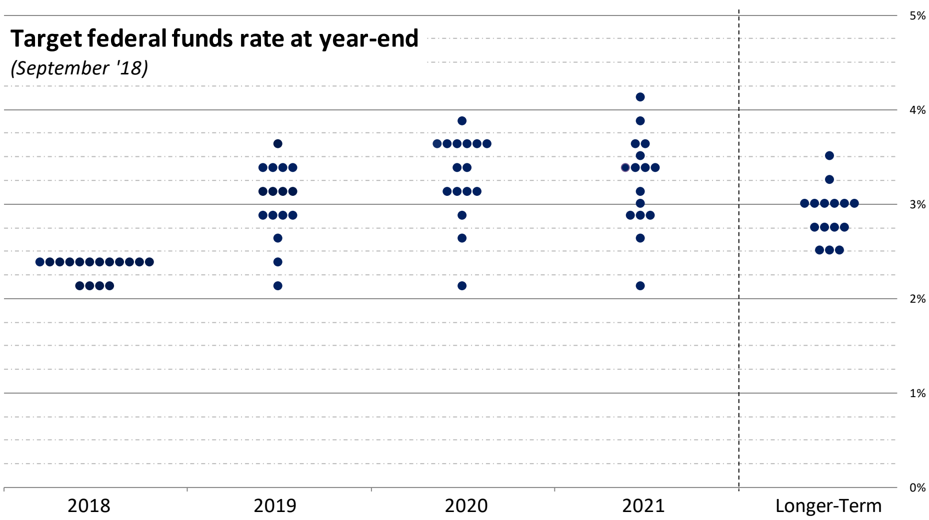
ECONOMIC WEEKLY

Even as Things Change at the Fed, All is Proceeding According to Plan

This week brought a blitz of Fed communication, the gist of which is the Fed is ready to exit the path of predetermined quarterly rate hikes and start making decisions on a meeting-by-meeting basis. This is pretty much what the Fed claimed it was doing all along, but this time, apparently, they mean it. That is to say, from Yellen to Powell, Fed Chairs have insisted the dot plot and other guidance do not guarantee an interest rate path. Nevertheless, the Fed has provided a stream of guidance like this phrase in the November minutes, “almost all participants expressed the view that another increase in the target range for the federal funds rate was likely to be warranted fairly soon,” signaling a December increase. The Fed plans to phase out this kind of guidance starting next month.

And yet, while this represents a change, it is a change planned since the Fed introduced forward guidance in response to the global financial crisis. The Fed has always insisted we pay attention to the full range of dots in the dot plot, and the 2019 dots vary from participants favoring no hikes to as many as six. It goes without saying those in the no-hikes camp would pause as soon as March, while more than half foresee pausing after September.



Note: Each dot represent the expectations of one FOMC member. The median range stayed the same throughout all years: for 2018 it is 2.375%, for 2019 it is 3.125%, for 2020 it is 3.375%. For 2021 the median is 3.375% and for the Longer-Term, the median came down from 3.375% to 3%. *Source: Federal Reserve Board of Governors*

The minutes make this clear by foretelling a further shift away from forward-looking language, likely starting at the December meeting. For months, the statement has suggested “further gradual increases” in rates. Participants plan to swap this for something emphasizing “evaluation of incoming data” and the “committee’s flexible approach.”

CONTENTS

ECONOMICS

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Traders knew communications uncertainty was coming eventually, but they are nevertheless left in the dark. Policy decisions have been predictable for two years. Starting next year, they will be considerably less so. Vice Chairman Richard Clarida offered some guidance on what that will mean in practical terms.

Data dependency: What it means and why it matters

Fed policy has always been data dependent, but once the FOMC was convinced the neutral rate had climbed above zero, participants have communicated in terms of adjusting interest rates from accommodative to neutral. In August, Chairman Powell announced a policy and communications shift away from r-star, or the natural interest rate, toward risk management and data dependency. Thursday's Fed minutes were the latest in a string of communications underscoring this change. On Tuesday, Vice Chairman Clarida explained what data-dependent policy means to him.

