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TRENDMACRO LIVE!

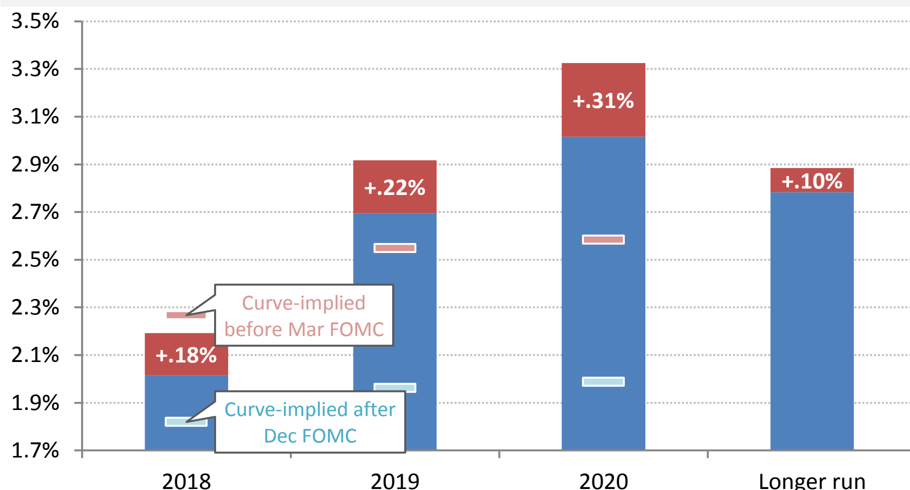
# On the March FOMC

Wednesday, March 21, 2018
**Donald Luskin**

**Powell stuck with Yellen's guidance, but we still don't know what he believes – if anything.**

As expected, the FOMC hiked the funds rate by a quarter point, and the "dot plots" of the projected rate for "appropriate monetary policy" were moved up at all tenors (please see the chart below and "Data Insights: Federal Reserve" March 21, 2018). The hike, and the dot-upgrade for 2018, were already *more than fully* anticipated by the money-market curve. While market expectations for 2019 and 2020 have moved up, they still lag even the *December* FOMC's projections, and now lag the new higher projections even more (please see the chart below).

**Fed funds rate projected by FOMC participants** Average
**December FOMC** **Increase at March FOMC**




Source: FOMC Summary of Economic Projections, TrendMacro calculations

- *This should not be seen as "tightening." It is a logical response that passively indexes policy to strongly improving growth and inflation expectations – core PCE inflation is expected at 2.1% in 2019 and 2020! – reflected in the FOMC participants' projections* (please see the chart at the top of the following page).
- *These improving expectations raise the estimate of the neutral rate of interest. Indeed, the estimate from the Fed's Laubach Williams model has risen by 17 basis points since the December FOMC, while core PCE inflation has stayed stable – which means today's*

**Update to strategic view**

**US FED, US MACRO, US BONDS:** As markets expected, a rate hike and all the dots move up. But this is not tightening, it's indexing the funds rate to the gradually rising neutral rate, rising along with growth and inflation expectations. Policy is no tighter today than it was after the prior rate hike in December. Powell didn't compound his February blunders by failing to repeat Yellen's key guidance language in the FOMC statement. In the post-meeting presser, he failed to explicitly embrace Yellen's doctrine of tracking the neutral rate of interest. But he answered a question about it sensibly, and at least there was no nonsense about "overheating." Powell has stumbled into a hawkish image, but as the first non-independent Fed chair since Miller, the risk is that he will be too dovish. Seeing through the risks arising from his seeming lack of a governing philosophy, this supports improving growth and inflation expectations which should, in turn, support higher long-term yields.

[Strategy dashboard]

