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Fed Thoughts: Wait Until Dark

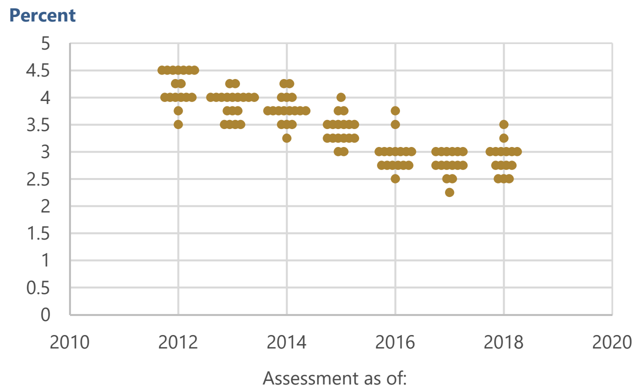
by Vincent Reinhart
Chief Economist & Macro Strategist

In remarks at the Federal Reserve (Fed) Bank of Kansas City's Jackson Hole Symposium, Chair Jay Powell took us stargazing. He explained that monetary policymakers steer by assessments of the natural rate of unemployment and the equilibrium (or neutral) real short-term interest rate and by the specification of an inflation goal. These are "starred" variables in the firmament of macroeconomic models. Over the three months after his Jackson Hole speech, Powell repeated another historical property of stargazing: different people interpret the same points of light differently. That is, Sumerian, Greek, Chinese and Native American astronomers saw a variety of shapes in the same source material. In this case, Powell, all by himself, interpreted the same source material differently in each of the three months.

The source material comes from the quarterly survey of participants of the Federal Open Market Committee (FOMC), who assess the three stars as part of the information released in the Summary of Economic Projections (SEP). When it comes to the neutral funds rate, Powell's points of light are the individual submissions of the appropriate federal funds rate in the long run that appear as a cluster at the far end of the SEP dot plot.

To show how variable these can be, consider the chart below where each swarm of black dots represents the assessments of the neutral funds rate by FOMC participants. The lowest lonely dot in April 2012 is now the highest lonely dot in 2018.

Summary of Economic Projections: Appropriate Federal Funds Rate in the Long Run

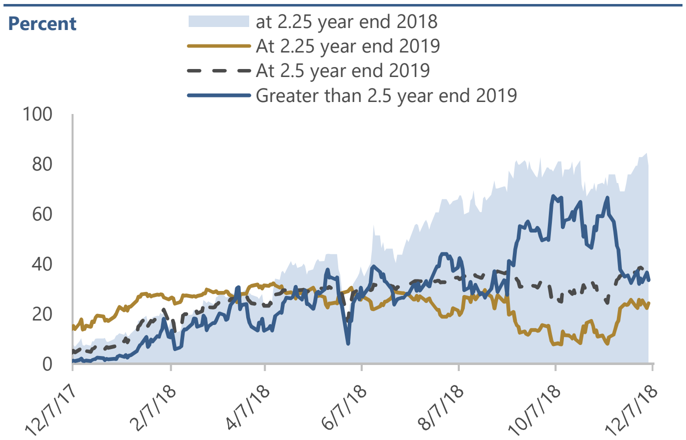


Note: Readings for 2012 are from the April meeting (the inaugural release of SEP), year-end for the intervening years and from the September meeting for 2018. Source: Federal Reserve, https://www.federalreserve.gov/monetarypolicy/fomccalendars.htm.

Equally changeable has been Chair Powell's use of the dot chart. In late September, at his post-FOMC-meeting press conference, Powell observed that the current funds rate was still lower than the lowest dot. In context, the inference was that even the most dovish participant could agree to more tightening. Doubling down in early October, Powell commented that, in his opinion, the funds rate was a long way from its neutral level, essentially selfidentifying his dot as floating high in the cloud at the far right. His words in October propelled the probability on two or more quarter-point hikes in 2019, inferred from futures market prices, to about two-in-three (as in the dark line in the next chart).

What a difference two months makes. In November, he noted the same configuration of the current funds rate and the lowest edge of the dot cloud as in September. However, he emphasized the distance (that the funds rate was close to the lower edge of estimates of its neutral level), rather than the sign (that it was below the cloud). In this context, market participants took him to mean that the scope for additional tightening is limited. Why? Powell essentially walked back his self-identification of a higher neutral rate, which suggested a plan of action in favor of a journey of discovery where the funds rate is set meeting by meeting, depending on the data. Framed by some disappointing economic releases, price losses on equity markets and a hostile tone from the White House, this talk of data dependence gutted expectations for policy tightening next year.

Implied Probabilities for the Federal Funds Rate From Interest-Rate Futures



Source: CME "Fedwatch tool", accessed December 7, 2018

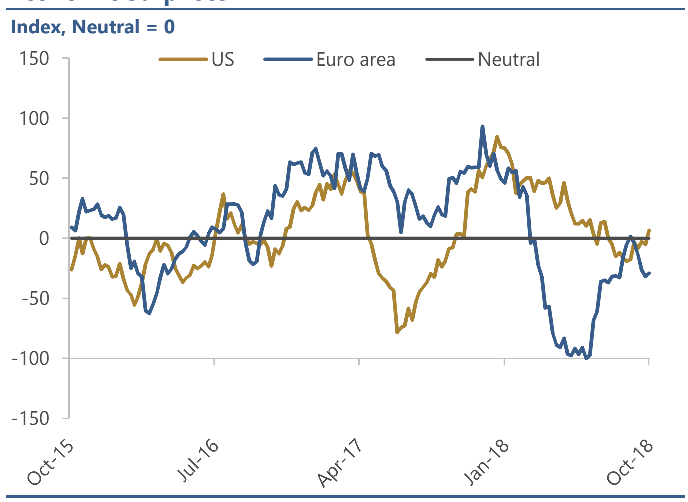
None of this is immediately relevant. Market participants presume the FOMC is proceeding full speed ahead for one last tightening this year at its meeting on December 18 to 19. The surprise-phobic FOMC sent a semaphore up the mast for all ships at sea to see, warning in the minutes of its November meeting that "…another increase in the target range for the federal funds rate was likely to be warranted fairly soon." This boat reaches the shore of a funds rate at 2¼ to 2½ percent, dutifully priced in as a nine-in-ten chance in futures markets.[1] This would mark the ninth consecutive policy action at press-conference meetings.[2]

