JANUARY 4, 2018

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ECONOMIC WEEKLY

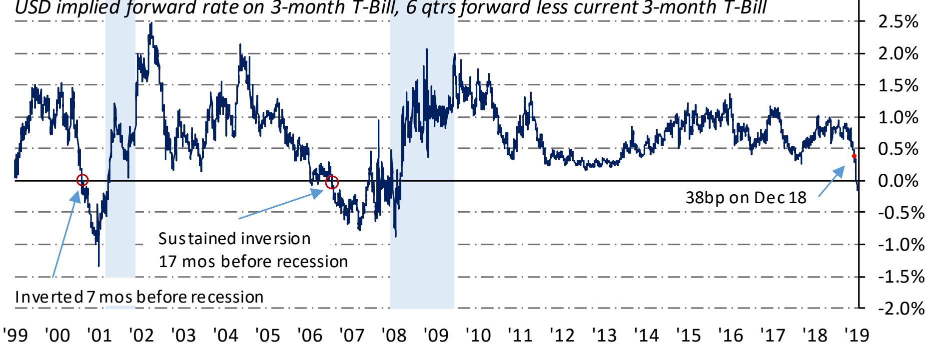
THE 2019 FED

December's FOMC meeting marked the most significant Fed communication error since Bernanke unleashed the "taper tantrum" in 2013. Five years ago, after sending the bond and stock markets into a tailspin by surprising traders with the end of QE3, Chairman Bernanke and other Fed participants spent considerable time and energy trying to understand trader thinking. Hopefully, the Powell Fed will respond in similar fashion after its December 19 misstep.

When Chairman Powell explained why the FOMC chose to hike rates despite financial markets suggesting it might be wiser to hold off, he spoke mostly about stocks. The stock market was not the only market signaling trouble, however. Near-term forward T-bills, the measure described in a recent Fed Discussion Series paper as a more accurate recession gauge than conventional yield curve analysis, inverted on the first day of trading this year. It was still positively sloped on December 19, but the forward T-bill curve was nevertheless flat enough that it should have caught the Fed's eye.

Fed near-term forward spread turns negative in 2019

USD implied forward rate on 3-month T-Bill, 6 qtrs forward less current 3-month T-Bill



Source: National Bureau of Economic Analysis, Matthew Boesler, Bloomberg

Asserting confidence does not inspire confidence
Demonstrating understanding inspires confidence

While the Fed watches the near-term forward spread as a recession indicator, it more accurately reflects fed funds rate expectations, with inversion implying an expected rate cut within 18 months.

1. History suggests traders could change their mind and the near-term forward spread could return to positive territory without a cut, as it did (briefly) in 2006.
2. Or, the Fed could cut rates as it did in 1996, avoiding recession and again returning the indicator to positive territory.
3. But, if traders' conviction in a rate cut holds and the Fed fails to deliver, it's a safe bet there will be a rate cut within 18 months. In the past, the first rate cut was usually after the economy slipped into recession.

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Disclosures are on the last page of this report.

The fact recession normally follows a near-term forward spread inversion reflects the fact the Fed is more likely to cut rates after the start of a recession than before, and when it does cut before a recession, it normally fails to cut enough to prevent the recession.

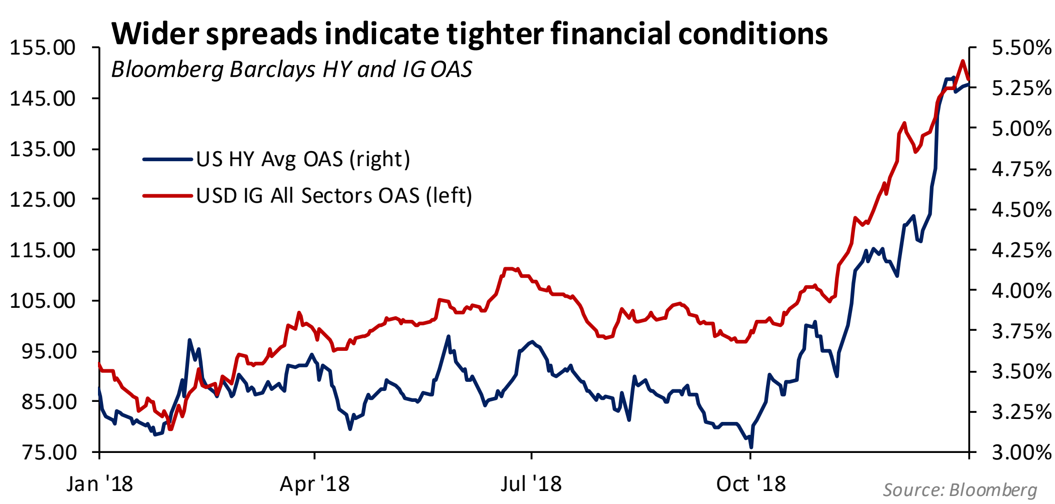
Chairman Powell likely intended to inspire confidence by downplaying financial market weakness and asserting the Fed's confidence in its forecast, but it was incomplete, coming across as bordering on arrogance. John Williams' reassertion of the Fed's confidence in its forecast had a similar effect. The problem, neatly summarized in the page 1 chart, is that markets collectively think the Fed's forecast is misguided.

