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TRENDMACRO LIVE!

On the September FOMC and BOJ

Wednesday, September 21, 2016

Donald Luskin

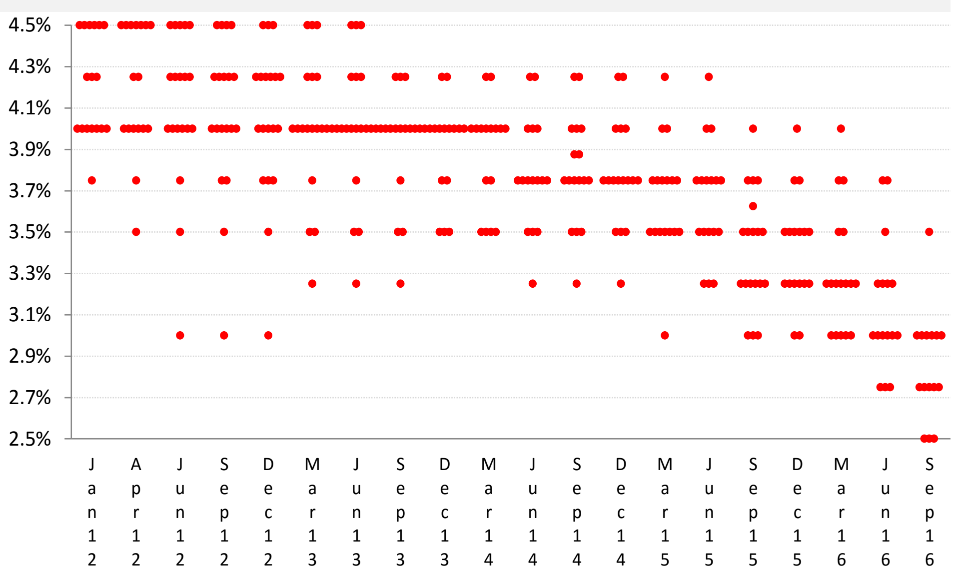
The FOMC didn't "blow itself up," but threatens to in December. The BOJ seeks overshoot.

FIRST, THE FED As we have long expected, the Fed did not in fact "blow itself up" at today's FOMC meeting (see "Gundlach and Load" September 12, 2016). All policy parameters, including the funds rate in a range of 0.25% to 0.50% were left unchanged.

That said, it seems as though the FOMC has deliberately left open the strong possibility that it will hike the funds rate at the December meeting.

- *Most significant in our view, today's FOMC statement said that "near-term risks to the economic outlook appear roughly balanced" – this is an optimistic uptick from the prior statement that the risks "have diminished," which had implied that the balance of risks was on the downside.*
- The Fed seems to be itching to hike rates – but has been held back by various risk-events (see, for example "Brexit: Who Won, Who Lost, What's Next?" July 11, 2016). Apparently the FOMC is looking beyond the last several weeks of weak data and market

"Longer term" federal funds rate from Summary of Economic Projections



Source: FRB, TrendMacro calculations

Update to strategic view

US FED: As we expected, no rate hike. But "roughly balanced" risks and three hawkish dissents set the stage for a December hike. This is inexplicable to us considering that the "longer run" estimates of the "neutral rate" continue to come down sharply, and that market-implied long-term inflation expectations are at or near the lowest in the history of the data. Normatively, the Fed should do nothing in December – and election-driven volatility will probably make that so. But without a risk-off environment between now and then, positively, we have to admit a hike seems likely.

BANK OF JAPAN: The BOJ announced an overt policy of inflation-overshoot, and "yield curve control" pegging the 10-year at 0.0%. Overnight rates, which act now only as a tax on banks, were not made even lower, so bank stocks rallied. The yen strengthened, but this is a not a clear signal of failure of these new policies. Since 2014 the yen has been a passive function of USD, which itself has been a passive function of the oil price.

[Strategy dashboard]

volatility, clearing the runway for the hike that it wants – inexplicably wants, in our view.

- Today there were three dissenters on the FOMC – George, Mester and Rosengren – who wanted a hike. This is the largest number of dissents since December 2014, and the largest number of hawkish dissents since December 2011. This sends a signal that, while the hawkish impulses may be coming most overtly from bit-players who have actual little influence, singing together their effective voice becomes louder.
- All but three of the "dot plots" presented for the funds rate at year-end 2016 in the Summary of Economic Projections show some degree of hike (see "Data Insights: Federal Reserve" September, 2016).
- That said, the average for year-end 2016 came down by 17 bp from September. The average for 2017 came down by 32 bp, and for 2018 by 35 bp. The "longer run" rate came down 29 bp, from 3.14% to 2.85% (please see the chart on the previous page).
- The first-ever median estimate for 2019 real GDP growth came in at 1.8%, below the median estimate for 2018.
- *So with the consensus on the FOMC agreeing that the "natural rate" or "neutral rate" is continuing to fall, and agreeing that growth is going to be even slower in the future than it is now – oh, and considering that market-implied long-term inflation expectations are still at or near the lower in the history of the data – it is nearly beyond our rational understanding why the Fed would even consider hiking the funds rate here.*
- In the post-FOMC press conference, Yellen was essentially asked to explain this great mystery. The best she could do was stammer out a Phillips Curve argument – that "ultimately what drives inflation is pressure in the labor market." So for this supposedly data-driven Fed, all that really counts is the unemployment rate – everything else can be modeled off that. Unfortunately, the models are based on assumptions about a nexus of unemployment and inflation that has not been visible in the data for decades. Indeed, in an excellent speech last week, Fed Governor Lael Brainard pointedly said that the Phillips Curve is now "flat" – her polite way of saying it is non-existent.
- Later in the presser, Yellen herself at least admitted that the Phillips Curve is flatter today than it was in the bad old days of the 1970s. For that matter, she has admitted as much to me in person.
- But it doesn't matter whether we agree with Yellen, or whether she is intellectually consistent. The reality is that the Fed, for whatever reason, is advertising a rate hike – as it has in various forms, actually, for the better part of two years. To maintain any credibility at all, it will have to actually hike every once in a while, as it did last December despite months of sharply weakening economic conditions.
- We still think our *normative* view that the Fed will stay on hold ought to and will carry the day. Volatility arising from the presidential election (see, among many, "Trump's To Lose" August 12, 2016) may create the risk-off environment that will stay the Fed's hand.

