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Fed Thoughts:
An Apt Place and an Awkward Time

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The story holds that the Economic Symposium at Jackson Hole run by the Federal Reserve Bank of Kansas City (FRBKC) achieved its iconic status for a simple reason: former Federal Reserve (Fed) Chair Paul Volcker loved fly fishing. When the FRBKC chose the venue by happenstance, Volcker signed up immediately. But once he was on the agenda, other Fed governors and Reserve Bank presidents elbowed in. So many policymakers in one place attracted media, and the private sector viewed it as a hot and increasingly hard-to-get ticket. The rest followed. To be fair, FRBKC guidance on content helped but happenstance as history is always a winning narrative.

Whatever the reason, central bankers should retreat to mountains once a year, as four lessons from backpacking apply to their jobs.

First, a path through the mountains looks much clearer from a distance than up close on the ground. That is, viewed from the lobby of the Jackson Lake Lodge, most routes look obvious. In 2018, the Fed had a straightforward map to raise rates that turned out to be increasingly harder to follow as the year advanced.

The reason, the second point, is that local conditions matter, including changeable weather and the volume of other foot traffic on the trail. The Fed's turn-of-the-year redirection of policy owed to officials discovering that they were pushing against an opposing flow of investors.

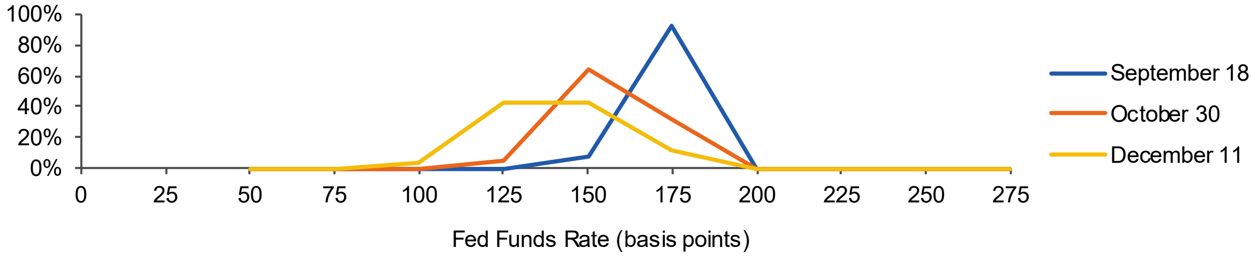
Third, gravity matters, which is why the way up the mountain is a slow slog compared to the way down. Monetary policy firming involves small steps stretched over time. Easing goes faster.

Fourth, Jackson Lodge is remote, and central bankers are mostly alone both physically and metaphorically. No one likes them when they are removing accommodation and their natural reticence almost guarantees that they will not put it back as quickly as some believe it to be appropriate.

Thus is the relationship between Fed Chair Jay Powell and President Donald Trump. Judged by Powell's most recent speech and the minutes from the July meeting, the Fed is a reluctant easer. Three reasons for July's quarter-point reversal were offered: inflation expectations had eased, the global economy had slowed, and risks to the global trading system were elevated. All three work for a one-off move, but they do not convey much momentum for subsequent action, especially if members do not agree which one is in force.

This is a problem for Fed Chair Powell because President Trump yearns for more, and Trump's tweet storms shape market expectations. As shown below, fed funds futures are consistent with at least three quarter-point reductions at the next three Federal Open Market Committee (FOMC) meetings. That is, policy is pictured as in recession mode, easing twice as quickly in 2019 as it firmed in 2018. We think—and we think that this is what the Fed thinks—that the fear of a downturn is outsized in current circumstances.

Implied Probabilities of Fed Action - 2019 Meetings



Source: CME Fedwatch tool, 9/4/19.

Such a misalignment may prove awkward for Fed officials, who have to call out their views on the appropriate fed funds rate at year-end in the "dot plot" section of the Summary of Economic Projections. Dots north of the market consensus may undo much of the stimulus embodied in a quarter-point reduction in the policy rate.

