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Fed Thoughts:
Passive Aggressive

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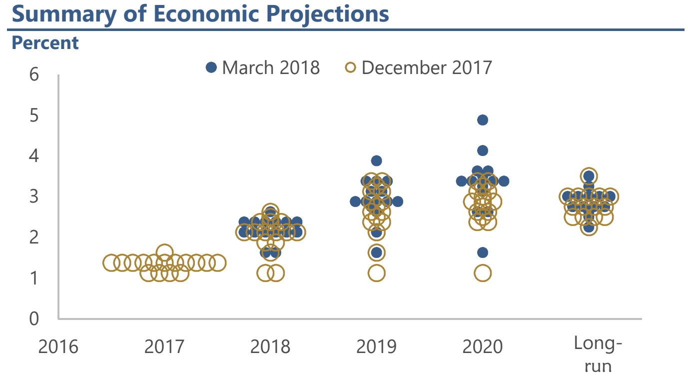
At the upcoming meeting of the Federal Open Market Committee (FOMC) on June 12 to 13, Chair Yellen will remain the dominant voice on the design of monetary policy. FOMC participants will bend to her preference for well-telegraphed, modest policy hikes at each of its four press-conference meetings. This lays a brick foundation for a staircase along which the federal funds rate rises one percentage point per year, preserving Yellen's preference for a lower-for-longer policy path. All along that predetermined climb, officials describe each decision as dependent on the data and made meeting by meeting.

This is why market participants view the upcoming meeting as a nonevent event, it is already completely built into financial prices. We heard the clicks of the Fed telegraph in the minutes of the prior meeting, and there is a press conference following this one. At that gathering, expect the Fed chair to explain one more step up the Yellen staircase.

Except, the Fed chair offering the "data made us do it" explanation will be Jay Powell. Janet Yellen left the building in February, although her intellectual spirit lingers, mostly by default. Market participants apparently prefer being pulled along by plodding but patient policymakers. This precedent is so well established that it is easier for the Fed to keep along this path than risk the general confusion that would result from straying. If the Fed had tightened at the May, non-presser, meeting, market participants would have ratcheted up the path expected for the fed funds rate by a factor of two—from four hikes a year to eight. And if the unthinkable—no action at the June meeting—happens, everyone would assume that this tightening cycle is done and dusted. So much is read into Fed action that investors would assume that inflation is off to the races in the first case and that the US economy is rolling over in the second.

In light of such risks, Chair Powell will keep on keeping on, raising the fed funds rate ¼ percentage point until he stops. If the economy surprisingly softens, he will stop sooner than plan, perhaps even more than built into markets. Mix in some vigor to the global economic recipe for the next few years instead, and he will still go slow, tolerate an inflation overshoot, and tighten for longer. That was, after all, the shift in the dot chart from December to March. The former painted a smooth ascent of the fed funds rate to its longer-run or neutral level, which would get inflation to the Fed's goal. Three months later, a legislated fiscal boost with the same nominal fed funds path in 2018 would produce an inflation track that necessitates the policy rate ultimately going above neutral.

Summary of Economic Projections



Source: Federal Reserve, accessed 3/21/18, at https://www.federalreserve.gov/monetarypolicy/fomcprojtabl20180321.htm.

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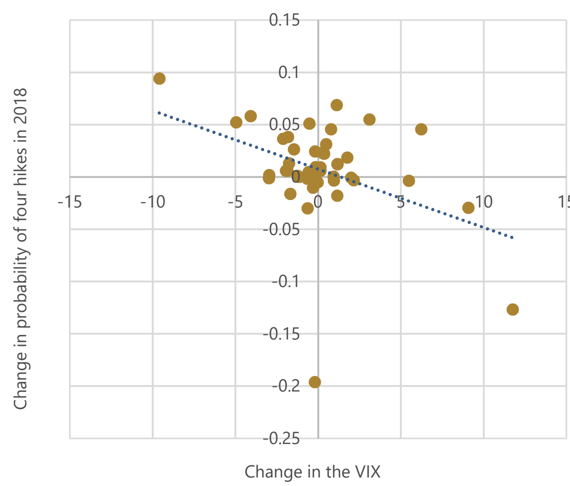
Market participants read more drama in the Fed narrative than warranted. To be sure, there is no confusion about the June meeting, as future prices put the probability mass almost completely on top of a quarter-point hike. There is more in play for rest of the year. The probability of four Fed increases in 2018 slowly built to above 50 percent as the Fed showed itself to be predictable but, of late, has swung with market sentiment. As shown at the right, the week-to-week change in this probability measured along the vertical axis moves negatively with changes in the VIX, the implied volatility of the S&P 500® equity price index inferred from options on futures.

This is an overreaction. Janet Yellen has not retained complete sway on the institution. Jay Powell is passively following a useful precedent, but he will be aggressive in seeing it through, even if it means accepting bouts of financial market volatility and overshooting the neutral fed funds rate for a time.

Why? First, the US economy is close to, if not above, full employment so Powell has less room to err on the cautious side of aggregate demand. Second, no one at the Fed knows what the neutral fed funds rate is, but they hope to come to a better understanding the closer they get to it, even if it is in passing. That is, their policy will only be responsive to events (excluding, obviously, large shocks) toward the end of the cycle. If they are lucky, they will stop just at the neutral rate when inflation settles at two percent (as the Yellen Fed mostly thought in December). They might overshoot modestly with scope for correction (as the Powell Fed thought in March and probably still does). The risk is that they stay too late in the game and have to correct more sharply. We think inflation and the policy rate goes above its long-run levels but not so much as to trigger recession. However, the world is sufficiently uncertain that a more significant overshoot cannot be ruled out, raising recession risks in 2020 and beyond.

Changes In The Probability of Four Hikes and The VIX Weekly, 6/17 to 6/18, Percentage Points



Source: CME Fedwatch tool (fed funds) and CBOE (VIX), accessed via FRED 6/5/18

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