Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
Thomas Demas, Managing Director
Michael Warren, Energy Strategist

FED SHADOW

The Agony of Victory at Jackson Hole

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Donald Luskin

The Fed has pretty much achieved its dual mandate. So why all the existential angst?

Several clients have shared with us a sense of foreboding about Fed Chair Janet Yellen's speech at the Jackson Hole conference next week. They are concerned that the present rally to all-time highs in US equities is fragile – not founded in fundamentals, but rather the product of artificial stimulus by the Fed. They fear Yellen will say something to upset it – not necessary a strong hint of coming rate hikes, but more some kind of confidence-shattering confession that the monetary emperor has no clothes.

We don't see what's so fragile and artificial about stocks moving to new highs now that forward earnings ex-energy have broken out to new highs. But to be sure, Yellen's appearance next week has a certain air of menace about it.

- This year's conclave has as its weirdly open-ended theme "Designing Resilient Monetary Policy Frameworks for the Future."
- Yellen skipped Jackson Hole last year, and then went on to ram through an ill-timed lift-off (see "On the December FOMC" December 16, 2015). This time, it will only be her fourth speech this year, an extraordinary exercise in reticence for any Fed chair.
- And for some reason the "What's Next" page of the Fed's website doesn't even have it on her calendar. **[Update 8/19/16: The speech is now posted as "The Federal Reserve's Monetary Policy Toolkit."]**

And it comes at a time of seeming intellectual ferment at the Fed, when indeed there is a greater than usual possibility that Yellen might say something revolutionary – and therefore dangerous.

- As usual, almost every day there's some Fed spokesperson who warns, seemingly authoritatively, that a rate hike might come at the next FOMC meeting. But the rate hikes never come.
- The minutes of the July FOMC, released yesterday, featured a long and tiresome repetition of the shopworn arguments for imminent rate hikes given by "some other participants," recited dutifully in the manner of a catechism. But the rate hikes never come.

Update to strategic view

US FED, US MACRO: There's an air or menace around Yellen's speech next week at Jackson Hole. She may use it to respond to the existential challenge to economic forecasting mounted by Bullard, or the challenge to inflation-targeting put forward by Williams. But we don't expect any grand reformulations of the Fed's mission at Jackson Hole – even less do we expect any new or more credible than usual tip-off that another rate hike is on the horizon. With unemployment and inflation near mandate-consistent levels, why change the policy that got us there? Recent challenges to the Fed's orthodoxy by its own participants only adds to the uncertainty that argues for staying the course or, if anything, easing policy from here. We strongly re-iterate our longstanding forecast that the Fed will not raise rates again until December at the very earliest, and very likely not even then.

[Strategy dashboard]

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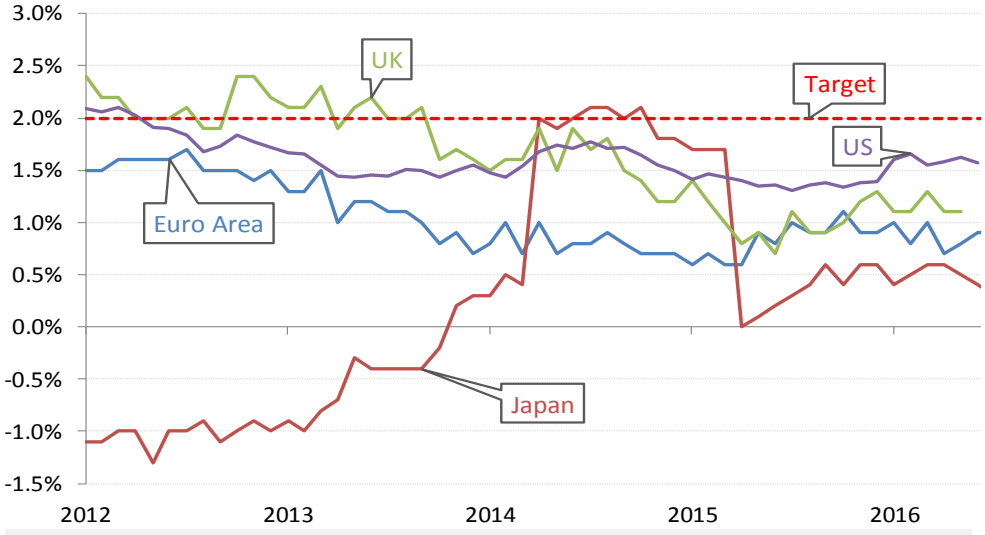
- Yellen herself has given warnings this year (see "For the Fed, Wrong is Better than Stupid" May 31, 2016). But the rate hikes never come.
- All that chatter seems intended to convey an air of institutional confidence. And yet there is increasing evidence that the Fed is losing its confidence in the old shibboleths.
- Yellen herself made a remarkable confession of her lack of confidence in a speech in late March, enshrining "uncertainty" as a key pillar in her policy outlook (see "Yellen Adds 'Uncertainty'" March 30, 2016).
- Next came St. Louis Fed President James Bullard's extraordinary statement, following the June FOMC, where he had boycotted the ritual of forecasting a longer-run funds rate, throwing up his hands at the futility of long-term economic forecasting (see "On the June FOMC" June 15, 2016).
- Suddenly, he's now by far the lowest "dot" for the optimal funds rate in 2017 and 2018 (see "Data Insights: Federal Reserve" June 15, 2016). Yet he is calling for a rate hike in 2016. Prior to this new conversion, for years Fisher has been promoting "neo-Fisherianism," and using the Japan experience to argue empirically that low policy rates cause low inflation. No wonder he has thrown up his hands.
- Now comes Yellen's hand-picked successor at the San Francisco Fed, John Williams, writing that the "natural interest rate" has permanently shifted lower, requiring a new and more aggressively accommodative policy framework from central banks. This is the same Williams who, as recently as May, was calling for two rate hikes in 2016.
- Bullard didn't quite dare to take his new agnosticism to its logical nihilistic conclusion – which would be to admit that without a theory of the equilibrium state of the economy, there can be no normative theory of how a central bank can improve the economy. But he

