



DEVELOPMENTS IN FINANCIAL MARKETS AND OPEN MARKET OPERATIONS

The staff reported on developments in the System Open Market Account. As of the most recent release dated January 23, 2019, total SOMA domestic securities holdings stood at \$3,829.7 billion, comprising \$2,064.8 billion in Treasury notes and bonds and \$1,628.9 billion in agency mortgage-backed securities. Relative to the prior release of January 16, total holdings declined by \$3.8 billion. The staff noted that this account covers SOMA securities holdings only — total size, composition, and the week-over-week change — and does not encompass the results of repurchase or reverse-repurchase operations, for which no point-in-time-safe data source is currently available; accordingly, no observations on those operations were presented.

STAFF REVIEW OF THE ECONOMIC SITUATION

The staff reviewed incoming data on real activity, the labor market, and prices. Core PCE inflation was running at 1.48 percent on a twelve-month basis, below the Committee's 2 percent objective. The unemployment rate stood at 3.9 percent, well below the estimated natural rate of 4.61 percent, and initial jobless claims of 213,000 remained low. The Chicago Fed National Activity Index was positive at 0.22, consistent with growth near or somewhat above trend. The Employment Cost Index reading was 134.3, and M2 stood at \$14,455.1 billion. The current target range for the federal funds rate was 2.25 to 2.50 percent.

The most recent Beige Book characterized economic activity as increasing in most of the country, with eight of twelve Districts reporting modest to moderate growth. Nonauto retail sales grew modestly and several Districts noted stronger holiday traffic than a year earlier, while auto sales were flat on balance. A majority of Districts reported that manufacturing had expanded but that growth had slowed, particularly in the auto and energy sectors. New home construction and existing home sales were little changed, with several Districts citing rising prices and low inventory as constraints, and commercial real estate activity was also little changed. The energy sector expanded at a slower pace, and lower energy prices contributed to a pullback in capital spending expectations. All Districts described labor markets as tight, with firms struggling to find workers at any skill level; wages grew throughout the country, with a majority reporting moderate gains and numerous Districts highlighting rising entry-level wages. Most Districts reported modest to moderate price increases, though reports were mixed on whether firms could pass higher input costs — often tied to materials and freight — through to customers. Outlooks generally remained positive, but many Districts noted that contacts had become less optimistic in response to increased financial market volatility, rising short-term interest rates, falling energy prices, and elevated trade and political uncertainty.

STAFF REVIEW OF THE FINANCIAL SITUATION



The staff reviewed financial conditions, which presented a mixed picture. The financial stress index was low at 0.075, but the VIX stood at 19.52, reflecting elevated market volatility relative to calmer periods. The Baa corporate spread was 2.38, a moderate but not distressed level. The Treasury yield curve had flattened considerably, with the 10-year/2-year spread at just 0.18, near — though not at — inversion. The spread of the 3-month Treasury bill over the current target rate was essentially nil at 0.005, indicating that market pricing embedded little to no expectation of further tightening. Taken together, these readings suggested that broad financial stress remained contained while volatility and the near-flat curve pointed to a tightening of conditions and heightened caution among market participants, consistent with the Beige Book's reports of contacts turning less optimistic amid volatility and rising short-term rates.

STAFF ECONOMIC OUTLOOK

Looking ahead, the staff assessed the forward-looking indicators bearing on the likely path of conditions. The estimated neutral real rate (r^*) was gauged at -0.5 , implying a materially lower neutral rate than embedded in standard specifications and suggesting that the current target range of 2.25 to 2.50 percent was already somewhat restrictive relative to neutral. Both inflation momentum, at -0.11 , and unemployment momentum, at -0.10 , were negative, indicating a softening trajectory in prices and labor-market slack rather than an accelerating one.

The reference-rule outputs diverged notably. The Taylor rule, the Balanced Approach rule, and the ELB-adjusted rule each prescribed roughly 75 basis points of additional tightening, reflecting the wide gap between the 3.9 percent unemployment rate and the 4.61 percent natural rate. These rules rely on level gaps and an implicitly higher neutral rate; with r^* estimated at -0.5 and inflation running below target, their prescriptions likely overstated the degree of tightening warranted. The First-Difference rule, which keys off the direction of change rather than level gaps, prescribed -25 basis points, consistent with the negative momentum readings and the low neutral-rate estimate. On the staff's read, the constellation of a deeply negative r^* , softening inflation and unemployment momentum, and below-target core inflation pointed toward an end of the tightening cycle and, on a pure loss-minimizing basis, toward modest easing rather than further hikes.

PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK

In their discussion of current conditions, participants converged early on the view that the incoming data warranted no change to the target range at this meeting. All five judged that core PCE inflation at 1.48 percent, below the 2 percent objective, removed any urgency to tighten further, while a labor market with unemployment at 3.9 percent, low jobless claims of 213,000, and a positive Chicago Fed National Activity Index gave no basis for easing. One participant emphasizing inflation risk observed



that a tight labor market and moderate wage gains across skill levels remained a legitimate future concern, keeping that member vigilant, but acknowledged that wage pressure had not translated into realized inflation above target and that current readings gave no case to hike. A participant focused on the labor market noted that the core triggers for a cut — rising unemployment or slowing job growth — were simply absent, though that member stressed that holding preserved the option to ease later should employment deteriorate.

Participants weighing financial conditions most heavily drew attention to the flattening of the yield curve, with the 10-year/2-year spread at 0.18 near inversion, and to the near-zero 3-month bill spread of 0.005 signaling that markets priced essentially no further hikes. Elevated volatility (VIX at 19.52) and a moderate Baa spread of 2.38 were read as evidence of fragile sentiment and some tightening in credit costs, reinforced by the Beige Book's explicit citation of contacts turning less optimistic amid volatility and rising short-term rates. Several participants noted that hiking into such conditions would tighten the stance further without an inflation justification, while the low financial stress index of 0.075 indicated conditions were not acute enough to warrant an easing move now. The unanimous predictive judgment was to hold the range at 2.25 to 2.50 percent and monitor whether wage pressures fed into inflation or whether financial stress abated.

The Committee then turned to the deterministic policy framework, whose loss-minimizing recommendation was -25 basis points, and to the reference rules underlying it. Participants generally agreed that the roughly 75-basis-point prescriptions of the Taylor, Balanced Approach, and ELB-adjusted rules were stale under present conditions: those rules leaned on level gaps and an implicitly higher neutral rate, whereas the estimated r^* of -0.5 implied the current range was already meaningfully restrictive. Most found the First-Difference rule, at -25 basis points, the more persuasive specification, since it responded to the negative inflation momentum (-0.11) and unemployment momentum (-0.10) rather than to a possibly mismeasured unemployment gap. A member attentive to markets noted that a 2.375 percent midpoint less inflation of 1.48 percent left a positive real rate likely above neutral given the negative r^* , corroborating the view that policy was restrictive.

Even so, participants divided on whether the framework's easing direction should translate into an immediate cut. The member emphasizing inflation declined to endorse the recommendation, reasoning that cutting with unemployment below the natural rate and wages firm risked stoking wage-driven inflation, and that insurance against reacceleration outweighed the modest concern of a somewhat restrictive stance; that member reiterated that markets priced a hold rather than an easing. The participant focused on employment accepted the easing direction fully but preferred confirmation in the hard labor data before acting, given that no employment deterioration had yet materialized. The



financial-stability participant likewise endorsed the direction while cautioning that credit was not distressed and that cutting ahead of any priced-in expectation risked signaling alarm the data did not support, favoring a pause to observe whether stress became self-reinforcing. The data-focused and market-focused participants echoed this tension, judging that the hiking cycle was over and an easing bias real, but that solid labor and above-trend activity, together with market pricing that embedded no imminent cut, made an immediate step premature; they leaned toward a smaller or delayed move contingent on confirmation.

In sum, participants broadly accepted that the direction of risk had shifted — that further tightening was not warranted and that the stance was likely at or slightly past neutral — while differing on timing and magnitude. The prevailing sentiment was that holding now preserved optionality: it avoided over-tightening into softening momentum while allowing the Committee to ease should the labor market weaken or financial stress intensify, and it kept faith with market expectations that pointed to a pause rather than an immediate reversal.

COMMITTEE POLICY ACTIONS

On the predictive question of the appropriate policy action at this meeting, the Committee voted unanimously, 5 to 0, to maintain the target range for the federal funds rate at 2.25 to 2.50 percent. On the separate question of the deterministic framework's -25 basis point recommendation, the Committee did not reach full agreement: no member endorsed the recommendation as-is, one member — the participant emphasizing inflation risk — declined to support it, and the remaining four members registered partial support, agreeing with the framework's easing direction but not with the magnitude or timing of an immediate cut. The recorded stance was therefore zero endorsements, one decline, and four partial.