Clarida began with the assertion that data dependency on its own is not a strategy. The Fed's strategy must combine incoming data with economic models to – with "a healthy dose of judgement" – formulate and communicate a rate path. Clarida suggests this should consist of a two-part process.

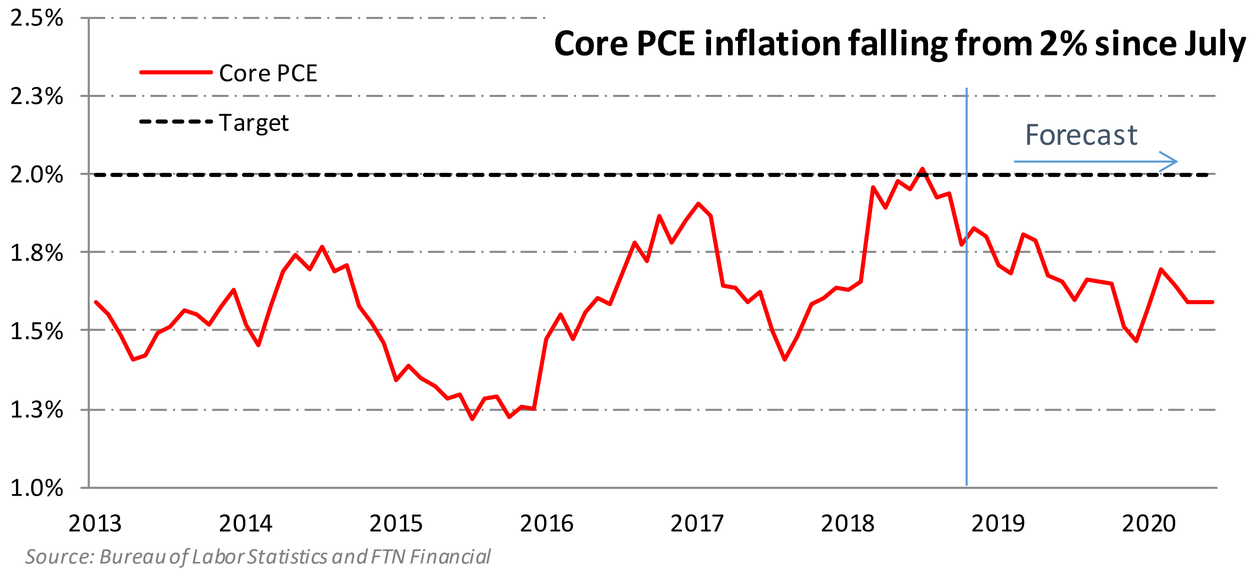
- First, incoming data should inform the FOMC where the economy is relative to where participants thought it would be. This part of data dependency is easily understood, as there is a "large family of policy rules in which the parameters of the economy are known." In other words, plug current data into a Taylor-like rule and you will get a policy recommendation.
- Second, the Fed should use incoming data to improve its models of u-star, r-star, and the rest of the constellation of variables used to make long-run policy decisions "in order to obtain its best estimate of where the economy is heading." Clarida points out the SEP demonstrates participants' estimates of these variables have already shifted, suggesting this is already standard practice at the Fed.

A December rate hike is almost certain. The November FOMC minutes revealed participants agreed another rate hike was "warranted soon," language used in the past to indicate a hike at the next meeting. But after that, the FOMC will monitor incoming data to make decisions both about whether the economy and inflation are running hotter or colder than expected.

