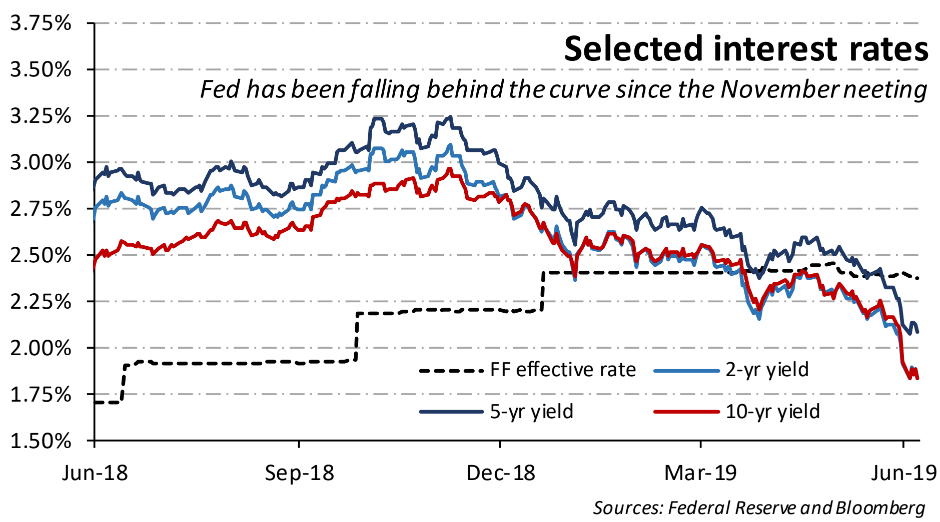
# ECONOMIC WEEKLY

## BEHIND THE CURVE

James Bullard, the only FOMC participant yet to acknowledge the need for a rate cut, offered an interim solution this Wednesday. In an interview with *MNI,* the St. Louis Fed President suggested the FOMC could adopt a bias to cut rates. "Based on past behavior, that would be a typical intermediate step that the committee might take, depending on sentiment around the table," He explained. "I don't know where everybody is on this," he added. "I think the bond market yields falling as much as they have is a relatively recent development, so people are kind of digesting that at this point."

As the chart demonstrates, it's not a recent development, unless eight months ago is recent. We point this out not to be unpleasant but because the Fed's pivot to easing is so slow it has completely flipped the bond market's Fed reaction function. This reversal itself indicates Fed policy stands coequal with trade tensions as a recession threat.




Bullard favors a June cut. "You could make a cut today based both on the idea that you want to re-center inflation and inflation expectations at target and that you want to take out some insurance in case the economy slows down more than we think." But he understands participants might need time to digest recent developments, especially the 50bp drop in intermediate yields since early April.

Unlike some at the FOMC, Bullard heeds markets. "To me, it's pretty clear that the bond market is seeing less growth and less inflation in the future than the Fed is," he told *MNI.* "That makes me think that the Fed is a little bit out of line with market expectations, and the yield curve inversion is a symptom of that. So it's suggesting that we are too hawkish for the current environment."

## CONTENTS



## ECONOMICS

Chris Low, Chief Economist
212.418.7909
chris.low@ftnfinancial.com

Rebecca Kooshak, Economic Analyst
212.418.7966
rebecca.kooshak@ftnfinancial.com

When traders see one path for rates and the Fed advocates another, we do not say the Fed is "diverging from the curve." We say the Fed is "behind the curve," because the Fed — just like the rest of us mere mortals — rarely wins a fight with the market. Of course, the market could change direction, and the market does overshoot, but this bond rally goes back eight months, far too long to suggest it is a mistake.

The Fed's standard methodical policy approach lends the institution gravitas. It also builds credibility, when — as in the summer of 2016 and the late summer of 2017 — slow and steady leads to the right outcome. But there are times when a rapid response is necessary. At times like this, participants' sound minds and good hearts can prevent them from doing the right thing.

