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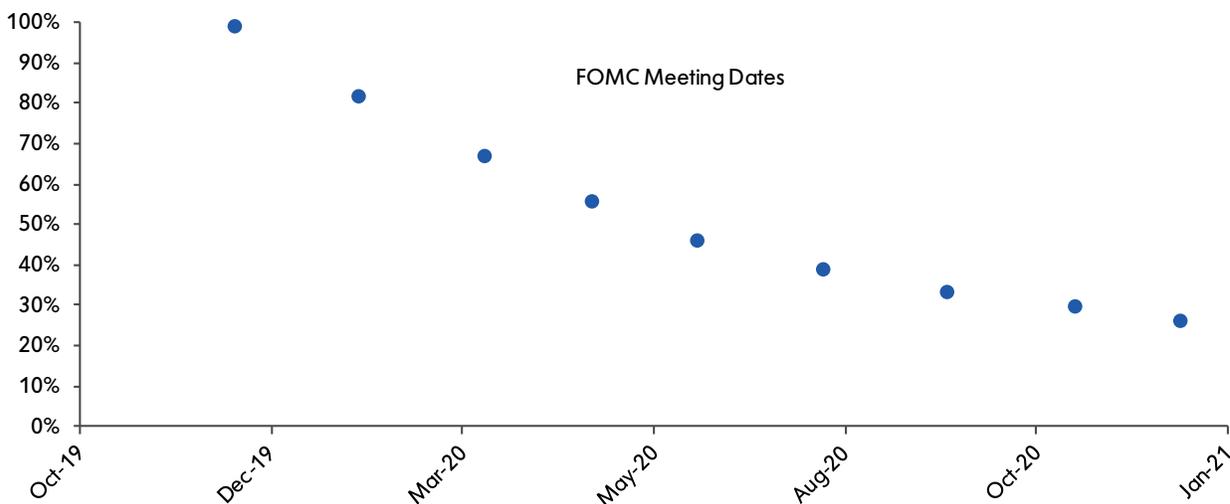
Fed Thoughts: **He Who Must Not Be Named**

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Subtlety is not the forte of this generation of Federal Reserve (Fed) officials. When they want a message to sink into the market psyche, they put coded words in the statement of the Federal Open Market Committee (FOMC), make sure that there are catchphrases in the opening remarks of the Fed Chair at his press conference, and then repeat those words everywhere, every time, and with little evident embarrassment. Such repetition allows every FOMC participant to enjoy multiple moments in the media spotlight while the group still keeps the market narrative thread from unraveling.

By now, the narrative thread is tightly wound. Everyone knows that the policy rate is at the “right place” to keep the US economy in its “good place.” This seems right to us, as our forecast rests on the fret-inducing assumption that partial international trade comity breaks out and obviates the need for additional insurance cuts by the Fed. This apparently seems right to market participants, too. Interest rate futures prices suggest there is no probability of the FOMC moving the policy rate at its upcoming meeting (the first dot in the chart below), which is our outlook as well. Moreover, the eight meetings of 2020 have mostly been priced out. The odds are about even for a 25-basis-point cut next year, a far cry from the rate-cutting frenzy of a few months ago but still reasonably pointed down in light of the evident risks to the global economic enterprise.

Probability of an Unchanged Policy Rate



Source: CME Fedwatch, accessed 11/21/2019.

The starting point for the global economy is a world laboring with contraction in trade volume and global manufacturing. The imposition of trade restrictions disrupting global supply chains, and the possibility of more to come, impede investment and create a growth headwind in advanced economies.

Because trade matters less to the US than its trading partners, the slowing has been less pronounced at home, from real GDP growth in the US around 3 percent last year to 2 percent this year and next. The differential is especially distinct in trade volumes and industrial production. After already stepping lower following the wrenching recession of 2008-2009, global trade volume ground to a halt over the past year, with considerable contraction posted in Asia and Europe.

Average Growth Rates of Imports & Exports (%)

	2000 - 2010	2011 - 2018	2018 - 2019
Advanced Economies	4.8	0.4	-2.9
United States	3.0	0.3	-1.8
Japan	4.5	-1.2	-4.7
Euro Area	5.8	0.8	-3.3
Other advanced economies	5.0	0.3	-2.8
Emerging Economies	4.9	0.6	-2.7
China	6.6	1.0	-2.1
Emerging Asia (ex China)	3.9	0.3	-4.4
Eastern Europe / CIS	6.2	-0.3	4.9
Latin America	4.8	0.6	0.0
Africa and Middle East	7.0	1.2	-3.9

Source: cpb.nl, accessed 11/21/19. Through August 2019 (percent).

The slowing is also less abrupt in the US because of cyclical insurance purchased by the Fed in the form of 75 basis points of policy easing. The breathing room that the Fed provided is more substantial than these cumulative cuts. At this time last year, financial markets were pricing in policy hikes, and removing the expectation of an increase is equivalent to a decrease. Also of note, the Fed eased more significantly than virtually all its central bank colleagues did.

We think that this ease is enough to extend economic expansion at around the same pace in 2020 provided our assumption about the political economy plays out. Our working hypothesis is that political necessity drives Presidents Trump and Xi to a limited trade deal that somewhat reduces trade uncertainty. More importantly, a trade truce takes future tariff hikes off the table and may roll back past ones. The net effect sustains economic momentum without requiring additional Federal Reserve accommodation.

The Fed will see even less need to ease policy next year if, as in our forecast, an acceleration of costs produces a modest incline in inflation. Pressure on profit margins is typical at this stage of the business cycle when resource use is taut. Domestic inflation should increase further if the US dollar depreciates as the rest of the world benefits relatively more from a ceasefire in the trade war.