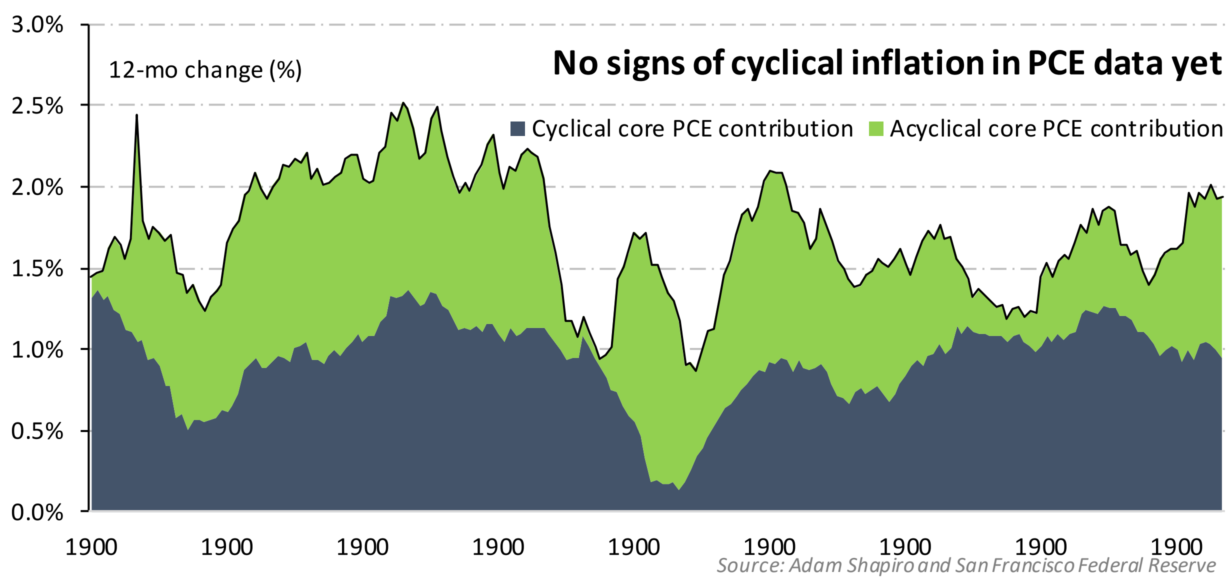
Clarida's approach is different from Powell's approach, in the sense that Powell talked about setting models aside altogether and making decisions "on a hunch," as Greenspan did in the late '90s. Reliance on models may be typical of the FOMC, however. As Dan Tarullo wrote last year, "many (though certainly not all) good monetary policymakers who were formally trained as such have an almost instinctual attachment to some of those problematic concepts and hard-to-estimate variables" like the u-star and r-star. In either case, however, data will determine immediate policy adjustments and will inform Fed understanding of the relationships between growth, employment, and inflation, perhaps warranting a shift in SEP forecasts including forecasts of the future path of rates.

Inflation uncertainty

In July, core PCE inflation reached 2.02%. Since then, it has fallen. In October, it dropped from 1.94% to 1.78%. For months, we at FTN Financial have anticipated lower core inflation based on the mix of data in recent inflation reports. This week, our thesis received substantial support from within the Fed itself.



On Monday, San Francisco Federal Reserve economist Adam Shapiro published an Economic Letter suggesting the Core PCE's rise to the Fed's 2% target was a fluke. Shapiro separates cyclical inflation components, like medical services, where inflation reflects labor costs, from acyclical components, where companies lack pricing power and inflation primarily reflects competition for market share. Cellphone services are the Fed's favorite example of acyclical pricing. The entire 2018 inflation increase, Shapiro writes, reflected faster acyclical inflation. Cyclical inflation actually slowed. As a result, "While risks to the outlook for inflation appear broadly balanced, they include the considerable possibility that inflation has not yet sustainably reached target."



In other words, Shapiro's bosses on the FOMC might think inflation risks are balanced, which is why Shapiro says they appear balanced, but risks are not really balanced at all, as inflation is more likely to fall than to rise.

As to why cyclical inflation is not rising, the Fed doesn't know. Shapiro is not willing to suggest the Fed's understanding of inflation is flawed, as Tarullo did last year. Instead, he insists cyclical inflation is "lagging," implying it will take off eventually. In the meantime, the FOMC has failed to achieve 2%

sustainable inflation. As a result, participants who think they have achieved their inflation target – most of them, judging from recent speeches – will have to rethink this conclusion next year.