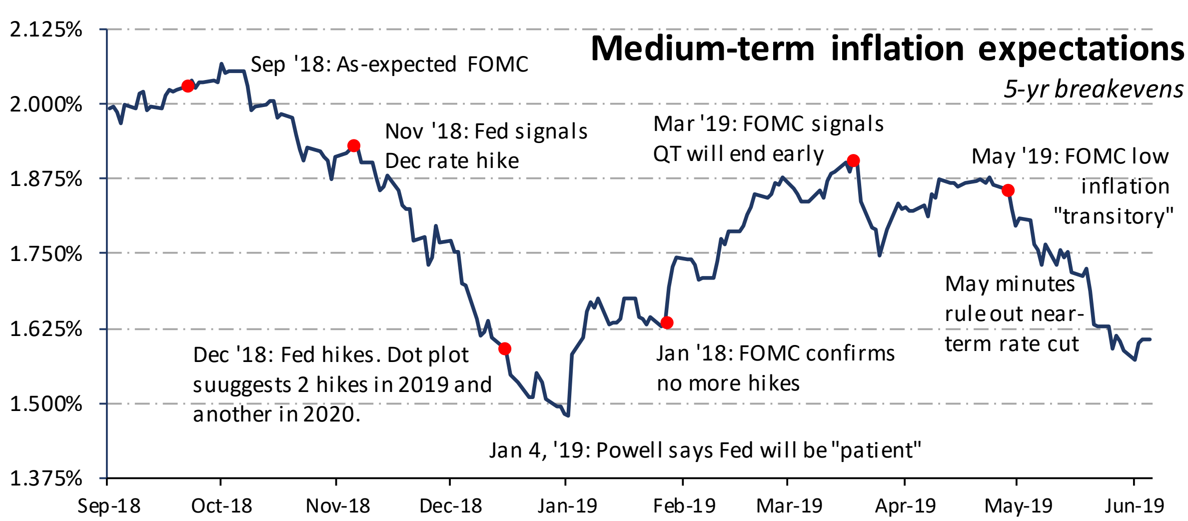
## Patient, or stubborn?

"Patient" FOMC participants argue against a rate cut because they are not certain their forecasts will continue to be wrong and they want more time to assess. As Dallas Fed President Robert Kaplan told *CNBC* on Thursday morning, the markets see something he doesn't see in the domestic data. We suggest he look at the domestic inflation data. Or the domestic PMI data. Or the domestic income and consumption data. But if he really wants to catch up with the markets' understanding of where rates should be, he ought to lose his domestic-only focus and expand his horizons to include international data.

## Can't see what the markets sees? Try a mirror

One of the biggest domestic influences on yields is one that FOMC participants fail to consider because they are standing too close. The Fed itself has a huge impact on the bond market, and not always in the direction you might expect. While fed funds are normalizing, rate hikes usually cause market rates to rise. Once normalization is over — and there are no models with nearly the kind of accuracy necessary to determine that point — a rising fed funds rate can cause market rates to fall, depending on circumstances. There's evidence of both over the past eight months.

Kaplan's struggle to understand falling market yields is easier to resolve if the horizon is extended because the May drop in yields was severe, but it was not isolated. Market yields have fallen for eight months, since the November FOMC meeting, with only occasional, brief backups. The Fed's need for more time to evaluate is growing tiresome, not least because one of the most significant reasons market yields have fallen since November is the Fed itself. Note the effect of key Fed communications on market inflation expectations in the chart below.



*Source: Federal Reserve, Bloomberg and FTNFinancial*

Market inflation expectations fell last year when it became clear the Fed was committed to hiking well past the market's perception of neutral. The low point in inflation expectations came on the morning Chair Powell pivoted to patient policy. The pivot resulted in an immediate jump in inflation expectations. The January Fed meeting confirmed the Fed would not tighten and inflation expectations rose almost a quarter point in a day. **Note: The promise of fewer future rate hikes translated into higher inflation expectations immediately.**