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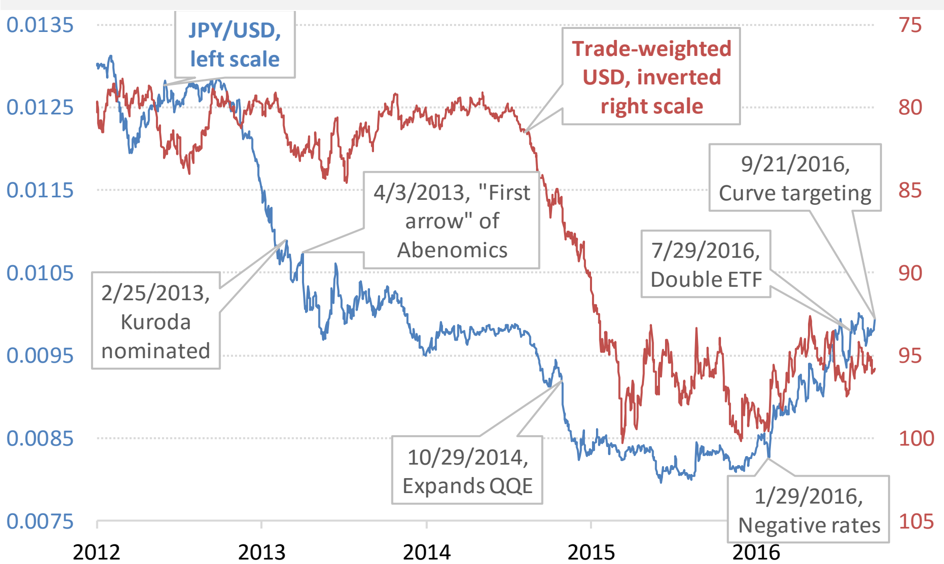
- But we have to give greater and greater credence to an alternate *positive* view that, for better or worse, it will in fact hike in December.

AND NOW, THE BANK OF JAPAN The Bank of Japan introduced two unusual new policy initiatives today. First, it committed to seeking inflation above its 2% target, *making it the first central bank we know of that has overtly committed to overshooting inflation*. Second, it introduced "yield curve control," in which it will *target the overnight rate at negative 0.1%, and the 10-year JGB yield at 0.0%*.

- *From here, this "yield curve control" actually means raising the 10-year yield a bit from its present slightly negative level.*
- Credibly committing to inflation-overshoot would achieve that and much more – making it difficult ultimately to cap the 10-year at 0.0%. But we don't understand why an overshoot promise should be credible from *any* central bank at this point, all of whom have failed for years to even meet their targets (see "The Agony of Victory at Jackson Hole" August 18, 2016).
- *Selling* 10-year JGBs from the BOJ's account arguably might lift the yield back to 0.0%, but obviously that would be a form of tightening. And nothing like that was discussed in the post-meeting materials. Indeed it was said that asset *purchases* would stay "more or less in line" with current levels of about ¥80 trillion.
- The 7% rally in Japanese bank stocks following the announcement implies relief that the BOJ didn't make the error of going deeper into negative overnight rates, which now act effectively like a tax on banks.
- *But the large yen strengthening would seem to imply an overall disbelief that the new policies will indeed increase inflation.*
- That said, in reality BOJ policy has had less to do with the exchange rate than is often believed (please see the chart below).

Does BOJ policy determine Yen weakness?



Source: Bloomberg, TrendMacro calculations

The first and biggest yen weakening, in 2013, accompanied the anticipation and arrival of Haruhiko Kuroda as new Prime Minister Shinzō Abe's hand-picked carrier of the "first arrow" of Abenomics (see "On Kuroda and Iwata at the BOJ" February 25, 2013).

- *After that, since 2014, the yen has pretty much strengthened or weakened as a passive function of the trade-weighted USD, which itself has strengthened or weakened as a passive function of the oil price* (see "Dollar Strength: A Crude Connection" April 23, 2015).
- Overall, we see the BOJ's new policy mix as a step in the right direction – a very bold step, in some sense, indeed showing a kind of "Rooseveltian resolve" – but one likely diminished in its effectiveness for having been being taken in the BOJ's usual opaque way – today former Fed Chair Ben Bernanke correctly called it "muddled."
- But the mere fact that this step has been taken ought to put to rest the idea in the markets, ascendant since the ECB's "steady as she goes" meeting two weeks ago, that central banks have reached "policy exhaustion" (see "Gundlach and Load" September 12, 2016).

Bottom line

As we expected, no rate hike. But "roughly balanced" risks and three hawkish dissents set the stage for a December hike. This is inexplicable to us considering that the "longer run" estimates of the "neutral rate" continue to come down sharply, and that market-implied long-term inflation expectations are at or near the lowest in the history of the data. Normatively, the Fed should do nothing in December – and election-driven volatility will probably make that so. But without a risk-off environment between now and then, positively, we have to admit a hike seems likely.

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