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TRENDMACRO LIVE!

On the November FOMC

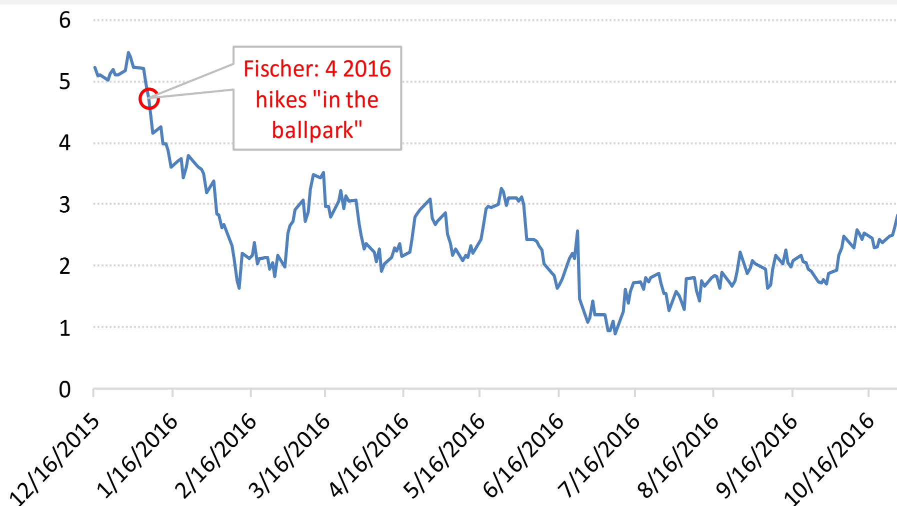
Wednesday, November 2, 2016
Donald Luskin

Barring an election shock, a December hike seems inevitable. It's a mistake, but not lethal.

The world is a different place for the FOMC than it was last December, at "lift-off" after seven years of a zero fed funds rate (see "On the December FOMC" December 16, 2015). Global markets reacted badly to this ill-timed move, made against the backdrop of deteriorating macro data and tightening financial conditions – and all the more after Fed Vice Chair Stanley Fischer's reckless remark in early January that four more hikes in 2016 were "in the ballpark."

- Even at lift-off, the yield curve was only discounting about five hikes over *three* years. Then Fischer's gaffe turned out to be a self-defeating prophecy, scaring the economy into near-recession and making his four hikes for 2016 completely impossible.
- *Now the curve is implying less than three hikes in three years* (please see the chart below). *That means about one rate hike per year.*
- There's nothing in today's FOMC statement to indicate the first of those three hikes won't be at the upcoming December FOMC. *We don't think the Fed should hike in December, and have a nagging*

Since lift-off: curve-implied number of Fed hikes over 3 years



Source: Bloomberg, TrendMacro calculations

Update to strategic view

US FED, US MACRO: The "case for an increase in the federal funds rate has continued to strengthen" – although the few changes in the statement language only point to weakening spending and a flimsy and cautious case for higher inflation. Job growth is "solid" – so an implicit Phillips Curve argument carries the day. Any shock – such as a surprise in next week's election, or a legal mess in its aftermath – could defer the hike. But we're resigned to it at this point, though we think it's a mistake. With financial conditions so much easier than they were at lift-off last December, we don't think a hike would cause great harm, but eventually there will be a hike that does. Fortunately the curve implies just one hike per year for the next three years. Yellen is aware of inherent uncertainties for policy in today's highly unusual economic environment, and is exploring new options while questioning old dogmas. Unfortunately the FOMC remains mired in conventional wisdom.