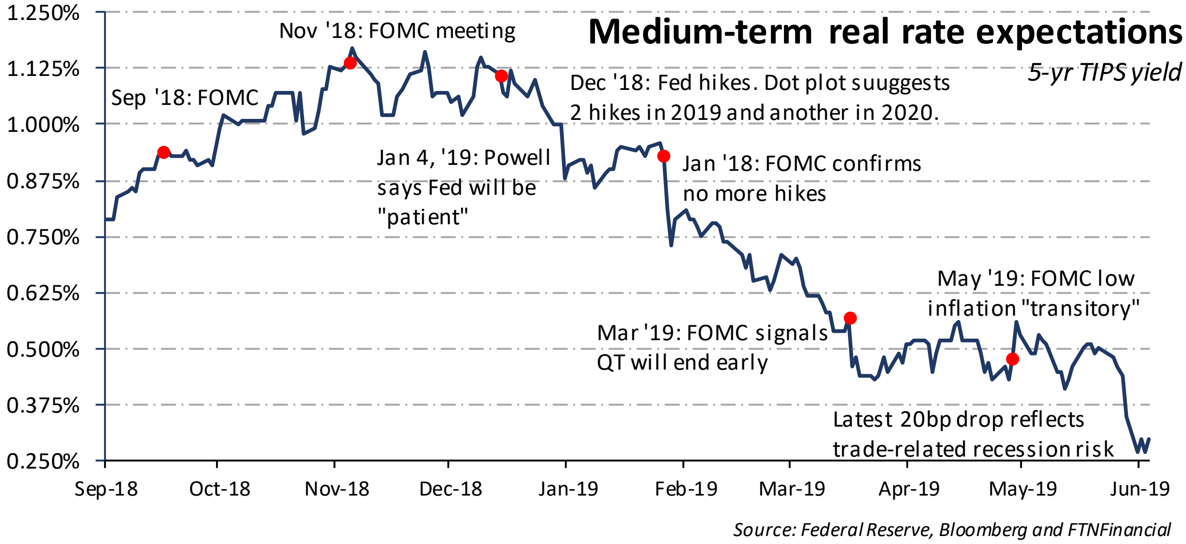
This year's peak in inflation expectations came the day of the March FOMC meeting, when the Fed announced QT would end early. A brief but sharp drop in breakevens was more likely a reflection of hedging and portfolio realignment after this market-shaking announcement than an actual shift in inflation expectations. After all, expectations climbed back close to the March high over the next few weeks.

The Fed triggered the real down leg in inflation expectations on May 1, when Chair Powell described weak growth and low inflation as "transitory" and "transient." Inflation might be 50bp below the Fed's target, but the Fed clearly had no inclination to do anything about it. Another significant drop in inflation expectations followed three weeks later when the minutes showed FOMC participants were not even thinking about cutting rates. **Note: The promise of a commitment to policy consistent with continued below-target inflation causes inflation expectations to fall.**

> The recent behavior of market inflation expectations is a reminder rate hikes or a commitment to maintaining too tight policy causes the inflation component of bond yields to fall, while rate cuts or a commitment to too easy policy causes the inflation component of yields to rise. This is one very important reason the Fed's attempts to manipulate long-term interest rates sometimes backfires. Depending on what happens to the real yield component of yields, tight policy can result in falling long-term yields, while rate cuts can lead to higher long-term yields.

The Fed is not the only thing to affect rates. A similar chart of real yields — the second major piece making up nominal yields — shows the importance of economic events in addition to the importance of the Fed[1]. Nevertheless, the Fed has a role here, too, because real rates, for the five year in this case, reflect the market's expectations of the average fed funds rate over the next five years. If the Fed hikes rates and traders think it can be sustained, the real 5-yr rate will rise. If the Fed hikes rates and traders think it increases the odds of recession, and therefore cannot be sustained, the real 5-yr rate will fall.

[1] Lately, the twists and turns of US-China trade negotiations and US, EU and Chinese manufacturing PMIs have been especially important.




In the chart, we annotated FOMC meetings again because our interest is to understand the Fed's influence. Several things pop out, again suggesting the Fed's influence on real rates is sometimes in the opposite direction expected.

- Note, for instance, the 25bp drop in real yields after the December 2018 dot plot showing three rate hikes planned in 2019-20. This means market expectations of the average real overnight yield — the real fed funds rate — was lower when the Fed implied 75bp of hikes over the next two years than if the Fed implied no increase in rates. This is a clear indication a 75bp increase in fed funds significantly increased market odds of recession. Rates would tumble in a recession.
- Powell's patient pivot on January 4 initially stabilized real rates because recession odds were lower.
- By the time the FOMC made the pivot official at the January meeting, however, economic fear had subsided to such a degree, the promise of lower rates in the near term lowered medium-term real rates as well.
- By the same token, the positive correlation between fed funds and 5-yr real rates was reconfirmed at the May FOMC meeting. Powell's insistence that low inflation is transitory — meaning the Fed would not cut rates in an effort to boost inflation — caused 5-yr real rates to rise for a couple of days.
- When the May minutes were released, showing near unanimous support for Powell's stance, however, the correlation flipped again. Real 5-yr yields plunged. What had changed? First, the US-China trade talks had collapsed. Second, Manufacturing PMI data suggested the collapse of the trade talks would deal a mighty economic blow. **Recession risk is back in play.**