> If participants follow Clarida's advice and use incoming data to inform not just the decisions at individual meetings but also their understanding of u-star and r-star, then consistent sub-2% inflation should convince them the economy can tolerate a lower unemployment rate and lower interest rates without inflation. In other words, it would be a good idea to pause rate hikes sooner rather than later.

The third mandate

When Chairman Powell spoke on Wednesday, economists' primary takeaway was his shift from "We're a long way from neutral" on October 3rd to "We're close to the range of neutral." It's important to note, however, this was in an aside, something Powell wanted to set straight before getting to the topic of his speech, financial stability.

Late in the economic cycle, which is to say, where we are now in the economic cycle, there are two justifications for rate hikes. The first is to prevent inflation from rising to far above the Fed's 2% target. The second is to promote economic stability. As Powell explained, "Under the dual mandate, jobs and inflation are the Fed's meat and potatoes…Financial stability [is] a topic that has always been on the menu, but that, since the crisis, has become a more integral part of the meal."

FOMC participants are engaged in a long-running debate over financial stability. Some participants, like Esther George and Robert Kaplan, worry there is excessive corporate bond issuance or asset prices are too high, suggesting they favor rate hikes to rein in speculative behavior, while others, including Neel Kashkari, argue against using rate policy to fight asset bubbles. Powell cut through this debate by reminding the world the Fed's financial stability mandate is not necessarily a mandate to fight bubbles. Rather, it is a mandate to work with other regulators to prevent bubbles from doing systemic damage.

Financial stability, Powell explained, must be forward looking. That is, it's not enough for a financial system to appear robust in good economic times. "A stable financial system is one that continues to function effectively even in severely adverse conditions." In a stable system, credit will be available to consumers and businesses even during recessions and financial corrections.

Regulators have now completed a three-part plan to ensure financial stability. The first step was strengthening the financial system by reducing bank trading risk and bolstering capital ratios. The second step was implementing a broad network monitoring financial stability. The third step was to explain the framework in a transparent fashion so that Congress can ensure the regulators continue doing their jobs. The Fed completed step three with the publication of its inaugural quarterly Supervision and Regulation Report this week.

Regulators are on the lookout for shocks, but they are also looking for vulnerabilities, defined as features of the financial system that amplify the impact of shocks. Vulnerabilities include things like excessive systemic leverage and rehypothecation, when a lender uses collateral received in a loan transaction as collateral in a second loan transaction.

Chairman Powell offered CLOs as an example. "The question for financial stability is whether elevated business bankruptcies and outsized losses would risk undermining" financial stability, Powell explained. "For now, my view is that such losses are unlikely to pose a threat to the safety and soundness of the institutions at the core of the system, and instead, are likely to fall on investors."

Note that home values and stock prices are not necessarily relevant to the Fed's financial stability mandate in this context. If stocks suffer a bout of irrational exuberance and people lose money in a nasty correction, it's fine from the Fed's point of view as long as the financial system is not jeopardized. It's not the Fed's job to prop up the stock market, nor is it the Fed's job to induce a correction when stock valuations appear high. The Fed's job is to ensure the stock market is not a systemic vulnerability.

The Supervision and Regulation Report exposes possible excesses in corporate borrowing and the appearance of frothy asset values but concludes these excesses do not rise to the level of vulnerabilities. That is, they do not warrant a policy response.

Bottom line: Maybe Kashkari has a point

On Friday morning, in a fitting coda to the week's communication from the Fed, Neel Kashkari told CNBC the Fed should not raise rates when inflation is quiescent. After all, as Powell and the FOMC minutes made clear, the fed funds rate is close to neutral. As Clarida noted, the Fed should use incoming data not only to make immediate interest rate decisions but also to improve its forecasting. Incoming inflation data showed inflation falling from 2%, while the San Francisco Fed Economic Letter suggests even lower inflation is likely next year.

