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Here's what spooked the market about the Fed today

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KEY POINTS
The Fed failed to sound like it was ready to pull back from its tighter policy path as much as markets had expected.
The central bank did hike interest rates but it did not remove language in its statement that would imply a slower path for rate hikes.
Fed Chairman Jerome Powell also rattled markets by saying the Fed was satisfied with its program to shrink its balance sheet and has no plans to change course.

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The Fed just raised interest rates — Here are three big takeaways
Stocks plummeted through lows of the year and investors flocked to bonds after the Fed failed to sound like it was easing off its tighter policy path as much as markets had expected.

The Fed raised interest rates by a quarter point, as expected, and lowered its median rate forecast to two hikes from three next year. But the central bank also retained language in its statement that the market saw as more aggressive than expected, in terms of future rate hikes.

But what really scared markets was that Fed Chairman Jerome Powell said the Fed was satisfied with its program to reduce the balance sheet and it has no plan to change it. Traders see that as another tightening path, since the Fed is reducing the balance sheet by making fewer purchases as Treasury and mortgage-backed securities it holds mature.

"I think the market reaction to all of this is the Fed is going to overdo it," said James Paulsen, chief market strategist at Leuthold Group. "How else can you look at this than it just smells, at a minimum, like a really big slowdown in the economy coming, maybe even something worse."

"Powell said he sees no problem with balance sheet runoff. That's the one that hurts," said Paulsen. "That's another potential path of dovishness that he didn't take."

Five experts on the Fed's big interest rate decision and what it means for markets
Strategists had warned the market was braced for a very dovish Fed and stock traders had been hoping for a big bounce in the market after the Fed's move. But the Fed retained a comment in its statement that it would see "further gradual" rate hikes, and changed it only by adding the word "some." Fed watchers had expected the language to be removed and replaced by an indication that the Fed would be more dependent on economic data.

“There’s a lot of nuance in the decision. I think what’s pretty clear from the statement is Powell is not poised to turn sharply dovish,” said Brian Dangerfield, macro strategist at NatWest Markets. “The Fed is going to be data dependent, but the data on which they are depending has not slowed dramatically.”

The Fed had been expected to raise interest rates by a quarter point and signal fewer hikes in the future. It had also been expected to lower its growth forecast, and change the language in its statement to reflect it will be more dependent on incoming economic data. It did lower the growth forecast, and for 2019, it now sees growth at 2.3 percent instead of 2.5 percent.

Stocks sold off initially but then bumped around before spiraling lower again. The Dow and fell through the lows of the year and bond yields fell. The Dow closed 1.5 percent lower at 23,323, and the S&P 500 was off 1.5 percent at 2,506.

The 10-year yield was at 2.75 percent, its lowest level since April.

“It just reinforces that between the Fed hiking and shrinking its balance sheet, it’s double tightening in 2019. I think it just reinforced the market did not get the dovish hike it was looking for,” said Peter Boockvar, chief investment strategist at Bleakley Advisory Group.

Paulsen said the action in credit markets showed fear, with big moves in high yield and other corporate spreads.

“You take the combination of the stock market and the bond market and just look at the spreads...you have to say most of those are suggesting the fed is making a policy mistake here,” Paulsen said.

Jim Caron, fixed income portfolio manager at Morgan Stanley Investment Management, however, said the market may be reading Powell wrong.

“I don’t think they’re seeing the dovish aspect of this. The bond market does,” he said. “The Fed was bound to disappoint. They just couldn’t be dovish enough. That’s just the way it was set up. Do I think this is the correct response? No. I think this is the equity market saying they didn’t cut their interest forecast the way they should have. There’s disappointment…I read what Powell said as very dovish. The bar I think he set to hike was very high.”

As expected, Powell did emphasize the Fed would not be on a preset hiking course. “From this point forward we are going to letting the data speak to us and inform us,” said Powell, adding that that would make the path of tightening uncertain.

Powell’s message was moderated and stocks came off the lows of the day when he said the Fed was at the bottom end of the range of estimates for the neutral rate.

Neutral is the level that is neither stimulative nor slowing for the economy, and there is much debate about where that level is. Powell also gave a nod to weaker financial conditions and said they played a role in the change in forecasts and interest rate expectations.

If Fed stops rate hikes before neutral, it's a bad sign: JP Morgan portfolio manager
Caron said the fact the Fed changed its average long-run rate for fed funds to 2.8 percent from 3 percent was very dovish, indicating it sees interest rates near neutral. The Fed raised its fed funds target range to 2.25 to 2.5 percent Wednesday.

Powell also said during the news conference that the Fed was near the low end of the range for neutral.

"What they're saying is you're going to stay at full employment and there's going to be no inflation pressures. that's their dual mandate. he's basically telling you through the forecast that there's no reason for them to raise interest rates," said Caron.

But he agreed the Fed comment on the balance sheet upset markets. "I think he did everything he could do but address the balance sheet. The balance sheet is the one thing I think he should have addressed," said Caron.

In the bond market, Treasury yields at the long end of the curve continued a move lower, edging closer to the short end, following the Fed statement.

The spread between the 10-year yield and yield were 13 basis points apart, in a so-called flattening move. Traders have been eyeing the spread in anticipation of a possible inversion, where the 2-year yield would rise above the 10-year — the sign of a coming recession.

"We have a bull flattening. Rates are falling and the curve is flattening. We have front yields which are basically unchanged. Long-end yields are coming down. That may speak to more concern," said Dangerfield. The flattening curve has been viewed as an economic warning.