That is right. The Fed is firming next week. In contrast, three factors make us think that the trimming of longer-term expectations is likely overdone. First, market participants are typically impatient about the evidence of Fed action as the Fed trundles along in removing accommodation, underweighting the core plan. Second, Fed communication is not as dovish as it seems; it is cautious on concerns about the market and political reaction. Third, Fed officials did not help matters by adopting their go-to metaphor of the moment. We heard that monetary policymaking in an uncertain world resembles walking around in a dark room. Both Chair Powell and Vice Chair Clarida explained that the best tactic is to go slow and stop sometimes to feel your way around. This analogy is useful to them right now but fails to illuminate their true intention. A more useful analogy than the one offered by Powell and Clarida for describing their longer-run plan ends this note.

1. Keep Calm and Carry On

The Fed's gradual, well-telegraphed removal of monetary policy accommodation is designed to tighten financial conditions and slow economic growth from its above-trend pace. The FOMC has undertaken this over the past nine quarters, even as inflation mostly tracked below their two percent goal, on the theory that the low unemployment rate would push up costs. It did, and inflation moved to their goal for a time. Of late, recent readings on inflation have flagged, and financial conditions have tightened a heap. However, the ticking lower in inflation probably owes to US dollar appreciation and the drop in oil prices, which we think has about run its course. The slowing in growth, thus far, is to a pace still above trend, and the unemployment rate is as low as ever. Consequently, additional slowing is growth necessary to extend economic expansion and probably requires firmer financial conditions. That is, they are getting what they wanted and are in closer pursuit of their goal. Being successful is not a reason to change plan.

Economic Surprises



Source: Citigroup Markets, accessed via Bloomberg December 1, 2018

The problem is that deceleration in activity is sometimes interpreted by the impatient as data disappointments. Indeed, a widely followed measure of cumulated surprises in economic data just dipped under water, but it had been bobbing above the

[1] Note that the readings from the chart, as with most trading screens, show a lower probability. Futures contracts settle based on the effective federal funds rate, which for the FOMC is inconveniently averaging close to the upper end of its target range. Precedent suggests that when the FOMC raises its range for that rate by 25 basis points, the Fed Board is almost surely going to raise the interest rate on excess reserves 20 basis points to get trading back into the middle of the FOMC band. As a result, the tightening of the effective funds rate priced into futures markets is 20 basis points. Overstating the size of the firming understates its implied probability.

[2] This count includes the decision to begin balance-sheet renormalization at the September 2017 FOMC meeting.

surface for most of fall. The US looks buoyant compared to the Euro area, which probably reveals that trade uncertainty weighs more on activity abroad because trade is more important to our trading partners than to us.

2. A Note of Caution is not the Coo of a Dove

Count how many times that Chair Powell has referred to the Federal Reserve as a "creature of Congress." (A lot, reflecting that the Fed's authority derives from the Congress's Constitutional ability to "coin money.") Count the number of days in the red for equity prices. Count the number of presidential tweets about the Fed. They all add up to counseling a low profile about the Fed's intent to remove policy accommodation and tighten financial conditions. The "Fed's Nucleus," to borrow a sobriquet from Bloomberg *Business Week*, is doing exactly that. (Is anyone worried about the *Sports Illustrated* curse? More seriously, nucleus has an unfortunate physics connotation.) Essentially, they cannot get blamed for raising rates if the data made them do it.

This explains Jay Powell's backtracking between October and November. After an untidy downdraft in equity prices and a barrage of presidential criticism, he chose to refrain from specifying which dot he was because that dot could become a bullseye. Rather, blame the data for the next action. And the action after that. We think the data will make them do it (as our forecast eventuates), which is why we pencil in four more quarter-point moves, counting the obvious one next week.

The pencil point, admittedly, was more forcefully pressed to the paper in previously rounds. Jay Powell is not complicated, so when he stops, he stops. If inflation falls from here, it will be hard for the Fed to firm past its March meeting. A planned pause with the anticipation of further action is out of his lane.

3. Wait Until Dark

Here is the point of the title of the piece, which is a bit of misdirection. Chair Powell's initial searching of the sky for points of light might suggest that he should wait until dark. Except and revealing, they keep talking about navigating in a darkened room, shut out from the sky and unsure of direction. This is more about the communications of policy, not about the setting of policy. Policy choice has always been about operating under uncertainty, feeling along. The unstated message is their rate guidance is going dark.

If so, the proper analogy is the 1967 film starring Audrey Hepburn, *Wait Until Dark*. A blind woman is inadvertently suspected of holding an item prized by a thuggish international cartel. SPOILER ALERT: In her familiar apartment, she is at an advantage at night when the lights go out.

Fed officials are explaining that they feel blind because they are about to turn the lights out on us by providing no guidance about future rate movements. As with Audrey, a dark room gives them an edge.

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