There are only two reasons the Fed raises interest rates. The first is to prevent inflation from accelerating beyond 2%. But if the economy is slowing and inflation is decelerating, the Fed risks potentially turning a slowdown into a full-blown recession by tightening now, thus locking in below-target inflation for another decade. The second is to prevent or address vulnerabilities threatening financial stability not addressed by macro-prudential regulation. The regulatory superstructure is adequate to address these risks, according to the Fed's Supervision and Regulation Report, meaning financial stability concerns do not justify rate hikes either.

The Fed is still planning to raise rates in December, in part because the Fed suffers from institutional inertia. In March, however, the FOMC will engage in a policy discussion that, for the first time since 2016, will not reach a pre-determined conclusion. We expect they will pause, but with every intention of resuming rate hikes in the future. As the economy slows and inflation falls, however, those future hikes could be a lot further off than participants think.

– Chris Low, Chief Economist

The Week Ahead

This Week's Numbers

		PRIOR	CONSENSUS HIGH	CONSENSUS LOW	CONSENSUS MEDIAN	FTN
Monday, December 3	Construction Spending MoM - Oct	0.0%	0.8%	-0.4%	0.4%	**0.5%**
	ISM Manufacturing - Nov	57.7	59.5	56.0	57.5	**58.0**
Wednesday, December 5	Nonfarm Productivity - 3Q F	2.2%	2.8%	2.2%	2.3%	**2.4%**
	Unit Labor Costs - 3Q F	1.2%	1.2%	0.8%	1.0%	**1.0%**
	ISM Non-Manufacturing Index - Nov	60.3	61.0	57.0	59.0	**59.8**
	Federal Reserve Releases Beige Book					
Thursday, December 6	Trade Balance - Oct	-$54.0b	-$52.0b	-$55.2b	-$55.0b	**-$55.0b**
	Factory Orders - Oct	0.7%	1.7%	-2.2%	-2.0%	**-2.0%**
Friday, December 7	Change in Nonfarm Payrolls - Nov	250k	240k	160k	199k	**210k**
	Change in Private Payrolls - Nov	246k	228k	170k	200k	**200k**
	Change in Manufact. Payrolls - Nov	32k	26k	10k	20k	**18k**
	Unemployment Rate - Nov	3.7%	3.8%	3.6%	3.7%	**3.7%**
	Average Hourly Earnings MoM - Nov	0.2%	0.4%	0.1%	0.3%	**0.2%**
	Average Hourly Earnings YoY - Nov	3.1%	3.2%	3.0%	3.1%	**3.0%**
	Wholesale Inventories MoM - Oct F	0.7%	0.7%	0.7%	0.7%	**0.7%**
	U. of Mich. Sentiment - Dec P	97.5	98.5	96.0	97.0	**97.3**
	Consumer Credit - Oct	$10.923b	$18.000b	$12.000b	$15.000b	**$12.000b**

Review

This week, Jay Powell's speech at the Economic Club of New York stirred global markets. Powell indicated that the FOMC was just a step away from reaching the neutral rate, surprising some market participants conditioned by Powell in October to think that the FOMC was a "long way from neutral." The S&P 500 rose nearly 2%, and 10-year yields dipped below 3.0% before ending the week at 3.0%. FTN Financial's economic forecast has included a pause after the FOMC's December meeting since September.

The Atlanta Fed's Q4 GDPNow forecast rose from last week's 2.5% to 2.6%, driven by personal income and outlays. The NY Fed revised its Nowcast marginally down from 2.51% to 2.50%, mostly on weaker new home sales.