To note the obvious, a distinct downside dominates the forecast landscape. We could be incorrect in our assumption that both Presidents Trump and Xi are rational actors or we could have misread their incentives. Also disconcerting, the two might intend to let international trade take off, but may have already used up too much runway to avoid an extended slowdown. Meanwhile, the US hurtles toward a contentious presidential election.

Recognize that the responsiveness of monetary policymakers to economic surprises will likely be muted at first and asymmetric in direction. The past two swings in the fed funds rate were based on theories. Fed officials first tightened in expectation that inflation would rise given the low unemployment rate. They next eased on the risk-management belief that it would be best to get in front of potentially disruptive trade events. Next time, they will be more evidence-based, especially on the firming side in light of their concern that inflation expectations may lodge permanently below their goal.

Though Fed Chair Powell and company is delivering lower borrowing costs—the fondest dream of many investors and a prominent politician—central bank officials are not getting a lot of love. Many of the questions at Powell’s recent press conference were some variant of “Now that you’ve stopped easing, when will you tighten?” The Commentator-in-Chief predictably repeated his criticisms of the Fed even as rates headed in his preferred direction. The only surprise in President Trump’s tweet that “people are VERY disappointed in Jay Powell and the Federal Reserve” was that the author waited 20 hours after the policy announcement to throw his Twitter bomb.

Trying to please market participants, commentators, and politicians is akin to negotiating a curfew with a teenager: easier is always better. Fed officials did not help themselves by proffering a muddled message as to why they switched from being inclined to tighten late last year, moved to neutral in the spring, and then eased outright in the late summer. According to speeches and summary descriptions of the discussions at Fed meetings, policymakers chose among three reasons to ease policy: inflation ran persistently below the goal of 2 percent, uncertainty about trade policy was weighing upon capital goods spending, and a slowing in global manufacturing activity risked metastasizing into activity broadly.

This highlights two nasty problems of monetary policy communications. First, a central bank that cannot coherently explain why it eased probably cannot coherently explain why it stopped. Second, communication failures, aside from the occasional lapse by a key figure under bright lights, usually belie a structural problem.

The structural problem is that the Fed could not candidly identify what had slowed the economy, why it needed to ease, and how the outlook had changed to call an end to the easing cycle. Actually, the issue is not what, why, or how.

It is who, which is a particular problem for an agency of the US government, even one like the Fed that has proven its independence over the years. He Who Must Not Be Named is President Trump because of his penchant for roiling the waters of international trade. Trade restrictions reduce our national aggregate supply as producers scramble to rejigger global production chains to find new low-cost avenues for commerce. The possibility of additional tariffs and sanctions adds uncertainty to business decisions that lower aggregate demand.

The Fed stopped policy firming at the turn of 2018 when it became evident that President Trump’s willingness to expand the scale and scope of the trade fight seeded headwinds to spending and production. When those headwinds intensified, the Fed eased policy as an offset. In light of its cumulative efforts and on the prospect that the China-US trade dispute would be taken off the boil, the Fed seems inclined to stop. Even a partial, first-round deal helps as it lessens uncertainty a bit and, more importantly, removes two scheduled roadblocks to expansion, tariff hikes, from the map.

Herein is the communications challenge for the Fed. Is it remotely plausible that the Fed could have singled out at the turn of the year the president’s trade policy as a reason to pivot to ease? Is it remotely plausible that the Fed would identify his trade policy as potentially getting better as a reason to stop easing?

As for the former, the tweet storm had already picked up in earnest, sending the direction of blame in the opposite direction. No good could have come trying to redound it on itself.

As for the latter, basing monetary policy on an anticipated political act is both awkward to the national dialogue and imprudent in forecasting.

Awkward because a central bank forecast that the administration would do this or that seems like the recommendation that the administration should do this or that. Here is why Chair Powell repeats that it is best if he “stays in his lane” and does not comment on non-monetary policy matters.

Imprudent in forecasting because the president has not shown himself to be a reliable partner in international negotiations. For Chair Powell to explain explicitly that he has stopped easing because he anticipates a trade deal is as unwise as a trapeze artist committing to swing into the open air before being completely confident that their counterpart has made a similar commitment.

Fed Chair Powell has reason to sound confusing. The alternatives are to be presumptuous about the political process, invite criticism, or to be left alone, mid-air.

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Vincent is Mellon's Chief Economist and Macro Strategist. In this role, he is responsible for developing views on the global economy and making relative value recommendations across global bond markets, currencies and sectors.

Previously, Vincent served as the Chief US Economist and a managing director at Morgan Stanley. For the prior four years, he was a resident scholar at the American Enterprise Institute (AEI). Vincent also worked in several roles at the Federal Reserve over 24 years, including Director of the Division of Monetary Affairs and Secretary and Economist of the Federal Open Market Committee (FOMC). His responsibilities at the Federal Reserve included directing research and analysis of monetary policy strategies and the conduct of policy through open market operations, discount window lending and reserve requirements. Prior to these roles, he was the principal liaison with the domestic desk at the Federal Reserve Bank of New York and was responsible for preparing a document outlining policy alternatives for each FOMC meeting. He was Deputy Director in the Division of International Finance and Associate Economist of the FOMC and spent five years at the Federal Reserve Bank of New York in both the domestic and international research departments.

His academic publications primarily concern the conduct of policy and issues related to the monetary transmission mechanism as well as an analysis of alternative auction techniques and Treasury debt management. After an undergraduate training at Fordham University, he received graduate degrees in economics at Columbia University.

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