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TRENDMACRO LIVE!

On the June FOMC

Wednesday, June 14, 2017

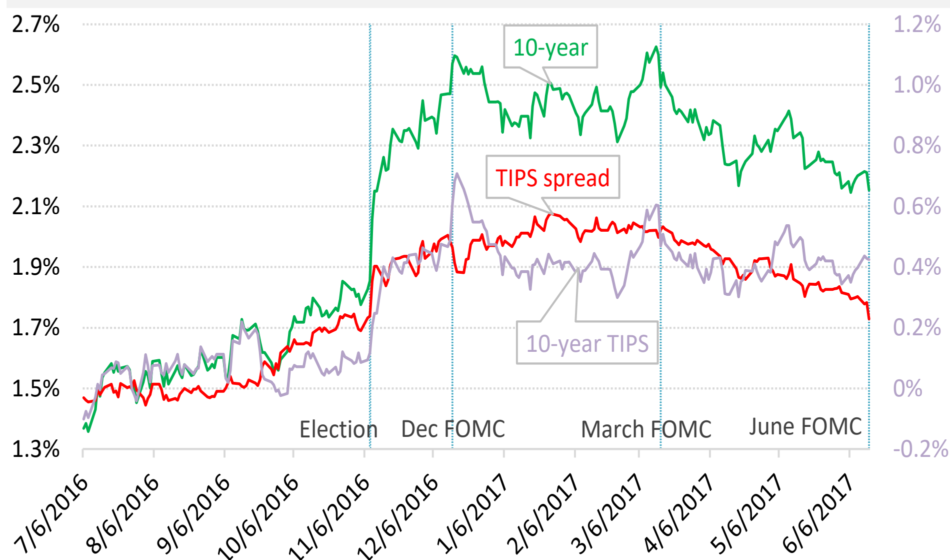
Donald Luskin

A rate hike despite this morning's inflation shock. Too tight, or is it all about oil?

Today's rate hike – *and a plan for balance sheet reduction* – *went forward despite a rude data surprise this morning – a negative reading for the May Consumer Price Index* (see "Data Insights: CPI/PPI" June 14, 2017). Weak inflation has been evolving all year, both in the CPI and in the Fed's preferred PCE Price Index, with core running at a 1.6% annual rate year-to-date. In today's Summary of Economic Projections, the FOMC downgraded its full-year 2017 estimate from 1.9% to 1.7%. As always, it promises 2% for the out-years (see "Data Insights: Federal Reserve").

- Core PCE inflation puts the Fed's favorite measure of the neutral rate of interest only a half percent above the funds rate.
- *This is why the money market curve expects no more rate hikes for 12 months, an expectation that only firmed today even after today's "dot plot" stubbornly continued to show one more hike in 2017. But with the average of the "dots" came down for all tenors.*
- *And we think the decline in inflation also explains the drop in the 10-year Treasury yield in 2017, which has come entirely from its inflation-compensation component* (please see the chart below).

10-year Treasury yield dynamics since post-Brexit bottom



Source: Bloomberg, TrendMacro calculations

Update to strategic view

US FED, US MACRO, US BONDS, OIL: A three-in-a-row rate hike at a quarterly FOMC meeting, despite a CPI inflation surprise. Treasury yields fell at this morning's CPI announcement, but this makes three-for-three: a big yield drop coinciding with a rate hike. But almost all the drop in the 10-year yield from the March highs has been in the inflation-compensation component. Weak inflation has been driven primarily by the weak oil price, now negative year-on-year. At present low inflation rates, the nominal funds rate is just half a percent below the Fed's neutral rate of interest, which is why the curve expects no more hikes for a year. The FOMC statement finally formally acknowledged an intent to reduce Treasury and MBS holdings, and published a separate statement detailing gradually rising caps for non-reinvestment. No more specific timeframe was given for inception – only "this year," with qualifications. We continue to believe purchases made little difference – as will non-reinvestment.