## Bottom line: Faster, please

The Fed just wrapped up its *Fed Listens* events, a series of meetings seeking advice from monetary policy experts outside the Fed on whether to change the way the FOMC conducts policy in order to avoid the zero lower bound. In the past, we have joked about NY Fed President John Williams' split personality, as he has alternated between dovish expressions of new, lower-for-longer thinking and hawkish expressions of the Fed's old way of framing the policy debate.[2] This commendable effort to explore change reflects a strong desire to follow the advice of the dovish John Williams.

In the traditional Fed view, the fed funds rate should rise except in recessions. After all, inflation cannot fall

[2] Williams is a true believer in the new, lower-for-longer policy approach, but he also believes the FOMC must make the decision to change first, before any FOMC member, himself included, should use it to make policy decisions.

unless the unemployment rate rises in its economic models. The only other variable, inflation expectations, is too stable to overcome a low unemployment rate. Hence, to the Fed, any late-cycle inflation drop must be "transitory" by definition. (The Fed dismisses anything acyclical as transitory.) We laid this out in the last week's *Economic Weekly*.

Unfortunately, structural changes that have altered reality enough to warrant the listening tour have not yet altered monetary theory even outside the Fed, with the exception of the few economists on the Fed's invite list studying income inequality. Traders are starting to understand persistent low inflation, but not academics. The Fed invited 112 university professors, two bankers and no traders to participate in its seven events. As Jim Bianco noted in a recent *Bloomberg Opinion* column about the tour, "The Fed is listening, just not to the markets."

The Fed must learn from the BOJ and the ECB, who also ignored markets in favor of models. Members of the ECB's policy committee discussed rate cuts and additional quantitative easing at this week's meeting. This is a good thing. Europe needs stimulus. But even if the monetary policy committee decides it wants to boost growth, there is no way they can provide monetary stimulus. Europe is stuck in a liquidity trap just as Japan is stuck in a liquidity trap, which is what happens when central bank zeal to check inflation causes rates to fall to the zero lower bound. Or, in Europe and Japan's experience, through it. A more negative policy rate will not spur credit, nor will another round of QE.

It would be inexcusable if the FOMC walks into a liquidity trap after watching first Japan and then Europe do it. The Fed should heed not just the direction, but also the urgency and magnitude of market guidance. An expansion-ending mistake will cost more than just jobs. It could spell the end of effective monetary policy in the United States as well.

– Chris Low, Chief Economist

# The Week Ahead

## This Week's Numbers

| | | PRIOR | CONSENSUS HIGH | CONSENSUS LOW | CONSENSUS MEDIAN | FTN |
|---|---|---|---|---|---|---|
| Tuesday, June 11 | NFIB Small Business Optimism - May | 103.5 | 104.0 | 101.0 | 101.8 | **101.0** |
| | PPI Final Demand MoM - May | 0.2% | 0.5% | -0.2% | 0.1% | **0.0%** |
| | PPI Ex Food and Energy MoM - May | 0.1% | 0.3% | 0.1% | 0.2% | **0.1%** |
| | PPI Ex Food, Energy, Trade MoM - May | 0.4% | 0.3% | 0.1% | 0.2% | **0.1%** |
| | PPI Final Demand YoY - May | 2.2% | 2.3% | 1.5% | 2.0% | **2.0%** |
| | PPI Ex Food and Energy YoY - May | 2.4% | 2.4% | 2.2% | 2.3% | **2.1%** |
| Wednesday, June 12 | CPI MoM - May | 0.3% | 0.2% | 0.0% | 0.1% | **0.1%** |
| | CPI Ex Food and Energy MoM - May | 0.1% | 0.2% | 0.1% | 0.2% | **0.1%** |
| | CPI YoY - May | 2.0% | 2.0% | 1.6% | 1.9% | **1.9%** |
| | CPI Ex Food and Energy YoY - May | 2.1% | 2.2% | 1.8% | 2.1% | **2.0%** |
| Thursday, June 13 | Import Price Index MoM - May | 0.2% | 0.3% | -0.5% | -0.3% | *0.2%* |
| | Import Price Index ex Petroleum MoM - May | -0.6% | 0.2% | -0.2% | -0.1% | **0.3%** |
| | Import Price Index YoY - May | -0.2% | 0.8% | -1.5% | -1.4% | **-1.1%** |
| Friday, June 14 | Retail Sales Advance MoM | -0.2% | 1.0% | 0.4% | 0.7% | **0.5%** |
| | Retail Sales Ex Auto MoM | 0.1% | 0.8% | 0.2% | 0.4% | **0.3%** |
| | Retail Sales Ex Auto and Gas | -0.2% | 0.8% | 0.3% | 0.6% | **0.4%** |
| | Retail Sales Control Group | 0.0% | 0.8% | 0.3% | 0.4% | **0.3%** |