Next week, Jay Powell delivers the Fed's Economic Outlook to the Joint Economic Committee of Congress, and several central banks globally will announce monetary policy decisions ahead of the FOMC's December meeting. The Reserve Bank of Australia and Bank of Canada are expected to leave rates unchanged on Monday and Wednesday, respectively. But Bloomberg Economics expects the Central Bank of Chile will hike on Tuesday, pointing to interest rate swaps that indicate three 25bp hikes from the current 2.75% rate to 3.5% over the next 12 months. In addition, Asia, Europe, and the US release PMI data, and the employment report is on Friday in the US.

Preview

Note: ★ = High Impact Event
All times Eastern Standard

Sunday, December 2

- 7:30pm – Japan: Nikkei Manufacturing PMI
- 8:45pm – China: Caixin Services and Manufacturing PMI

Monday, December 3

- Ward's Total Vehicle Sales
- 4:00am – EU: Markit Manufacturing PMI
- 4:30am – UK: PMI Manufacturing
- ★ 9:15am – US: New York Fed President John Williams speaks at The Evolving Structure of the US Treasury Market Conference. (Permanent FOMC voter.)
- 10:00am – US:
  - ISM Manufacturing
  - ISM Employment
  - Construction Spending
- ★ 10:30am – US: Fed Governor Lael Brainard delivers keynote speech at Treasury Market Conference.
- 1:00pm – US: Dallas Fed President Robert Kaplan speaks. (FOMC voter in 2020.)
- 6:50pm – Japan: Monetary Base Growth
- 10:30pm – Australia: Reserve Bank of Australia announces its monetary policy decision.

Tuesday, December 4

- ★ 4:15am – UK: Bank of England Governor Mark Carney speaks at UK Parliament.
- 4:30am – UK: Markit/CIPS UK Construction PMI
- 5:00am – EU: PPI
- 4:00pm – Chile: The Central Bank of Chile announces its monetary policy decision.
- 7:30pm – Hong Kong: Nikkei PMI
- 7:30pm – Japan: Nikkei Services and Composite PMI
- 8:30pm – Japan: Bank of Japan Deputy Governor Masazumi Wakatabe speaks.
- 8:45pm – China: Caixin Services and Composite PMI

Wednesday, December 5

- 4:00am – EU: Markit Services and Composite PMI
- 4:30am – UK: Markit/CIPS Services and Composite PMI
- 5:00am – EU: Retail Sales
- 8:15am – US: ADP Employment Change
- ★ 8:30am – US:
  - Nonfarm Productivity
  - Unit Labor Costs
- 10:00am – Canada: Bank of Canada announces its monetary policy decision.

- 10:00am – US: ISM Non-Manufacturing
- ★ 10:15am – US: Chairman Powell testifies at the Joint Economic Committee.
- ★ 2:00pm – US: Federal Reserve releases its Beige Book

Thursday, December 6

- ★ OPEC meets in Vienna.
- ★ 12:15pm – US: Atlanta Fed President Raphael Bostic speaks. (2018 FOMC voter.)
- 8:30am – US: Trade Balance (Last: -$54.0b)
- 8:50am – Canada: Bank of Canada Governor Stephen Poloz speaks on global economic developments and risks and vulnerabilities of Canada's financial system.
- 10:00am – US: Factory Orders
- 12:00pm – US: Household Change in Net Worth.
- 6:30pm – US: New York Fed President John Williams speaks with Mervyn King at London School of Economics event.

Friday, December 7

- 3:30am – UK: Halifax House Prices
- 5:00am – EU: GDP Q3 Final (YoY 1.7%; QoQ 0.2%)
- ★ 8:30am – US:
    - Nonfarm Payrolls (Last: 250k. Consensus: 200k)
    - Unemployment Rate (Last: 3.7%. Consensus: 3.7%)
    - Average Hourly Earnings (Last m/m and y/y: 0.2% and 3.1%. Consensus m/m and y/y: 0.3% and 3.1%.)
- 10:00am – US: University of Michigan Consumer Sentiment
- ★ 12:00pm – US: Fed Governor Lael Brainard speaks on financial stability at the Peterson Institute.
- 3:00pm – US: Consumer Credit

– Rebecca Kooshak, Economic Analyst