Imagine a jumbo jet flying through a storm. The captain comes over the PA, says he is confident everything will be just fine if the crew presses on — it was sunny five minutes ago, after all. He notes the radar suggests there might be a mountain range ahead, but the GPS, which lags a few miles behind the plane in rough weather, indicates a clear route ahead. He prefers to use the GPS. Panic ensues. Now imagine the same plane in the same storm. The pilot notes that because the GPS lags, the crew will climb a thousand feet just in case. Confidence achieved.

Financial market data offers an alternative take on economic data. As in our jumbo jet, the meaning is hazier — it's never 100% certain what traders are focused on, after all — but more immediate, with a much shorter lag than economic data. In contrast to the Chairman, Dallas Fed President Robert Kaplan got it just right this Thursday in an interview with Bloomberg Television's Mike McKee. McKee asked if the correction in stocks has been severe enough to justify changing the Fed's behavior. Kaplan adeptly reframed the question by listing issues weighing on markets and noting they justify a pause. In other words, the Fed shouldn't react to the market, but it should react to what the market is focused on.

Kaplan noted three big areas of concern:

1. **Decelerating global growth.** GDP growth is slowing in the US, EU, China, UK, and emerging economies.
2. **Weakness in interest-sensitive and economically-sensitive industries.** New home sales peaked in November 2017. Car sales peaked in September 2017. Copper prices peaked in December 2017. Oil prices peaked in September 2018.
3. **Tightening financial conditions.** Global equity market capitalization is down $17.6 trillion since January 27 of last year. Kaplan noted wider credit spreads. US investment grade spreads have widened from 96bp in October to 151bp today. High yield spreads have widened from 300bp to 527bp.[1]



[1] Bloomberg Barclays IG and HY index data.