## *Review*

This week, James Bullard and John Williams suggested a rate cut might be warranted, Markit PMI and ISM Manufacturing PMI disappointed along with May's payroll numbers; a deal with Mexico may not be reached before tariffs go into effect, and the ECB policy meeting was not as dovish as markets had hoped.

- Saint Louis Fed President James Bullard suggested a rate cut in a speech at the Union Club of Chicago Monday. He cited below target inflation, falling inflation expectations, and a yield curve moving toward a more decisive inversion. The yield curve's deeper inversion, he said suggests, "current policy rate setting is inappropriately high." He concluded, "a downward adjustment in the policy rate…may be warranted soon."

- May payrolls grew by 75k jobs, just enough to offset the -75k revision to March and April, with business & professional services (+33k) and health care & social assistance (+24k) contributing the bulk. Year-on-year average hourly earnings growth dipped marginally from 3.23% to 3.11%.

- Wednesday, Mexico's foreign minister met with Mike Pence at the White House. President Trump tweeted, "*progress is being made, but not nearly enough! Border arrests for May are at 133k… Further talks with Mexico will resume tomorrow with the understanding that if no agreement is reached, Tariffs at the 5% level will begin on Monday, with monthly increases per schedule.*" Yesterday, *Reuters* reported Mexican soldiers and armed police blocked 300-400 Guatemalan migrants crossing the southern Mexican border in a major demonstration of compliance with President Trump's demands. Moody's and Fitch downgraded Mexico's credit rating the same day; the latter on increased risk of public finances and continued macroeconomic weakening.

- The ECB extended the timeline for which it keeps rates ultra-low, announced TLTRO-III terms, assessed the unfavorable impact of negative interest rates on banks, discussed possible rate cuts and possible new QE, and raised its economic forecast for GDP and inflation growth in 2019.

Draghi explicitly called on governments to change policies to complement the ECB's policy. The EC threat to Italy of a fine for excessive deficit spending suggests Draghi will not get much traction on fiscal stimulus. He also suggested "structural reforms" to euro area should be "substantially stepped up," citing the EC's country specific recommendations updated yesterday.

- On TLTRO III, the ECB said it will set each operation 10bps above the average rate on the EU's main refinancing operations, which has been 0%. The exception is for banks where net lending exceeds a benchmark, the rate applied in TLTRO III will be lower and can be as low as the average interest rate on the deposit facility (currently -0.4%) at the time of the operation plus 10 bps. While this approach likely appealed to the MPC's sense of central banker propriety, it amounts to using small banks to subsidize the big ones, reverse Robin Hood style.
- The ECB tweaked forward guidance language on the timeline it expects to maintain its key interest rates. It used to say rates would remain at present levels "until at least the end of 2019…or as long as necessary" and now says "until at least through the first half of 2020, and in any case for as long as necessary." (Its three key interest rates are the deposit facility rate set to -0.4%, main refinancing operations set to 0.0%, and marginal lending facility rate set to 0.25%.)
- On the positive versus unfavorable impact of negative interest rates, the Governing Council assessed the positive aspects are not "undermined by possible side effects on bank-based intermediation." It added, it will "continue to monitor carefully the bank-based transmission channel of monetary policy and case for mitigating measures."
- It raised its real GDP annual forecast one-tenth from March's forecast to 1.2% in 2019 and two-tenths for 2020 to 1.4%. Inflation, remains muted, but the ECB expects it to increase in the medium term due to labor costs, tightening labor markets, and high levels of capacity utilization pressures. Note that this inflation prediction, Fed style, has been constant, and constantly wrong, for years. After the meeting, Finnish central bank Governor Olli Rehn called for a thorough review of ECB inflation forecasting. Rehn is a top candidate to replace Draghi 's when his term ends later this year.

