confusion. The final predictive vote stood at four in favor of 25 basis points and one for no change.

The optimal-framework deliberation reframed the discussion sharply. Presented with a loss-minimizing recommendation of -25 basis points, participants examined why the framework diverged from both their predictive votes and the three level-based rules printing 75 basis points. A common thread emerged: those level rules assume a higher neutral rate, whereas the estimated r^* of -0.5 percent implies the current 2.00 to 2.25 percent range may already be restrictive. Participants found the First-Difference rule most persuasive under these conditions, since it responds to momentum rather than a stale neutral-level assumption, and both inflation momentum (-0.055) and unemployment momentum (-0.15) were negative. The inflation-focused participant candidly observed that with core PCE at 1.51 percent and no upward momentum, the usual case for hiking lost its grounding, and that the risk here was undershooting rather than overheating. The employment-focused participant read the same evidence as confirmation that policy was likely already too tight and that a pre-emptive move would protect jobs before deterioration set in.

Not all participants were equally comfortable with the magnitude. Several who accepted the easing direction questioned whether a full 25 basis point cut was warranted against a still-firm labor market at 3.7 percent unemployment. The inflation-focused participant noted that inflation was not collapsing and that a full cut into such a tight labor market felt large, leaning toward a smaller step or a hold on magnitude while accepting the direction. The centrist participant, whose role is the literal reading of the data, judged that below-target and decelerating inflation supported easing but likewise flagged that the broad stress index at 0.072 remained low and that a full step might run ahead of the evidence. The market-focused participant emphasized the genuine conflict between the front-end T-bill spread,



which still pointed to higher rates, and the flat curve, which argued for pause or ease, concluding that markets signaled 'pause-or-cut' rather than a decisive cut and that an immediate move ran slightly ahead of front-end pricing. The financial-stability and employment-focused participants were most firmly persuaded that the -25 basis point call, both direction and magnitude, fit the deteriorating forward-looking signals — the near-inverted curve, elevated VIX, and creeping credit spreads — and that a cut would insure against curve inversion and credit destabilization before they hardened.

COMMITTEE POLICY ACTIONS

On the predictive question of what action the Committee expected to take at this meeting, the vote was four in favor of raising the target range by 25 basis points to 2.25 to 2.50 percent and one in favor of leaving the range unchanged. On the separate question of the optimal-policy framework's recommendation to reduce the target range by 25 basis points, the Committee recorded two members endorsing the recommendation as-is — the participants weighting employment and financial stability most heavily — and three members in partial agreement, endorsing the easing direction but not the full magnitude or immediate timing, namely the inflation-focused, centrist, and market-signal participants. No member declined the recommendation outright.