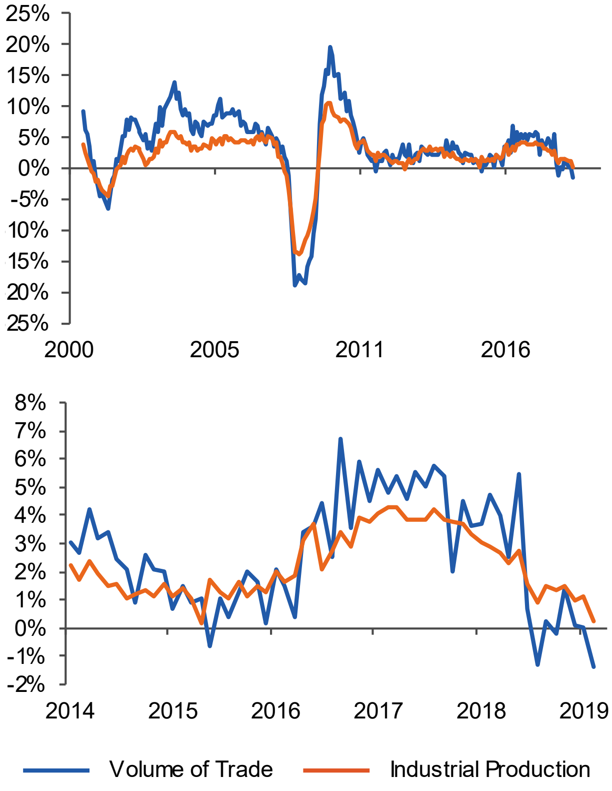
Why are we so sure that the Fed delivers one-quarter point of ease on September 18? They told us is in the oblique fashion of Fed officials. In his speech and in July's minutes, Fed Chair Powell neither pushed back on the prevailing consensus of a 25-basis-point cut nor swam up to a more substantial move. His silence conveyed consent, and consequently investors coalesced on a quarter-point move.

Why do we harbor doubt about two more quarter-point moves to round out the year? As much as market participants desire such action, the improbable rings true: President Trump is right about the economy in three respects.

First, equity prices would be much higher (perhaps not 10,000 Dow points as the President asserted) if the trade dispute with China were resolved because output and income would be on a faster upward track. Uncertainty about trade is a deadweight loss, interfering with supply chains (hence lower output) and discouraging long-lived fixed investment (hence lower aggregate demand), not to mention the direct impairment on the trade in goods. The growth of global trade came a screeching halt this year, with the twelve-month change down 1.4 percent in June. Prices also fell, implying that trade values fell even more.