[Strategy dashboard]

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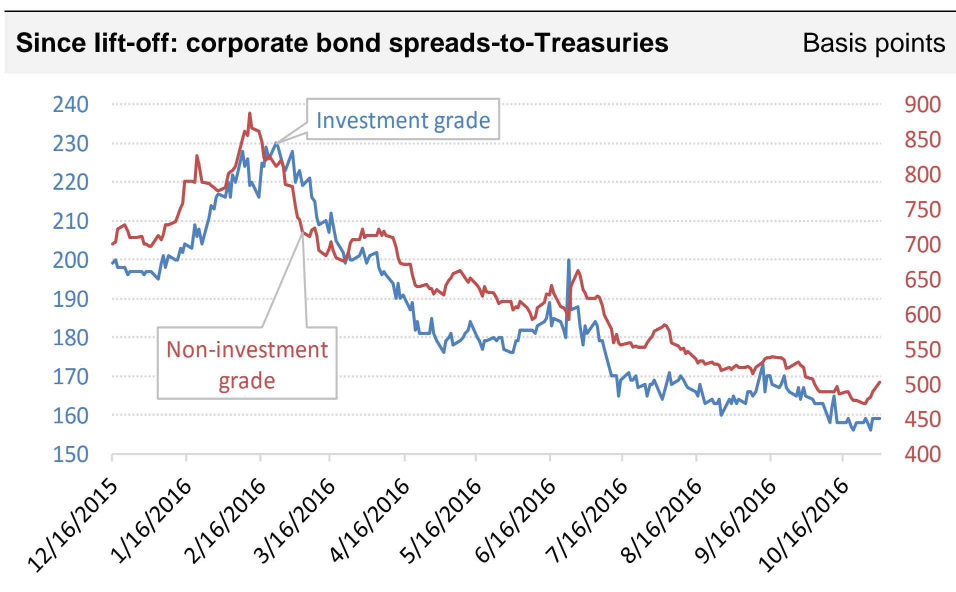
suspicion that something will keep it from doing so – but we have become resigned to it (see [“On the September FOMC and BOJ”] September 21, 2016).

- *A December hike – especially if it is made in the context of a once-a-year-at-Christmas regime now implied by the curve – will be a mistake, but probably not a catastrophic one*. It won’t happen if there’s a lot of volatility arising from some kind of surprise in next week’s election (we catalog a number of possible surprises beyond just an unexpected Trump victory in “On the First Presidential Debate” September 27, 2016). If it does happen, it will only be because things are relatively tranquil.
- One critical difference between last December and today is the tremendous loosening of financial conditions that has occurred as oil has recovered from its near-death double-bottom in January and February. The crash in oil prices led to a catastrophic widening in corporate bond spreads, which had the impact of multiple rates hikes before the Fed piled one more on top – the pressure of which drove spreads even wider (please see the chart below). So as to a hike this coming December, well, “what difference, at this point, what difference does it make?”

Since lift-off: corporate bond spreads-to-Treasuries Basis points



Source: BAML, Bloomberg, TrendMacro calculations

- We can’t be sure which future hike will be the one to stumble on the tripwire that pushes the economy into recession. We think it’s not this one that seems to be coming. But at least it would appear the Fed is cautiously tip-toeing – just the right behavior if you are near a tripwire.
- After the market’s brutal reaction to last December’s lift-off, Yellen seem to get it. We maintain that her March 29 speech, giving more weight to “uncertainty” in policy-making, was a turning point for her in her on-the-job training (see “Yellen Adds ‘Uncertainty’” March 30, 2016).
- Even now, as the seemingly baked-in-the-cake December hike comes nearer, Yellen continues to explore “uncertainty.” In a