Who's Who: The 2019 FOMC

Governors	
Chair Jay Powell	Last August, Powell signaled tolerance for economic growth in his Jackson Hole speech. Traders rejected Powell's rigid defense of balance sheet run-off and the possibility of rate hikes in 2019 at the December press conference. Today, Powell acknowledged market concerns and indicated flexibility on rates and the balance sheet.
Vice Chair Richard Clarida	On Nov 27, Clarida explained data dependency in terms of making policy decisions and ongoing refinement of u-star and r-star estimates. This was a direct reversal of Powell's Jackson Hole call for less reliance on r-star and u-star now that the fed funds rate is near neutral.
VC for Supervision Randall Quarles	On Oct. 18, Quarles was optimistic about the economy. When near full employment, he explained, productivity is essential. Machine learning, 5G communications, and 3-D printing should allow continued productivity growth.
Governor Michelle Bowman	As a new governor focused on community banks, Bowman has not weighed in on the economy or policy. Look for her to follow, not lead.
Governor Lael Brainard	On Dec. 18, Brainard noted, "The most likely path for the economy is positive, although some tailwinds that have provided a boost are fading, and we may face some crosscurrents." Believes risks to financial stability are low but could rise as a result of tight economic conditions.
Voting Presidents	
New York: John Williams	Williams' attempt to calm markets after the December FOMC meeting failed. His key comment, "We are actually saying pretty clearly this is how we see it now based on our positive, pretty optimistic view of the economy, and we will change that as needed," was interpreted as a refusal to acknowledge risks already priced into markets.
Chicago: Charles Evans	On Nov. 16, told a Chicago audience, "I personally would not be bothered by inflation moving up – not beyond – but moving up to 2.5%."
Boston: Eric Rosengren	Favored a "mildly restrictive policy stance" when he last spoke about rates, but that was on Oct. 1, a very long time ago in market terms.
St. Louis: James Bullard	Dec. 7, before the last 2018 rate hike, Bullard argued, "the policy rate is about right over the forecast horizon."
Kansas City: Esther George	One of the Fed's most hawkish participants in recent years, but George did not advocate a discount rate hike in December. That, plus the big drop in the highest 2019 dots in Dec., may signal a moderation in her views.
Non-voting Presidents	
Cleveland: Loretta Mester	On Dec. 21, Mester echoed Williams attempt to reassure traders. "We think the economy's underlying fundamentals are quite good," she explained in reference to the December rate hike, but "I certainly take a look at what's going on in financial markets." If she was really watching markets, one might ask why she voted to raise rates, however.
Philadelphia: Patrick Harker	On Nov. 16, Harker told the *Wall Street Journal* he favored a pause until the Fed is certain inflation is rising.
Dallas: Robert Kaplan	On Thursday, Kaplan told Bloomberg Television's Mike McKee markets reflect three concerns he sees in the real economy: decelerating global growth; weakness in interest-sensitive and economically-sensitive industries; and tightening financial conditions – the last particularly evident in wider credit spreads. Kaplan concluded, "My own view is we should not take any further action on interest rates until these issues are resolved."
Minneapolis: Neel Kashkari	In a December 3 *Wall Street Journal* interview, Kashkari warned, "If we were to overdo on interest rates, I do think that could cause a recession, and I know none of us want that to happen."
Richmond: Thomas Barkin	On Oct. 3, was not worried about tariffs or growth.
Atlanta: Raphael Bostic	On Dec. 6, said rates were "within shooting distance of neutral."
San Francisco: Mary Daly	On Nov 13, Daly warned, "The economy is outstripping what we think in the long run is the sustainable pace of growth."

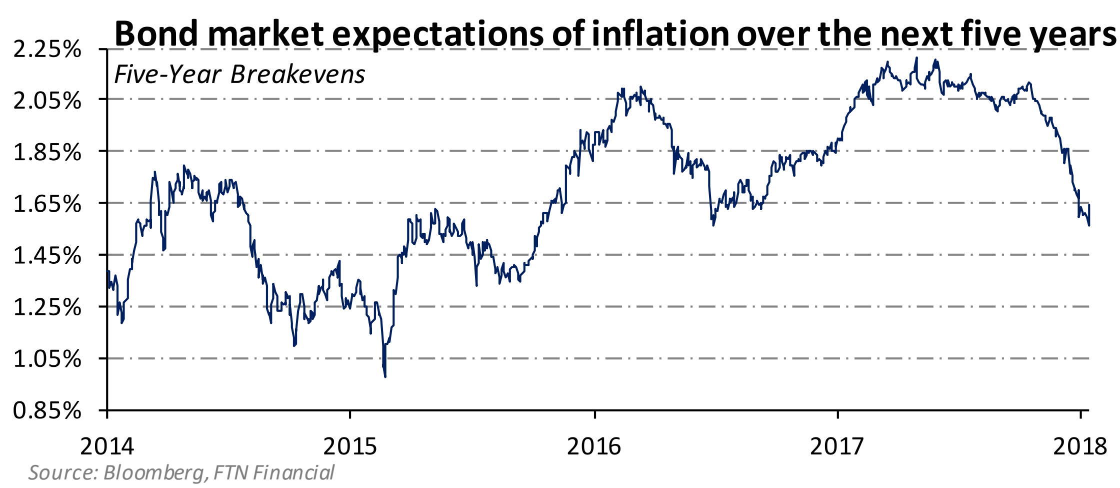
Contrast Kaplan's assessment to Powell's answer to Steven Beckner, who in the December press conference asked if the recent 50bp drop in 10-yr note yields was meaningful. Powell's response:

> "Again, we do focus on a broad range of financial indicators, and I—really, we don't obsess about any particular one. You know, we look at a whole range of them, and we ask ourselves, what's really going on in the broad picture out there? You know, if you ask what's going on with the long—certainly the long, longer-maturity Treasury market has come in some. That's consistent with, you know, a risk-off feeling in the stock market as well. And, you know, we don't know whether that'll persist. Really, the longer Treasury has moved in a range above 3 percent and down 3 percent as the risk sentiment has changed. You know, I think if rates were to stay low for a longer period of time, that could be thought of as a signal of expectations of lower growth. But, you know, we don't know that that'll happen. As I mentioned, our forecast for next year is—I think, in keeping with most other forecasts—is that we'll still have solid growth next year, declining unemployment, and a healthy economy."