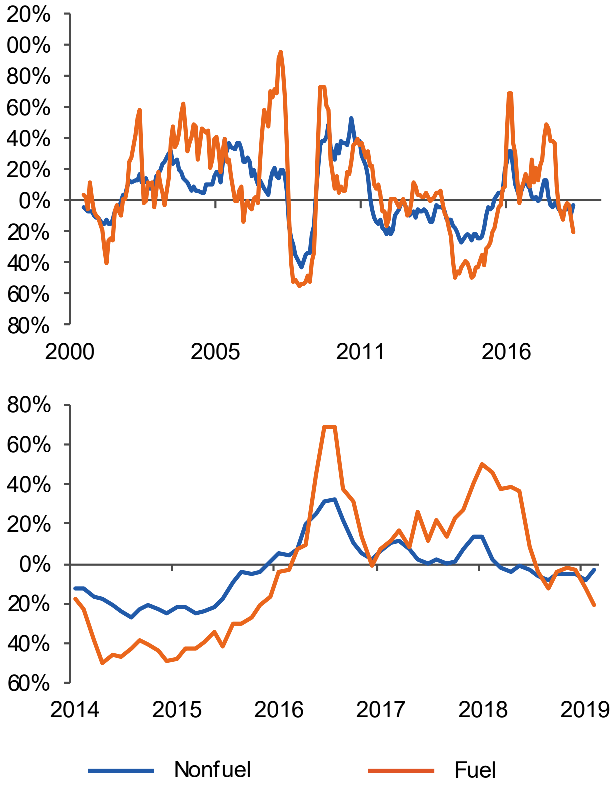
Global Trade and Industrial Production

12-Month Change



Global Trade Prices

12-Month Change



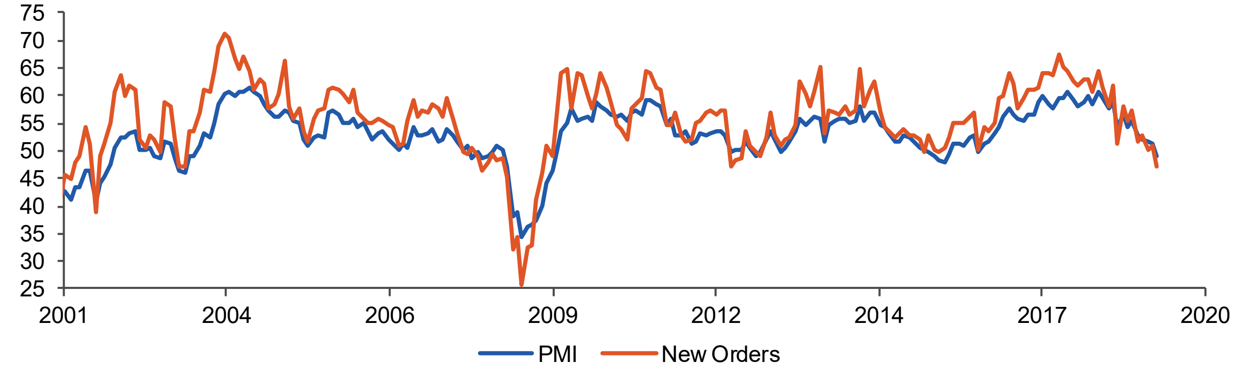
Source: CPB.nl, World Trade Monitor, accessed 9/4/19.

Second, trade matters more to US trading partners than to the US. US production relies more on services, and the US brings in far more value from foreigners than it sends to them (i.e., the US has a large trade deficit). It is not surprising that purchasing manager indexes in our trading partners took a relatively bigger hit.

Third, the US has more cyclical momentum than our trading partners. A few European partners are technically in recession even as the US tracks 1¾ percentage point growth in nowcasts for the third quarter. True, US purchasing managers indicate spending intentions below the breakeven point and the survey of new orders predicts a further movement to the south. However, these are indicators of manufacturing, and the world is in a manufacturing recession. Purchasing managers of such firms scan a bleak order book and look restively at building inventories. Though they are negative, that tail no longer wags the dog as services and other activity are mostly impervious to trade ructions.

ISM Purchasing Managers' Index and New Orders

Neutral = 50

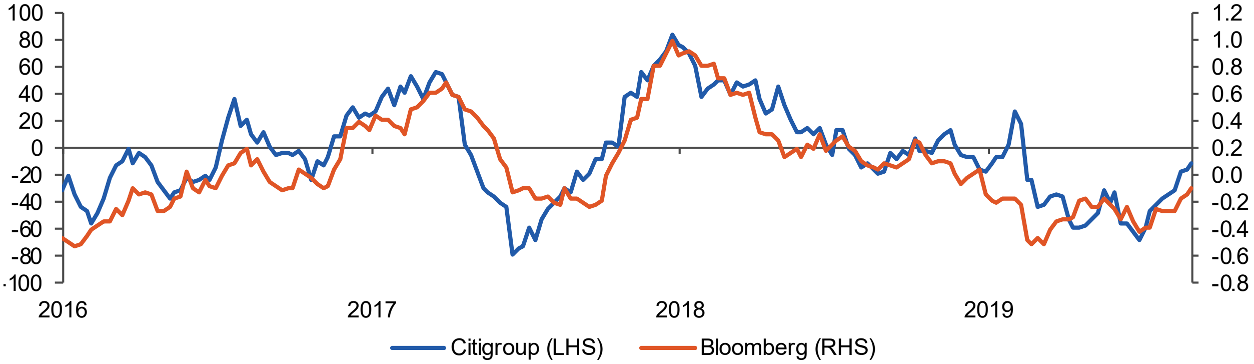


Source: Institute for Supply Management, access via Bloomberg, 9/4/19.

