March 2018

Fed Thoughts:

Back to the Future?

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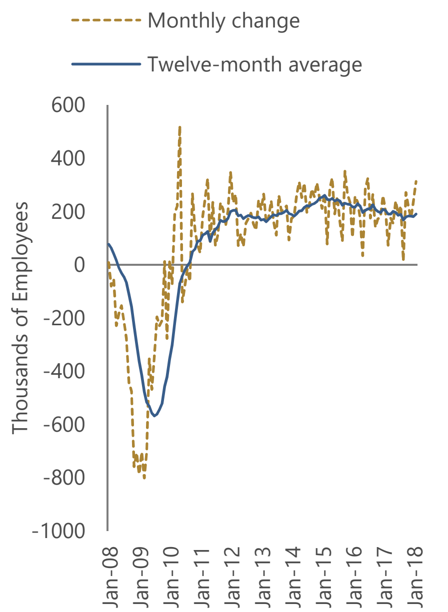
One month into the job, Federal Reserve (Fed) Chair Jerome Powell must be wondering what more is in store. Stock market correction, check, bipartisan (actually, partisan from both sides of the aisle) interrogation on Capitol Hill, check, and policy interventions on international trade by the president who appointed him, check. In the event, Chair Powell conveyed a balanced and relaxed demeanor in his February Congressional appearances when delivering the semiannual report on monetary policy.

Indeed, Chair Powell was so relaxed we are thinking about applying the soon-to-be-trademarked J-Pow! to spice up his image.

Three points emerged from his two-day grilling from what seems so long ago.

First, Chair Powell readily admitted that events since the Fed reported the economic projections of FOMC participants in December had firmed up the outlook for real growth. The administration added to budget stimulus, foreign growth picked up, and US data ran strong. The employment situation for February piled more fuel on that latter fire, with 313,000 jobs created, on net, to pull the twelve-month average near 200,000. A hot labor market pulls in new workers, though, and for the fifth month in a row, the unemployment rate held at 4.1 percent.

Nonfarm Payrolls



Source: Bureau of Labor Statistics, accessed via FRED, March 13, 2018

Spending data have not kept up, which is why tracking numbers for first-quarter real GDP growth hover around 2 percent. This is about now, and payroll gains are about forward momentum, which Jay Powell admitted was in motion.

Second, the Fed chair offered those views as his personal opinion. That is, he did not retreat behind the last written text of the group. Fed communication is in play, and his inaugural appearance as chair probably points the way. Yes, there will continue to be plenty of talking heads on monetary policy, but all those governors and Bank presidents will draw a brighter line between what the group previously said and what the speaker currently thinks. Of course, a sharper distinction between the group and the individual makes it likely that observers focus more on the one who has more heft in moving the committee—its chair. This is back to the future, repeating the pattern when the world hung on the words of Chairs Volcker and Greenspan.

Third, Powell remains in the long shadow cast by his immediate predecessor. Much of the discussion on the Hill was about the evident lack of cost and price pressures. That the twelve-month growth of average hourly earnings clocked in at 2.6 percent in February supports Yellen's view that there is no hard-and-fast line where resource use tips from slack to excess. This observation will be tested when the unemployment rate dips below 4 percent sometime soon. This, however, is the monetary policy battle

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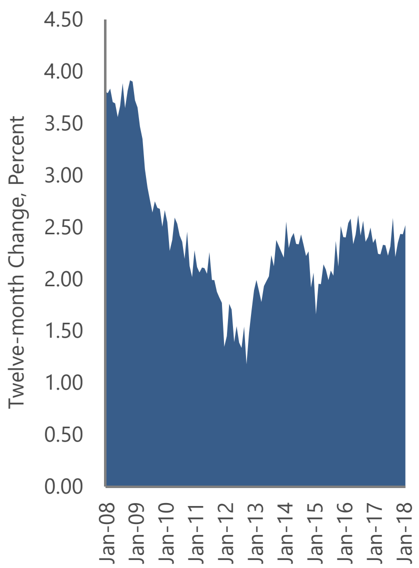
of the back half of 2018. As has been their wont this tightening cycle, Fed officials signaled strongly that a 25 basis point firming is in store at the March meeting. Taking all the proffered clues, market participants currently price in about 90 percent probability weight on Fed officials pulling the trigger in March, at least as judged by fed funds futures.

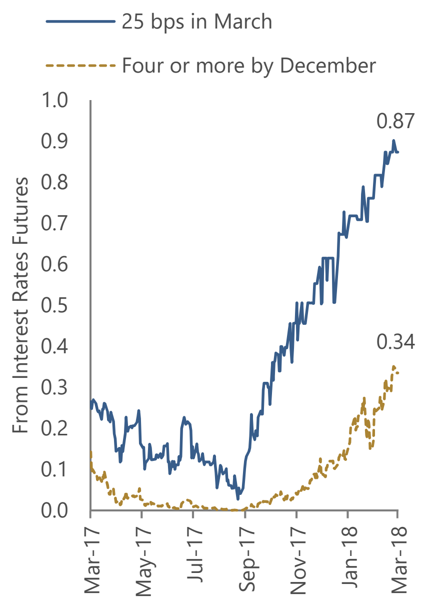
Average Hourly Earnings



Source: Bureau of Labor Statistics, accessed via FRED, March 13, 2018

Enough good news has been forthcoming to suggest Fed action this month will be accompanied by favorable headlines of the sort "Fed Confident about Expansion." When tightening is treated as good news, central banks tighten.

Implied Probabilities of Fed Action



Source: CME Group, accessed March 15, 2018

The sense is building, though, that the process gets harder when the Fed picks up the pace of firming; now about one-third probability attaches to four or more 25 basis point moves this year. Four has sounded right to us for some time, given our view that the global economic engine is chugging along at a nice clip and cost pressures are emerging. That is why the Yellen conjecture about how labor market pressures push up costs matters. Remember, the former chair only said slowly, not never.

As inflation picks up, financial market prices will conform to four moves. As long as the Fed seems acceptant to react but not over-eager to do so, the process should work smoothly. Any perceived slowness to respond might spur inflation jitters, and Powell will have to get into his deLorean (electric, of course) and revisit the Volcker-Greenspan fight to rein in outsized inflation expectations. More likely, the Fed has to resist the urge to be over-assertive. The hearings, however, indicate that J-Pow! executes low-key well.

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