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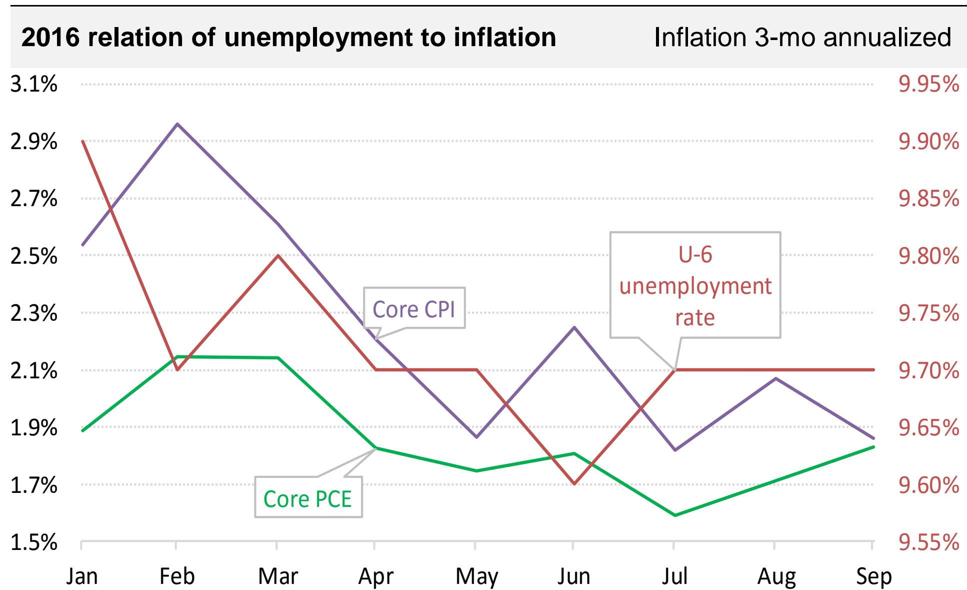
[remarkable speech two weeks ago](), which has gotten entirely too little attention, Yellen openly questions the [Phillips Curve dogma]() that has been the underlying rationale for lift-off all along.

- Yellen admits, "the influence of labor market conditions on inflation in recent years seems to be weaker than had been commonly thought." That's putting it too mildly. It not only "seems" to be – it is! In fact, in 2016, overall unemployment and high-frequency readings on core inflation have all been *coming down at the same time – exactly the opposite* of what the Phillips Curve would predict (please see the chart below).



Source: BLS, BEA, TrendMacro calculations

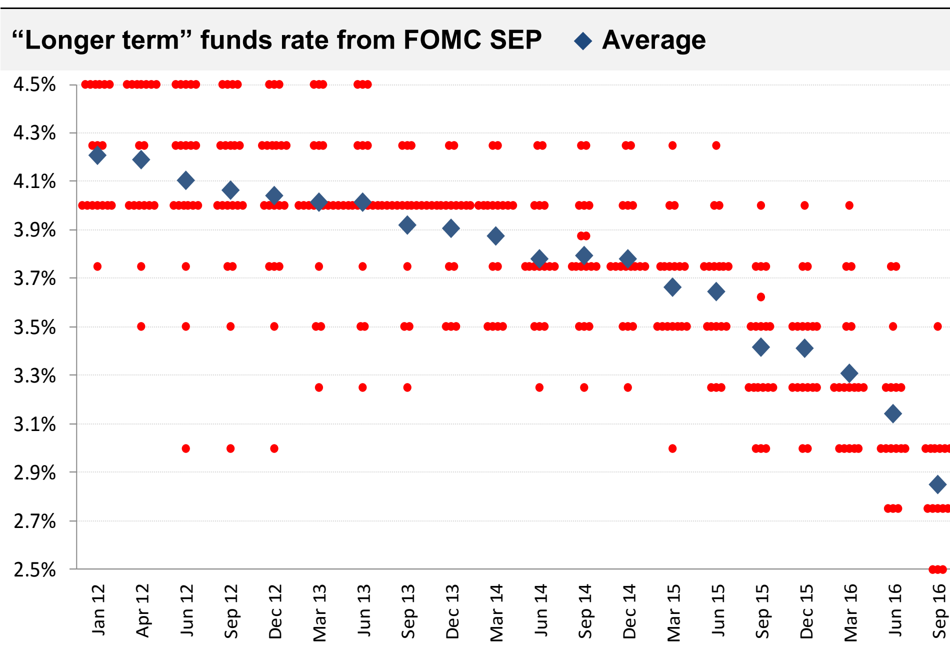
- Elsewhere in that same speech, perhaps without consciously connecting it to her Phillips Curve apostasy, Yellen speculated on the advantages of "running a 'high-pressure economy,' with robust aggregate demand and a tight labor market." Yellen goes on:

> *One can certainly identify plausible ways in which this might occur. Increased business sales would almost certainly raise the productive capacity of the economy by encouraging additional capital spending, especially if accompanied by reduced uncertainty about future prospects. In addition, a tight labor market might draw in potential workers who would otherwise sit on the sidelines and encourage job-to-job transitions that could also lead to more-efficient – and, hence, more-productive – job matches. Finally, albeit more speculatively, strong demand could potentially yield significant productivity gains by, among other things, prompting higher levels of research and development spending and increasing the incentives to start new, innovative businesses.*

- *Uh… really? You mean growth is good? You mean we don't have to sacrifice growth over fears of inflation (which, again, has been*

coming down all year)? Bring it on, Ms. Yellen, assuming you can actually do such a thing with the brittle tool of monetary policy, which is the only tool you've got.

- Contrast this to the profoundly conventional – and, perhaps without realizing it, utterly defeatist – pronouncements of Boston Fed President Eric Rosengren. He dissented at the September FOMC, calling for a rate hike then and there. In a round of subsequent press interviews – from which we sense he took great personal satisfaction and delight, having learned that on a dovish FOMC there are certain advantages to being a hawk – he explains himself by noting "we're relatively close on both full employment and on where our inflation target is, and we have an interest rate that is well below what we think the interest rate will be in the long run."
- He fails to note that what "we think" about long-run interest rates has been secularly coming down, FOMC meeting by FOMC meeting, for the entire four and a half years over which participants have been surveyed (please see the chart below). And he fails to make a cogent argument why, if conditions are so perfect, we ought to change the policies that got us there.



Source: FRB, TrendMacro calculations

- Rosengren didn't dissent today (while his two colleagues who dissented in September did so again). Yet today's FOMC statement feels more like it was written by Rosengren than by Yellen, mired in conventional wisdom and, indeed, barely changed at all from September's. Let's take a close look at the language (for a full red-line comparison, see "Data Insights: Federal Reserve" November 2, 2016).
- The headline immediately reported by the financial media is that the FOMC believes "the case for an increase in the federal funds rate has continued to strengthen." In September, it had only "strengthened."
- *But what is that case, exactly, that has "continued to strengthen"?*

- Among the few changes in today's statement, the FOMC points to weakness in household spending, which in September was said to be "growing strongly" but now only "rising moderately."
- The only other change is that inflation is now said to have "increased somewhat since earlier this year" – which, if we are talking about core inflation, is flatly untrue (again, see the chart on page 3). But even this is hedged by noting, as in September, that it is "still below the Committee's 2 percent longer-run objective."
- Inflation-compensation is now said to have "moved up," but as in September, it "remains low."
- To be sure, today's statement removed September's claim that inflation is "to remain low in the near term, in part because of earlier declines in energy prices." But that says nothing about core inflation – which, again, is declining – nor about long-term steady-state inflation.
- So that's it? That's how "the case for an increase in the federal funds rate has continued to strengthen"?
- *No, the real case is the Phillips Curve, despite Yellen's own critique of it. The one other change in today's statement is that "job gains have been solid" – deleting September's qualifier "on average."*
- Solid? We suppose that's a matter of judgment. But as we recall, the most recent jobs report only showed 156,000 net payrolls gained, and that was a miss versus expectations (see "On the September Jobs Report" October 7, 2016).
- *The combination of intellectual flimsiness and bull-headedness here continues to make us think that the FOMC would easily be scared out of hiking in December by the slightest shock – but at the same time, a December hike seems inevitable just because, well, just because they say it is.*

Bottom line

The "case for an increase in the federal funds rate has continued to strengthen" – although the few changes in the statement language only point to weakening spending and a flimsy and cautious case for higher inflation. Job growth is "solid" – so an implicit Phillips Curve argument carries the day. Any shock – such as a surprise in next week's election, or a legal mess in its aftermath – could defer the hike. But we're resigned to it at this point, though we think it's a mistake. With financial conditions so much easier than they were at lift-off last December, we don't think a hike would cause great harm, but eventually there will be a hike that does. Fortunately the curve implies just one hike per year for the next three years. Yellen is aware of inherent uncertainties for policy in today's highly unusual economic environment, and is exploring new options while questioning old dogmas. Unfortunately the FOMC remains mired in conventional wisdom.