Consumer inflation excluding food and energy YOY



Source: BEA, Eurostat, Cabinet Office, TrendMacro calculations

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On the web at
trendmacro.com

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Donald Luskin
Chicago IL
312 273 6766
don@trendmacro.com

Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

Michael Warren
Houston TX
713 893 1377
mike@trendmacro.energy

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found cover in the idea that there are "regimes" – states of the economy that won't last forever and don't converge on any expected state. Regimes will last until they suddenly don't – so we can model them as permanent, and then fine-tune them by central bank policy. With respect to the current regime, he is conveniently able to adhere to the official line that inflation in the near term will return to the Fed's target of 2%. So none of Bullard's high-falutin' theorizing leads to any new policy stance.

- *But Williams, for his part, went so far as to suggest that in the permanent new world of a low "natural interest rate," central banks ought to raise their inflation targets, in order to move the natural rate higher, away from the zero-bound where Fed policy is ineffective.*
- This is not a new idea – it's been promoted since the Great Recession by the International Monetary Fund. It is new for an FOMC member to give it so much credence. In our view it impounds so many assumptions, presumptions and fallacies, theoretical and practical, as to be laughable – yet Williams offers it with so little argument as to treat it as nearly self-evident.
- And never mind that, try as they might, the central banks of the world haven't even been able for years to get core inflation all the way up to their *current* target of 2% (please see the chart on the previous page). Just why should we think they can get it higher still?
- And Williams laments, as it seems central bankers always do, that there is only so much that monetary policy can accomplish. At some point fiscal policy has to step up. *But it's not as though governments around the world, including ours, have failed to try supposedly stimulative spending policy. So if you are a central banker, perhaps you still feel on the hook to at least try to do more.*

So here we have three of the 17 members of the FOMC experiencing some degree of the agony of defeat. And yet, by the numbers, why are they not luxuriating in the joy of victory?

- The Fed has pretty much achieved its mandate. The unemployment rate is 4.9%, and year-on-year core PCE inflation, while not all the way to 2%, is at a respectable 1.6%.
- To be sure, for all that, output and income growth are slower than one might like or might expect given the happy state of unemployment and inflation.
- But from the Fed's standpoint, output and incomes are residuals – the drivers, enshrined in the dual mandate, are unemployment and inflation.
- And obviously, in the case of unemployment – given the shrinkage of the labor force participation rate – the headline number is misleadingly rosy.
- *So it seems that the Fed must feel both that it has the wrong benchmarks, and that those benchmarks are imperfectly specified. Altogether, they are insufficient to capture the Fed's true implicit mandate, to single-handedly fine-tune the economy to greatness*.

- Perhaps especially in a US election year, and in a political atmosphere around the world, steeped in a sense of dissatisfaction with the *status quo* (see "Trump's To Lose" August 12, 2016), an elite government agency like the Fed feels it is incumbent upon itself to "do something," or at least to act like it's trying, even though that "something" goes beyond its statutory purpose.
- With all that said, we can interpret the angst felt by some of our clients about Jackson Hole as a fear that the Fed will confess that it cannot, in fact, put a chicken in every pot and a car in every garage – and that this confession will lethally undermine confidence.
- *We can't see how, at this point, thoughtful people – who, presumably, are the marginal price-makers in markets – could really imagine that the Fed could do much more that would be effective. The most that can be reasonably hoped for is simply not to screw up – as indeed the Fed did with its ill-timed lift-off last December.*
- Such a screw-up would take the form of interpreting the economy's nearly mandate-consistent state as automatically requiring that rates ought to be hiked. But there is no sense in reversing course on the policies that have created desired results simply because those results have been achieved. If you reverse the policies, you will reverse the results.
- *We see Yellen's "uncertainty," Bullard's agnosticism, and Williams' embrace of secular stagnation as moving the FOMC's center of gravity further away from additional tightening errors – or, if anything new, toward some form of additional easing. If that means Yellen will give a speech that existentially re-examines the nature of policy, then bring it on – that's a discussion that is long-overdue.*
- But we expect little drama from Yellen at Jackson Hole. This is an election year, and she's a liberal Democrat appointed by a liberal Democrat. She's not very likely to admit that there are fundamental problems that need fundamental change. This is a "four more years" moment for her, if anything.
- We strongly re-iterate our longstanding forecast that the Fed will not raise rates again until December at the very earliest, and very likely not even then.

Bottom line

There's an air or menace around Yellen's speech next week at Jackson Hole. She may use it to respond to the existential challenge to economic forecasting mounted by Bullard, or the challenge to inflation-targeting put forward by Williams. But we don't expect any grand reformulations of the Fed's mission at Jackson Hole – even less do we expect any new or more credible than usual tip-off that another rate hike is on the horizon. With unemployment and inflation near mandate-consistent levels, why change the policy that got us there? Recent challenges to the Fed's orthodoxy by its own participants only adds to the uncertainty that argues for staying the course or, if anything, easing policy from here. We strongly re-iterate our longstanding forecast that the Fed will not raise rates again until December at the very earliest, and very likely not even then.