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TRENDMACRO LIVE!

On the December FOMC

Wednesday, December 14, 2016

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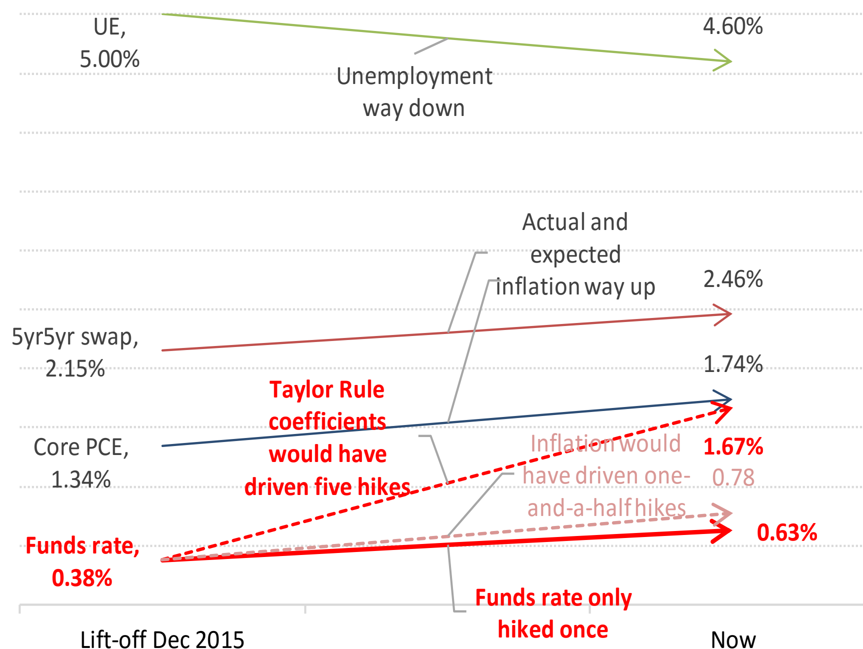
The Fed is on a new "policy rule," and the Trumponomics punchbowl won't get taken away.

Markets seem a little freaked out because the "dots" moved up slightly (see "Data Insights: Federal Reserve" December 14, 2016). But that doesn't mean the Fed is planning on tighter policy, as we explain shortly. *Indeed, for now, with today's 25 basis point rate hike to a mid-point of 5/8%, the Fed is arguably easier than it was a year ago right after lift-off.*

- *Core PCE inflation is 40 basis points higher, so even after today's hike, the real funds rate is 15 basis points lower than at lift-off.*
- *Add the 0.4% drop in the unemployment rate – and apply coefficients in a standard Taylor Rule – and the funds rate should be 1.04% higher than it is now after today's hike* (please see the chart below).

We think the Fed is now operating on what amounts to a new "policy rule,"

Since lift-off: monetary policy and (seemingly) key determining variables



Source: BLS, BEA, Bloomberg, TrendMacro calculations

Update to strategic view

US FED, US MACRO: Today's 25 basis point hike leaves the real funds rate 15 basis points lower than a year ago, at lift-off. With inflation higher and unemployment lower over 2016, policy is arguably easier now. The freak-out in markets about the slight uptick in the "dots" representing the forward rate path is misplaced. Yellen explicitly noted that participants are expecting "fiscal policy" that will point to a higher neutral interest rate – a higher funds rate in relation to that would not be a tightening, but rather only a tracking exercise. We think the Fed is now targeting the real neutral interest rate. Yellen and Fischer have both talked about "running a 'high-pressure' economy" as a means of influencing it higher. Yellen walked that back a bit today, but then walked back her walk-back. We are convinced that the Fed will do nothing to take the punchbowl away as Trumponomics takes hold.

[Strategy dashboard]

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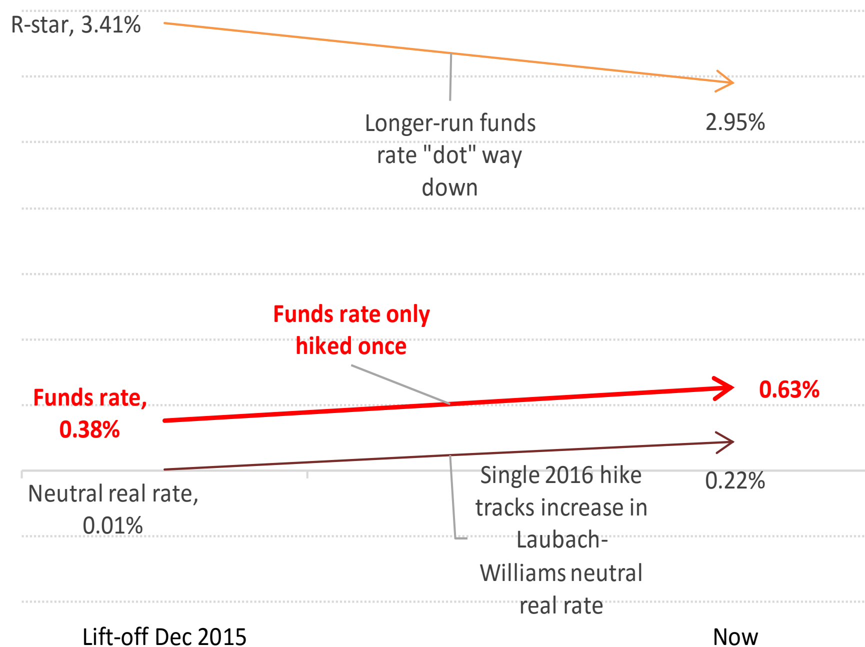
and shading its adherence to that rule to the dovish side. This rule and this stance will guide the FOMC through Donald J. Trump's pro-growth economic agenda (see "Trump and the 'Reflation Trade'" November 15, 2016). *The Fed learned – from the near-recession that followed last December's lift-off* (see "On the December FOMC" December 16, 2015) – *that the old rules don't work anymore. The new rule will call for extreme gradualism, and will keep the Fed from snatching the punchbowl away from Trumponomics, despite a media drumbeat to the contrary.*