In fact, economic surprises have been much less negative, consistent with activity finding a cyclical bottom. Limited feedthrough from trade and insulation provided by the US service economy implies that modest Fed easing offsets the Trump trade shock—provided the trade shock dissipates. We think that there will be two quarter-point moves in the next three meetings, consistent with Powell's constrained tone and our view of the economy and the political economy, which is less than is priced into markets.

US Economic Surprise Indexes

Neutral = 0



Source: Citigroup and Bloomberg, 9/4/19.

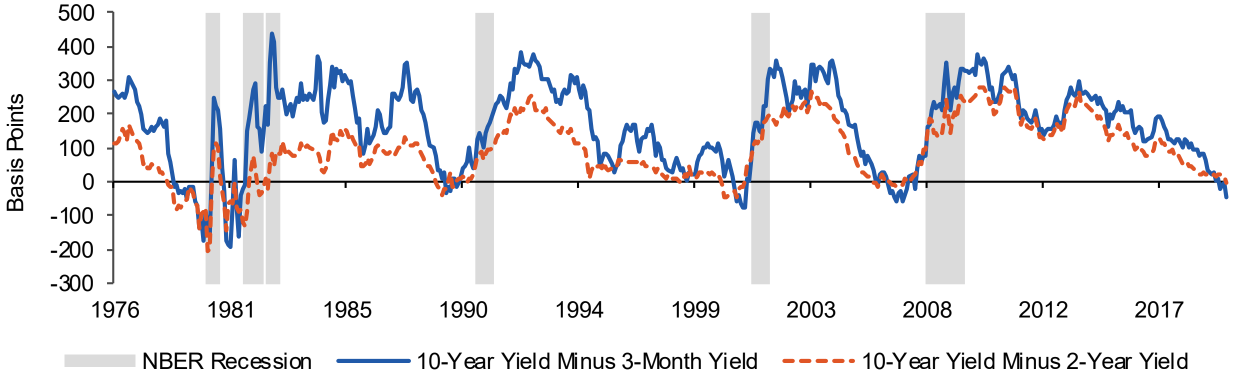
PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS.

However, our base assumption is that trade frictions will stop getting worse, remembering that the cessation of a drag on the level of activity produces a pop for growth. Both Presidents Trump and Xi must be restive about their economies, the former pressed by financial markets and the latter worried about capital flight.

The Fed probably shares this forecast that the economy gets a little lift from the partial resolution of trade uncertainties in part because it is hard to write down an outlook assuming that your political betters fail epically. If so, a move at all three remaining meetings of the year seems a stretch. Look, therefore, for some disappointment from the Summary of Economic Projections, as fewer dots hug the horizontal axis than market participants might hope.

Also do not expect much empathy from the Fed about the inversion of the term structure. The last time Fed Chair Powell was asked the question in a press conference it resulted in a thousand-yard stare. We are similarly unfocused. Everybody gets the arithmetic. The chart and table counts the months since mid-1976 when the ten-year Treasury yield was below the three-month bill rate and the two-year note yield, respectively. While the yield curve inversion has been infrequent since 1976, about 70 percent of that time was in advance or in recession. It would seems to be a signal.

Slope of the Treasury Term Structure



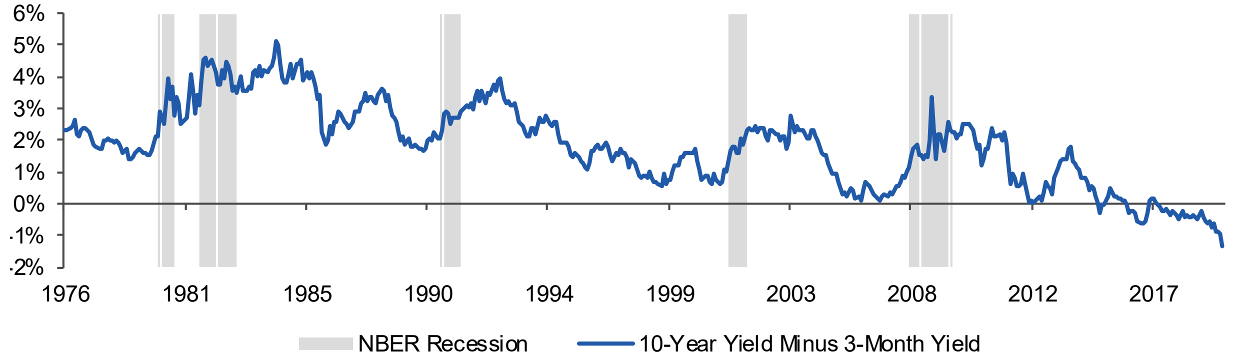
Share of Months with an Inverted Yield Curve