The Atlanta Fed's Q2 GDPNow forecast fell one-tenth from 1.5% last Friday to 1.4%. The NY Fed revised its Nowcast sharply lower, from 1.48% to 1.0%. ISM manufacturing, trade data, and May's dismal jobs report drove the forecast lower.

## *Preview*

Note: ★ = High Impact Event
All times Eastern Daylight

### Saturday, June 8

★ G20 finance ministers and central bank governors meet in Fukuoda, Japan. US Treasury Secretary Steven Mnuchin speaks on a panel with Kun Liu, China's finance minister, about tax challenges resulting from digitalization. (Through June 9)

### Sunday, June 9

- Hong Kong: Thousands expected to protest a proposed extradition law permitting return of fugitives to China.

- ★ China:
  - Exports – May (Last Y/Y: -2.7%; Con: -3.8%)
  - Imports – May (Last Y/Y: 4.0%; Con: -3.3%)

### Monday, June 10

- President Trump's 5% tariffs on Mexican goods starts unless a deal is struck this weekend. Tariff rates planned to increase monthly until hitting 25% in October.
- 4:00am – Italy: Industrial Production – Apr
- 4:30am – UK:
  - GDP MoM – Apr (Last: -0.1%)
  - Monthly GDP 3M/3M change – Apr (Last: 0.5%)
  - Industrial Production – Apr
  - Manufacturing Production – Apr
  - Trade Balance – Apr
- 8:15am – Canada: Housing Starts – May
- 8:30am – Canada: Building Permits – May
- 10:00am – US: JOLTS Job Openings - Apr
- 11:30am – US: $36b 3M and $36b 6M Treasury Bill Auctions

### Tuesday, June 11

- UK: British lawmakers question Huawei executives on security as the UK weighs whether to allow the company to play a role in next-generation broadband networks.
- ★ 4:30am – UK: Labor Market Report
- 6:00am – US: NFIB Small Business Optimism - May
- 8:30am – US:
  - PPI Final Demand – May (Last Y/Y: 2.2%; Con: 2.0%)
  - Core PPI – May (Last Y/Y: 2.4%; Con: 2.3%)
- ★ 1:00pm – US: $39b 3Y Treasury Note Auction
- 7:50pm – Japan:
  - Core Machine Orders
  - PPI Y/Y – May (Last: 1.2%; Con: 0.7%)
- ★ 9:30pm – China:
  - CPI – May (Last Y/Y: 2.5%; Con: 2.7%)
  - PPI – May (Last Y/Y: 0.9%; Con: 0.6%)

### Wednesday, June 12

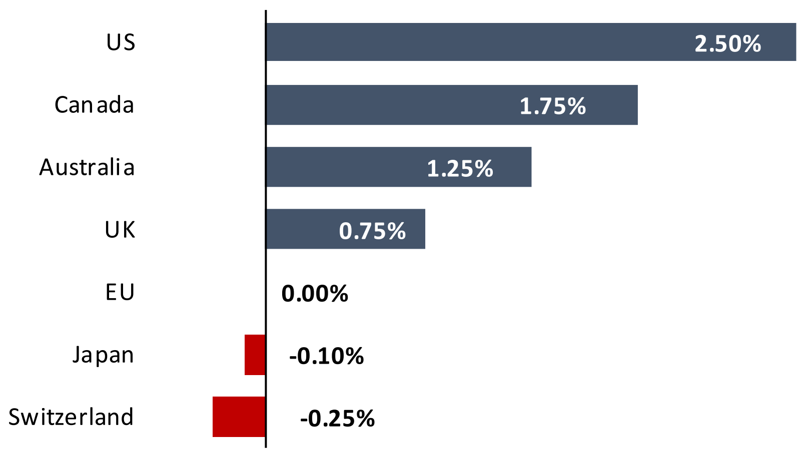
- Japanese Prime Minister Shinzo Abe visits Iran to meet with Iran's Supreme Leader Ayatollah Ali Khamenei. (It's the first visit by an incumbent Japanese leader to Iran since 1978.)
- 1:00am – Singapore: Retail Sales – Apr (Last Y/Y: -1.0%; Con: 0.3%)
- 4:00am – Italy: Unemployment Quarterly – Q1
- ★ 5:00am – EU: ECB President Mario Draghi speaks in Frankfurt.