- The Fed has struggled to understand why the economy has been so resistant to stimulus, and reacted so badly to lift-off. The result is a new reliance on the idea of the "neutral rate of interest" (which we explore in detail in "Gundlach and Load" September 12, 2016).
- The neutral rate is how the Fed frames policy debates now. It hasn't explicitly made it into any FOMC statements yet. But Chair Janet Yellen started talking about it at the FOMC press conference a year ago at lift-off. In Congressional Testimony last month she wrapped up her rationale for only gradual rate hikes by saying, "the neutral federal funds rate – meaning the rate that is neither expansionary nor contractionary and keeps the economy operating on an even keel – appears to be currently quite low by historical standards." And it featured prominently in the prepared remarks preceding today's press conference, using mostly the same words.
- The volatile reaction to lift-off in the face of improving labor markets and inflation has the Fed appreciating *how* low. The FOMC's "dots" that represent the "longer-run" funds rate, also known as "R-star" – a proxy for the steady-state neutral rate – has been drifting lower for three years, until today. But just since lift-off one year ago it has been lowered by 46 basis points (please see the chart below).

Since lift-off: monetary policy and the neutral rate of interest



Source: Federal Reserve. FRBSF, TrendMacro calculations

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- *The single 2016 hike in the funds rate – that is, today's hike – maps to the small upward change over the year in the Fed's favorite proxy for the contemporaneous neutral rate* – *the San Francisco Fed's calculation of the Laubach/Williams model* (again, please see the chart on the previous page).
- *This is the Fed's new policy rule. When Trumponomics or some other force raises the Laubach/Williams model's estimate, the FOMC will hike again.*
- *In this framework, the slight uptick in today's "dots" – representing FOMC members' estimates of the "appropriate" funds rate over time – after literally years of secular stagnation in which the "dots" have been relentless moved lower – reflects the Fed's expectation that the real natural rate will begin to rise now. Yellen said as much explicitly in the prepared remarks preceding today's press conference. She went so far in the subsequent question-and-answer session as to indicate that some participants are looking ahead to new "fiscal policy" that could raise the neutral real rate.*
- *We can't emphasize enough that a higher funds rate in the face of a higher real neutral rate is not, in and of itself, a tightening of policy.*
- Yellen and Fischer have been preparing the markets for cognitive dissonance as a seemingly low policy rates appears inconsistent in relation to a further drop in the unemployment rate and a further rise in core inflation.
- As we already noted after the November FOMC (see "On the November FOMC" November 2, 2016), Yellen had explored in an October speech the desirability of the Fed "temporarily running a 'high-pressure economy,' with robust aggregate demand and a tight labor market."
- Her rationale is that the global economy's "secular stagnation" – which is responsible for the low neutral rate of interest – is the consequence of "hysteresis." It is an atypically long-lived reaction to the short, sharp shock of the 2008-2009 crisis has left a lingering shortfall of demand, which has led to a decline in output growth, which in turn has led to falling productivity, resulting in a vicious cycle.
- *Letting the economy "overheat" by deliberately failing to tighten policy as unemployment falls and inflation rises could be a salutary countershock.* Yellen says,

> *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.*

- Three weeks after Yellen put forth that theory, Fischer chimed in with a speech in which he adopted a tone that makes it seems certain that the Fed will, indeed, experiment with this form of deliberate policy overshoot.

> *That is not an issue that can be answered purely by theorizing. Rather, it will be answered by the behavior of output and inflation as we approach and perhaps to some extent exceed our employment and inflation targets.*

- To be sure, in the question-and-answer session in today's press conference, Yellen seemed to back away from this, contradicting Fischer, saying that it's "an important research question," but "I don't favor running a high-pressure economy as some sort of experiment."
- *But then she went on to note that the FOMC's "dots" do anticipate what she called an "undershoot" of the unemployment rate through 2019, relative to the rate deemed proper for the "longer run." If that isn't running a high-pressure economy we don't know what is.*
- This notion of deliberately keeping policy easy as the economy speeds up, as a countershock against hysteresis, is completely consistent with using the neutral rate as a policy rule. The overshooting is only with respect to unemployment and inflation, targets that the Fed will no doubt still talk about, but is no longer aiming at.
- The new target is the neutral funds rate. *Overshooting the old targets is what the Fed thinks will enable it to hit the new target.*

Bottom line

Today's 25 basis point hike leaves the real funds rate 15 basis points lower than a year ago, at lift-off. With inflation higher and unemployment lower over 2016, policy is arguably easier now. The freak-out in markets about the slight uptick in the "dots" representing the forward rate path is misplaced. Yellen explicitly noted that participants are expecting "fiscal policy" that will point to a higher neutral interest rate – a higher funds rate in relation to that would not be a tightening, but rather only a tracking exercise. We think the Fed is now targeting the real neutral interest rate. Yellen and Fischer have both talked about "running a 'high-pressure' economy" as a means of influencing it higher. Yellen walked that back a bit today, but then walked back her walk-back. We are convinced that the Fed will do nothing to take the punchbowl away as Trumponomics takes hold.