[Strategy dashboard]

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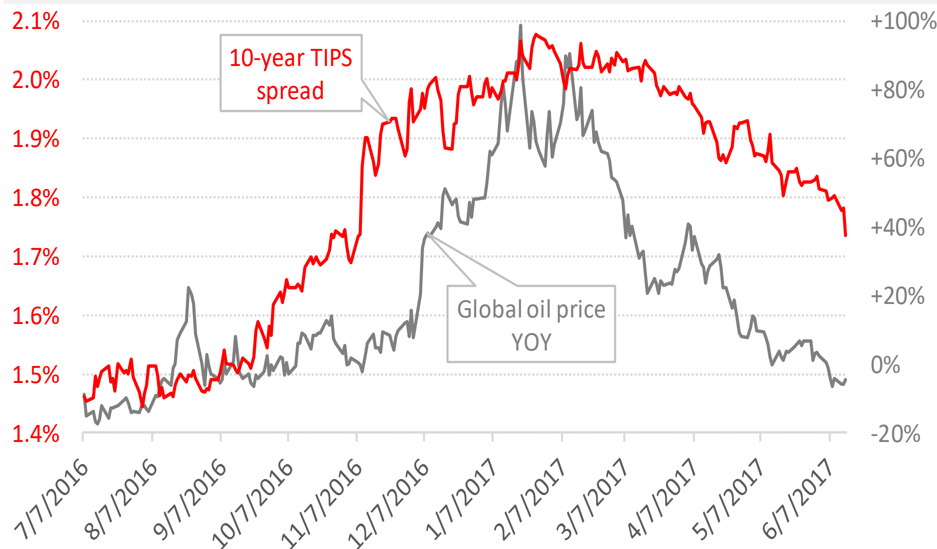
- *The major culprit is energy.* The oil price has gone from an almost 100% year-on-year gain in mid-January to a 3% loss now, a rollover corresponding in time to the rollover in the 10-year TIPS spread (please see the chart below).

10-year TIPS spread versus oil price



Source: Bloomberg, TrendMacro calculations

- *The energy component in May's CPI fell at an annual rate of 28.2%. It's leaking into core inflation, which grew in May at an annual rate of only 0.8%, and it's now flat on a 3-month basis.*
- All that said, it is noteworthy that *the peaks in the 10-year yield have corresponded perfectly with the two prior FOMC rate hike announcements* (again, please see the chart on the previous page) – and today, at the third-in-a-row hike, yields are falling sharply *again* to a new post-election intra-day low (though still significantly above the post-Brexit lows of last July).
- *Quite a few clients have told us they believe this indicates the Fed has been hiking rates too aggressively, driving a worrisome flattening of the yield curve.* That *may* prove to be the case ultimately, but from what we know now, we are more inclined to point the finger at the oil price – unless one wishes to assert that a too-tight Fed has, itself, influenced the oil price to fall.
- We continue to think that oil is priced to perfection, and that it should advance from here (see "Is Oil Priced to Perfection Again?" May 9, 2017), at the same time as we expect US and global economic growth to accelerate (see "On the May Jobs Report" June 2, 2017). *We don't think the Fed has been too tight so far* – indeed, we would argue that it hasn't tightened at all, because the rate hikes have been roughly indexed to the recovering real neutral rate of interest (see "Yellen's March to Neutrality" March 6, 2017).

But based on the uninspiring data at the moment – and the gloomy consensus we are picking up from most clients – we understand why the markets expect no more hikes any time soon. But in today's FOMC

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[About us]

statement, we can't point to any particularly darkening language that reflects any less confidence in the economy.

- The most significant language change are with respect to inflation. In May's statement, the FOMC was still proudly noting that inflation "recently has been running close to the Committee's 2 percent longer-run objective." Today, just six weeks later, that has had to be changed to: "recently has been running close to the Committee's 2 percent longer-run objective."
- A new note of caution was added: "…the Committee is monitoring inflation developments closely."
- In the prepared introduction to today's press conference, Chair Janet Yellen blamed the present deterioration in inflation to "one-off" factors –weirdly, not mentioning oil, but focusing on falling cell-phone plan and prescription drug prices.

Today's FOMC statement, for the first time, recognized the Fed's plans to reduce its Treasury and MBS holdings – an intention first announced, rather sneakily in our view, in the minutes of the March meeting (see "Time for Taper Tantrum Two?" April 6, 2017).

- US stocks began to weaken a bit as Yellen began to talk about these plans. We're not sure why. We don't see that she said anything beyond what was already out in print, in the FOMC statement and in a separate statement detailing the balance sheet normalization plan.
- As already indicated, the normalization would consist only of non-reinvestment of maturities. Today we learned that non-reinvestment of maturing Treasuries will be capped at $6 billion per month, increasing in steps of $6 billion at three-month intervals over 12 months until it reaches $30 billion. For MBS, the cap will start at $4 billion per month, and will increase in steps of $4 billion at three-month intervals over 12 months until it reaches $20 billion.
- *That means, for the first year, about $300 billion will roll off, cumulatively. By our rough-and ready look, that's about three quarters of what would have rolled off if no caps were in place.*
- *There is no announced start date for the balance sheet reduction. Today we learned only what we already knew: it will be "this year, provided that the economy evolves broadly as anticipated."*
- *And there was no indication of what the FOMC's ultimate target is for the size of its balance sheet.*
- The normalization statement said it would be "a level appreciably below that seen in recent years but larger than before the financial crisis." That's not much help.
- We do take comfort from the assurance that "The Committee expects to learn more…during the process of balance sheet normalization." This is unknown territory, and learning-by-doing is inevitable. At least the Fed appreciates that.
- We note that, as the balance sheet expanded in the financial crisis, the critical moment was when its size exceeded the value of