- ★ 8:30am – US:
  - CPI – May (Last Y/Y: 2.0%; Con: 1.9%)
  - Core CPI – May (Last Y/Y: 2.1%; Con: 2.1%)
  - Real Average Hourly Earnings – May (Last Y/Y: 1.2%)
- ★ 1:00pm – US: $24b 10Y Treasury Note Auction
- 2:00pm – US: Treasury Budget Monthly Statement

### Thursday, June 13

- UK: First ballot race takes place for Conservative Party leadership with further ballots scheduled for June 18, 19, and 20.
- EU: Euro area finance minister meet to discuss financial penalties for Italy over its debt load and budget. IMF MD Christine Lagarde presents an IMF report.
- China financial regulators and banking industry executives meet in Shanghai to discuss accelerating Shanghai's development as a financial center.
- OPEC oil market report, including demand forecasts, and OPEC production released.
- 12:30am – Japan: Tertiary Index M/M – Apr (Last: -0.4%)
- ★ 2:00am – Germany:
  - CPI – May F (Last Y/Y: 1.4%; Con: 1.4%)
  - CPI EU Harmonized – May F (Last Y/Y: 1.3%; Con: 1.3%)
- ★ 3:30am – Switzerland: The Swiss National Bank sets monetary policy. Investors anticipate the bank taking its key interest rate even lower in hope it will weaken the Swiss franc.

**Switzerland has the lowest rate in the world**

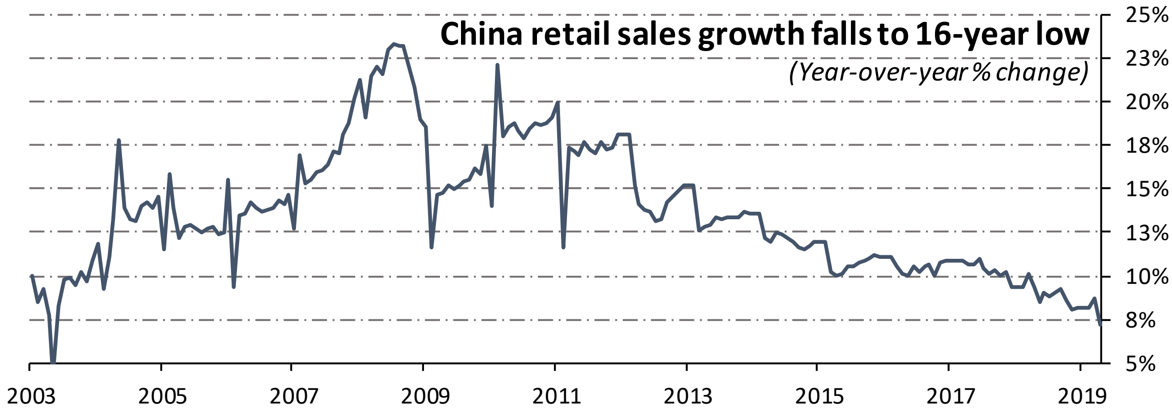



*Source: Federal Reserve Board, Bank of Canada, Bank of England, Reserve Bank of Australia, European Central Bank, Bank of Japan, FTN Financial*

- 5:00am – EU: Industrial Production – Apr
- 8:30am – US:
  - Import Price Index (Last Y/Y: -0.2%; Con: -1.4%)
  - Export Price Index (Last Y/Y: 0.3%)
- 1:00pm – US: $16b 30Y Treasury Note Auction
- ★ 10:00pm – China:
  - Retail Sales Y/Y – May (Last: 7.2%; Con: 8.0%)

- Fixed Assets Ex-Rural YTD Y/Y – May (Last: 6.1%; Con: 6.1%)
- Industrial Production Y/Y – May (Last: 5.4%; Con: 5.4%)

Retail sales in April slowed to a 7.1% year-over-year pace, its weakest since 2003. Consumer goods led the slowdown, as the country's falling export orders forced firms to reduce staffing levels. May's preliminary PMI report shows an improvement in export sales, but "firms" remain "relatively cautious" about staffing levels. The employment subindex showed a marginal drop in staff numbers, which may weigh on May's retail sales.