Since July 1976

	10-Year Yield Minus 3-Month Yield	10-Year Yield Minus 2-Year Yield
Total	10.4%	13.5%
In recession	9.3%	17.1%
Within 6 months of recession	29.6%	21.4%
Within 12 months of recession	64.8%	52.9%
In or within 12 months of recession	74.1%	70.0%

Source: NBER and Bloomberg, accessed via Bloomberg on 9/4/19.

Estimated 10-Year Treasury Term Premium



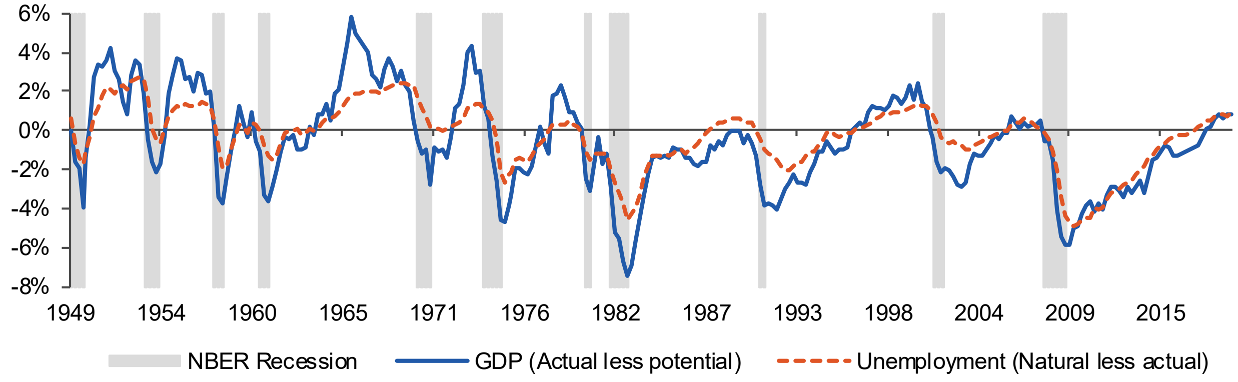
Source: NBER and Bloomberg, accessed via Bloomberg on 9/4/19.

Here is the arithmetic: long-term Treasury yields represent a weighted average of expected future short-term interest rates plus a term premium. For most of the post-World War II period, that premium was fat. The only way that the average of that premium and the expected future short rate could be low (and below the long rate) is if the short rate was expected to be very low—a policy response normally associated with recession. Hence, everyone's hair goes on fire with low yield spreads.

Instead, we put considerable stock in the lower panel. Large Fed holdings of government securities and the pull of $17 billion of foreign sovereigns with negative nominal yields keeps Treasury returns low, reflected in negative term premiums.

There is another association to consider. In our view, a better predictor of recession is the resource gap, whether in terms of GDP or unemployment. Recessions follow from the attempt to deal with strains on resources, as shown below. We are not worried about an imminent downturn (a view shared in risk markets) because the Fed appears willing to ease even as the output gap widens. Fed officials may do this, for now, but their resolve will flag as they go further above the horizontal line of excess demand. That is why we are not on board the market boat down river to quarter-point cuts at every meeting. Expect two and be done.

Estimated Resources Gaps



Source: BEA, CBO, and NBER, accessed via Fred.

This is the narrow path of the forecast. The Fed's ease is enough to blunt the Trump effect on US growth. The presidents of China and the US steer away from their respective cliffs in this game of chicken, not making circumstances materially better but importantly not worsening them. Because the US has more protective padding than most and the global free-for-all is reigned in by political self-interest, the Fed's ease is short of that currently priced into markets but still enough to keep risk on.

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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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