In plain English, Powell suggested the financial markets are wrong. He acknowledged the message from bonds is the same as the message from stocks, that the economy will be a lot slower next year. But the Fed expects only a modest slowdown. FOMC participants think the economy will run above capacity, unemployment will fall, and, by implication, inflation pressures will increase.

Not mentioned by Kaplan or Powell, but equally relevant, inflation and inflation expectations are already in retreat. China's PPI has slowed from 7.8% to 2.7% since February 2017. EU core CPI inflation is stuck at 1%. US core PCE inflation has retreated from 2.01% to 1.87% since July. Five-year inflation expectations in the bond market have fallen from 2.06% to 1.48% in three months.

Kaplan likely avoided bringing this up because the Fed does not like to acknowledge an international influence on US inflation. Nor does the Fed like to acknowledge the bond market's inflation view, partly because the market's inflation forecast implies excessively tight monetary policy and partly because the Fed believes it can keep inflation expectations high by denying inflation might move lower. Nevertheless, falling inflation and inflation expectations are a fourth good reason to rethink the policy approach.



A long pause

Kaplan advocated no rate hikes in the first half of 2019, after which he suggested the Fed could reassess and regroup. During which time, rest assured, the markets will do the same. It is wise advice. Since September, the Fed got so far ahead of the curve, it is now behind the curve in the other direction. The Fed is still talking about hikes, while the market is looking for a cut.

Charles Evans and James Bullard, both voting presidents, are also in the pause camp based on recent communications. Patrick Harker, Neel Kashkari, and Raphael Bostic, all non-voters, favor a pause as well. That's only six of 17, and not even one board member is on the list. This is critical, as voting Presidents Williams, George, and Rosengren are likely opposed to signaling a pause. And, the Fed has traditionally stopped raising rates only when the governors are ready to stop.

Still, it's a start. Any change has to begin somewhere. Quarles and Brainard could be the first governors to come around, because Brainard is one of just a handful of participants consistently mindful of what it means to have a symmetrical inflation target, and Quarles is optimistic about productivity growth, which would allow faster growth without inflation. The critical question is how long it will take before pause advocates convince Chairman Powell.

We expect Powell will turn fairly quickly, in no small part because he's the one who has to stand up and explain the Fed's decisions to the press at eight FOMC press conferences this year, starting on the 30th of this month. He was clearly uncomfortable in December, in part because the Fed's message was more dovish than in November, so he was surprised when it turned out to be overly hawkish. The Fed failed to understand the violence of the shift in sentiment in the fourth quarter. This morning, Powell indicated a willingness to be flexible, both about the path of rates and the speed of balance sheet runoff.

On December 19, announcing a pause would have quieted the markets. Now, that is not enough. As Jim Vogel notes in the *Weekly Report*, traders will worry that any pause will be temporary, followed by another quick hike or two at the first sign of a relief rally in stocks. Powell's all-meetings-are-live-in-2019 rhetoric will have traders looking over their shoulders all year. The Fed has to find a way to signal a pause likely to last.

At this point, calm will come in one of three ways. The FOMC could commit to a multi-quarter pause, as suggested by Kaplan. The Fed could indicate no desire to raise rates further. Or, the Fed could cut rates, getting ahead of the curve again. The last option is extremely unlikely — Fed logic makes rate cuts almost impossible when the unemployment rate is under 4% — but a long pause is possible. We expect whatever the Fed promises up front, the pause will last through the year at least.