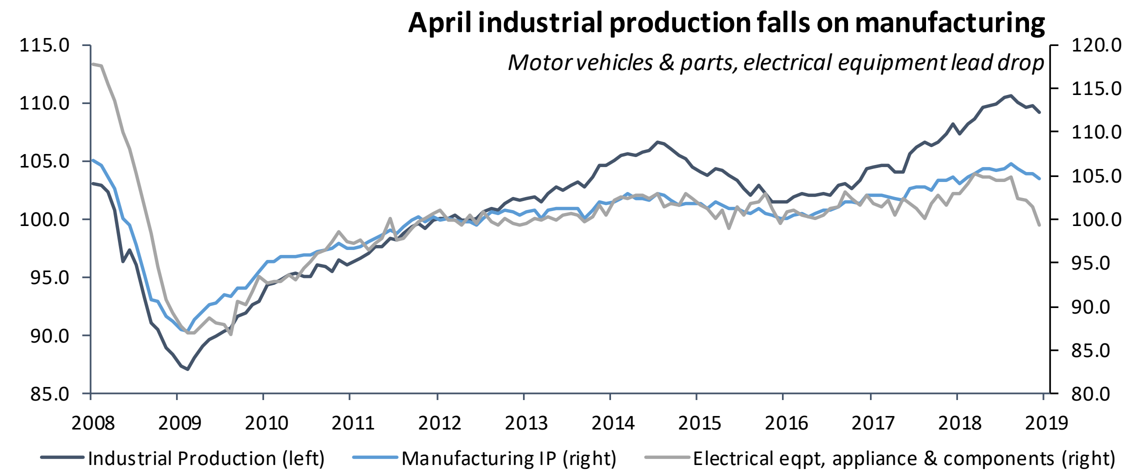


*Source: National Bureau of Statistics of China*

## Friday, June 14

- 12:30am – Japan:
  - Industrial Production Y/Y – Apr F (Last: -1.1%)
  - Capacity Utilization M/M – Apr (Last: -0.4%)
- 2:45am – France:
  - CPI – May F (Last Y/Y: 1.0%)
  - CPI EU Harmonized – May F (Last Y/Y: 1.1%)
- 4:30am – Hong Kong:
  - Industrial Production Y/Y – Q1 (Last: 1.3%)
  - PPI Y/Y – Q1 (Last: 0.3%)
- ★ 8:30am – US:
  - Retail Sales (Last M/M: -0.2%; Con: 0.7%)
  - Retail Sales Ex Autos & Gas (Last M/M: -0.2%; Con: 0.6%)
  - Retail Sales Control Group (Last M/M: 0.0%; Con: 0.4%)
- 8:55am – UK: BOE Governor Mark Carney speaks in London.
- 9:15am – US:
  - Industrial Production – May (Last M/M: -0.5%; Con: 0.2%)
  - Manufacturing Production – May (Last M/M: -0.5%; Con: 0.2%)
  - Capacity Utilization – May (Last: 77.9%; Con: 78.0%)

Slowing manufacturing, particularly in durable goods, led April's 0.5% m/m drop in industrial production. Motor vehicles & parts (-3.3%), machinery (-2.4%), electrical equipment (-2.0%) and aerospace/misc trans equipment (-0.9%) led the fall, which were all hit by the first round of 25% tariffs in 2H 2018. Non-durables were also lower, albeit paper products and apparel posted



*Source: Federal Reserve Board, Haver Analytics*

★ 10:00am – US:

- Business Inventories
- UMichigan Consumer Sentiment – June P (Last: 100.0; Con: 98.0)
- UMichigan Current Conditions UMichigan Expectations

– Rebecca Kooshak, Economic Analyst