Recommended Reading

Russia Hacked our Election! (So what?)
Scott Adams
Scott Adams' Blog
June 13, 2017

A Financial System That Creates Economic Opportunities: Banks and Credit Unions
Steven T. Mnuchin and Craig S. Phillips
US Department of the Treasury
June 12, 2017

Comeytose State
Mark Steyn
Stein on America
June 10, 2017

All 213 Beatles Songs, Ranked From Worst to Best
Bill Wyman
Vulture
June 7, 2017

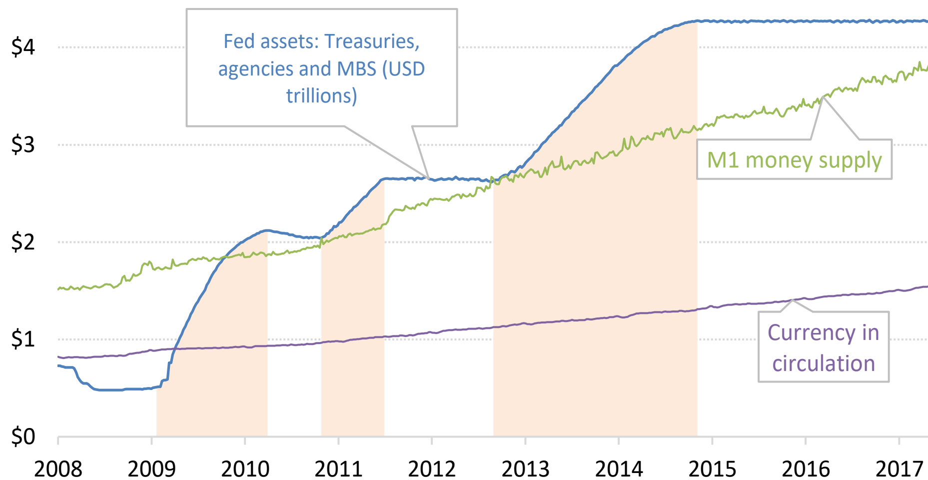
Obamacare Is Not Making Healthcare More Affordable
Charles Blahous
E21
June 13, 2017

Out of the Desert
Ali Al-Naimi
Penguin Books
November 2016

[Reading home]

currency in circulation. That level is, informally, considered a limit on central bank asset holdings – a level justified by "seignorage" – above which debt is being monetized. That Rubicon was crossed in early 2009 (please see the chart below), and to return to its shores would imply a very considerable asset reduction, to below $2 trillion (depending on when in the future it is achieved, considering that the amount of currency in circulation secularly rises).

Fed Treasury and MBS holdings **Purchase periods**



Source: Federal Reserve, TrendMacro calculations

- We note the striking coincidence that both QE2 and QE3 began precisely when the M-1 money supply had risen to meet the then-prevailing level of Treasury and MBS holdings (please see the chart above). If that turns out to be a "rule" for the Fed, the balance sheet cannot even fall by a full $1 trillion.
- We continue to believe purchases made little difference – as will non-reinvestment.

Bottom line

A three-in-a-row rate hike at a quarterly FOMC meeting, despite a CPI inflation surprise. Treasury yields fell at this morning's CPI announcement, but this makes three-for-three: a big yield drop coinciding with a rate hike. But almost all the drop in the 10-year yield from the March highs has been in the inflation-compensation component. Weak inflation has been driven primarily by the weak oil price, now negative year-on-year. At present low inflation rates, the nominal funds rate is just half a percent below the Fed's neutral rate of interest, which is why the curve expects no more hikes for a year. The FOMC statement finally formally acknowledged an intent to reduce Treasury and MBS holdings, and published a separate statement detailing gradually rising caps for non-reinvestment. No more specific timeframe was given for inception – only "this year," with qualifications. We continue to believe purchases made little difference – as will non-reinvestment.