– Chris Low, Chief Economist

The Week Ahead

This Week's Numbers

		PRIOR	CONSENSUS HIGH	CONSENSUS LOW	CONSENSUS MEDIAN	FTN
Monday, January 7	ISM Non-Manufacturing Index - Dec	60.7	60.3	56.0	59.0	**58.5**
Tuesday, January 8	NFIB Small Business Optimism - Dec	104.8	105.0	102.0	103.0	**102.5**
	Trade Balance - Nov	-$55.5b	-$51.6b	-$56.2b	-$54.0b	**-$55.0b**
	Consumer Credit - Nov	$25.384b	$20.000b	$12.700b	$16.000b	**$18.000b**
Delayed	Advance Goods Trade Balance - Nov*	-$77.2b	-$73.1b	-$78.0b	-$76.0b	**$77.0b**
Delayed	Wholesale Inventories MoM - Nov P*	0.8%	0.8%	0.3%	0.5%	**0.4%**
Delayed	New Home Sales - Nov*	544k	622k	535k	568k	**560k**
Delayed	New Home Sales MoM - Nov*	-8.9%	14.3%	-1.7%	4.5%	**2.9%**
Delayed	Construction Spending MoM - Nov*	-0.1%	1.2%	-0.5%	0.2%	**0.1%**
Delayed	Factory Orders - Nov*	-2.1%	1.0%	-1.2%	0.3%	**0.2%**
Thursday, January 10	Wholesale Inventories MoM - Nov F	--	0.8%	-0.2%	0.5%	**0.3%**
Friday, January 11	CPI MoM - Dec	0.0%	0.0%	-0.3%	-0.1%	**-0.2%**
	CPI Ex Food and Energy MoM - Dec	0.2%	0.2%	0.1%	0.2%	**0.2%**
	CPI YoY - Dec	2.2%	2.0%	1.8%	1.9%	**1.8%**
	CPI Ex Food and Energy YoY - Dec	2.2%	2.2%	2.1%	2.2%	**2.1%**
	Monthly Budget Statement - Dec	-$204.9b	$5.0b	-$16.0b	$0.0b	**$5.0b**

**Scheduled for next week, but delayed until the shutdown is resolved.*

Review

This week, 10-year yields fell 8bp from 2.64% to 2.56% after a disappointing ISM Manufacturing report followed disappointing PMI manufacturing reports in China and Europe, indicating substantial softening in global growth.

Friday's strong employment report sent 10-year yields back up to 2.6%, and yields continued to rise to 2.67% after Fed Chair Powell spoke about the rise in average hourly earnings being "quite welcome" and not raising "concerns about too high inflation."

- The ISM Manufacturing Index fell five points from last month's 59.3 to 54.1 (consensus was 57.5). While a reading above 50 percent indicates a general expansion in manufacturing, the New Orders Index, a key component, fell 11 points from last month's 62.1 to 51.1 to hover just above the 50-line threshold. Five out of 18 industries, which include petroleum and coal, fabricated metals, nonmetallic minerals, paper, and plastics and rubber reported softening customer demand. Seven industries reported no change and six reported growth. Survey respondents reported challenges related to Brexit (e.g., relabeling products in the chemical industry), steady business but incoming orders slowing (furniture), and re-sourcing difficulties related to the China-US tariff dispute (computer and electronics).
- Changes in nonfarm payrolls for December blew out expectations with 312k jobs added versus the 184k consensus. Restaurants and bars led the rise, with 41k additions followed by construction (rose 38k), health care (rose 38k), manufacturing (rose 32k), and retail trade (rose 24k). Unemployment ticked up two-tenths to 3.9%, while March and August's unemployment rate were revised down a tenth from 4.1% and 3.9%, respectively, and October was revised up a tenth to 3.8%.

- Powell's remarks on Friday were designed to offer markets the forward guidance expected at his post-meeting press conference last month. He referred to the jobs report as "very strong" and increase in labor force participation as "very welcome." He also acknowledged the weakness in the ISM report as well as slowing Chinese consumer demand. "When we get conflicting signals," Powell offered, "policy is very much about risk management. First, there is no preset path for policy." Then paused to emphasize, **"and particularly, with the muted inflation readings that we've seen coming in, we will be patient as we watch to see how the economy evolves."** And with that, the Dow soared 200 points in addition to the 400-point increase following the employment report. (As an interesting aside, perhaps one of the most nerve-wracking questions Bernanke, Yellen, and Powell addressed was about the ongoing abuse, hostility, and harassment of women in the economics profession and what the American Economic Association could do to help relieve the problem. Bernanke offered that he would be taking over as President of the American Economic Association and would be working to conduct surveys among its members to report on the climate of the environment.)

The Atlanta Fed's Q4 GDPNow forecast fell from 2.7% on December 21st to 2.6%, and the NY Fed revised its Nowcast marginally from 2.48% to 2.49%.

Next week is filled with Fed speakers, and December's FOMC minutes are due out on Wednesday.

Preview

Note: ★ = High Impact Event
All times Eastern Standard

Due to the government shutdown, both data collection and reporting will be delayed at the Commerce Department, which funds the Census Bureau, the Bureau of Economic Analysis, and the Department of Agriculture. Reported data is likely to be revised at later dates.

The Bureau of Labor Statistics is fully funded until September 2019, so monthly employment reports, CPI, PPI, and other agency-related data will continue without disruption. The following statistics are expected to be released at some point during the week, but may be delayed until the shutdown is resolved:

- *Advance Goods Trade Balance*
- *Wholesale Inventories*
- *Retail Inventories*
- *New Home Sales*
- *Construction Spending*

Saturday, January 5

★ 8:00am – US: New York Fed President John Williams speaks on monetary policy at American Economic Association meeting in Atlanta. (Permanent FOMC Voter)
- 10:15am – US: Atlanta Fed President Raphael Bostic speaks. (FOMC Voter in 2021)
- 12:30pm – US: San Francisco Fed President Mary Daly speaks. (FOMC Voter in 2020)

Sunday, January 6

- 7:30pm – Japan: PMI Composite

Monday, January 7

- 2:00am – Germany: Factory Orders
- 3:30am – UK: Halifax House Prices
- 5:00am – EU: Retail Sales
- 10:00am – US: (*Census Bureau – data report may be delayed*)
    - Factory Orders
    - Durable Goods Orders
    - Capital Goods Orders and Shipments
- 10:00am – US: ISM Non-Manufacturing Index
- 11:30am – US: $39bn 3M and $$36bn 6M US Treasury Bill Auctions
- 12:40pm – US: Atlanta Fed President Raphael Bostic speaks

Tuesday, January 8

- 2:00am – Germany: Industrial Production
- 5:00am – EU:
    - Consumer Confidence
    - Economic Sentiment
- 6:00am – US: NFIB Small Business Optimism
- 8:30am – US: Trade Balance
- ★ 10:00am – US: JOLTS Job Openings
- 1:00pm – US: $38bn 3Y Treasury Note Auction
- 3:00pm – US: Consumer Credit

Wednesday, January 9

- 5:00am – EU: Unemployment Rate
- 8:15am – Canada: Housing Starts
- 8:20am – US: Atlanta Fed President Raphael Bostic speaks.
- ★ 9:00am – US: Chicago Fed President Charles Evans speaks on economy and monetary policy. (FOMC Voter)
- ★ 10:00am – Canada: Bank of Canada monetary policy decision
- 10:30am – UK: BOE Governor Mark Carney responds to online Q&E.
- ★ 11:30am – US: Boston Fed President Eric Rosengren speaks on economic outlook. (FOMC Voter)
- ★ 1:00pm – US: $24bn 10Y Treasury Note Reopening
- ★ 2:00pm – US: FOMC meeting minutes
- ★ 8:30pm – China:
    - CPI
    - PPI

Thursday, January 10

- 8:30am – Canada: New Housing Price Index
- 8:35am – US: Richmond Fed President Thomas Barkin speaks on long-term growth. (FOMC Voter in 2021)

- 10:00am – US: Wholesale Inventories (*Census Bureau data may be delayed*)
- 11:30am – US: 1M and 2M Treasury Bill Auctions
- ★ 12:00pm – US: Jay Powell speaks at The Economic Club of Washington DC
- ★ 12:30pm – US: St. Louis Fed President James Bullard speaks on economy and monetary policy. (FOMC Voter)
- ★ 1:00pm – US: Chicago Fed President Charles Evans speaks. (FOMC Voter)
- 1:00pm – US: $16bn 30Y Treasury Bond Reopening
- ★ 5:30pm – US: Fed Governor Richard Clarida speaks.

Friday, January 11

- 4:30am – UK:
    - Trade Balance
    - Industrial Production
    - Manufacturing Production
    - Monthly GDP
- ★ 8:30am – US:
    - CPI
    - Core CPI
    - Real Average Hourly Earnings
- 2:00pm – US: Monthly Budget Statement

– Rebecca Kooshak, Economic Analyst