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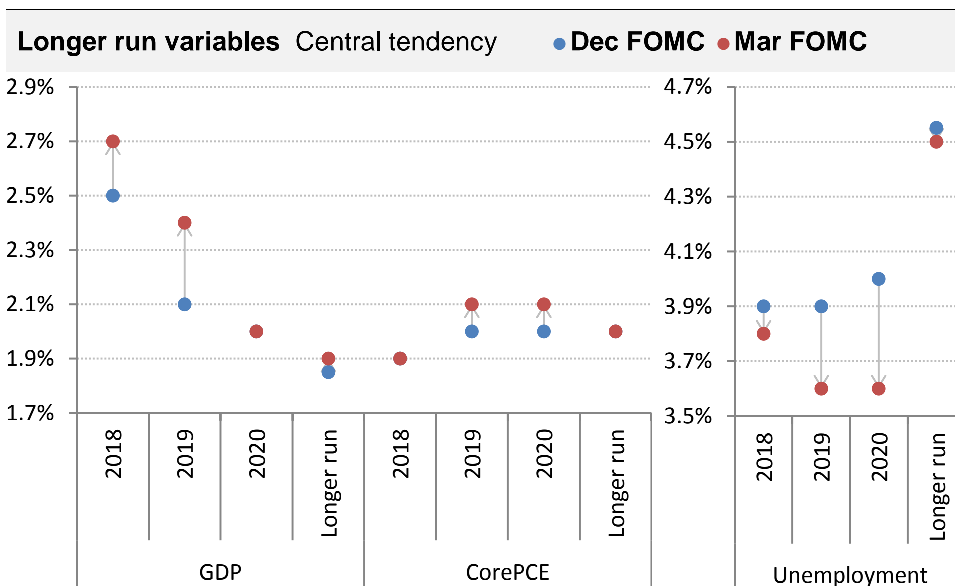
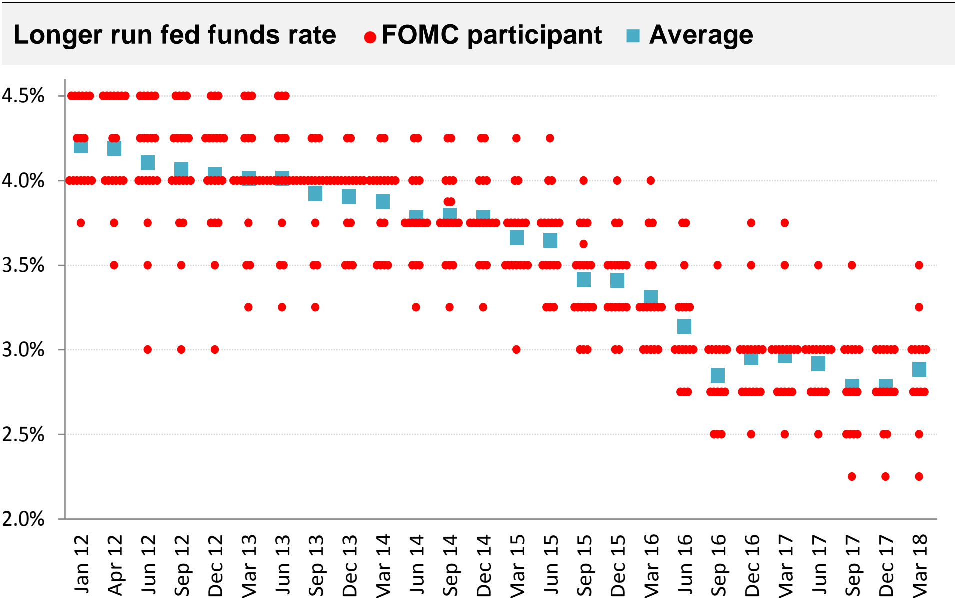



*25 bp funds rate hike effectively leaves policy pretty much as it was then.*

- *It is not "hawkish" – it is merely optimistic, and we think also correct – for the FOMC to expect that the neutral rate of interest is rising. To use their lingo, "headwinds" are becoming "tailwinds." That's a good thing, and it's a good thing to see the FOMC's average estimate of the longer-run funds rate (a close proxy for the neutral nominal rate of interest, assuming 2% inflation) to have ticked up for the first time since December 2016, in the flush of optimism immediately following the presidential election* (please see the chart below).

Today's FOMC statement had only one important new phrase: "The

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**Recommended Reading**

**GOP pushes for 'phase two' of tax cuts**
Naomi Jagoda
*The Hill*
March 18, 2018

**The Real Reason for Trump's Steel and Aluminum Tariffs**
Martin Feldstein
*Project Syndicate*
March 15, 2018

**The Blockchain Pipe Dream**
Nouriel Roubini and Preston Byrne
*Project Syndicate*
March 5. 2018

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economic outlook has strengthened in recent months."

- *Of vastly more importance is what didn't change. The key 44-word sentence that encapsulates the FOMC's forward guidance differs not at all from that of January's. It was absolutely essential that Powell retain this lanugage to signal continuity with the Yellen regime. He came into this meeting with two strikes, and he really needed not to get a third by changing this language and signalling any discontinuity at all* (see "Chairman Powell, You Have Just Been Hazed" February 22, 2018, and "On Jerome Powell's Testimony" February 27, 2018).
- That language has been the way prior chair Janet Yellen encoded the Fed's new policy doctine based on the concept of the neutral rate of interest, or the natural rate, or r-star – which we believe endows the Fed with a rational, rules-based and market-based framework for decision-making (see, among many, "Yellen Gives Conservatives Something to Cheer" February 17, 2017). In Powell's first Congressional testimony in late February, he omitted any references to that doctrine, and regressed into unsophisticated – and arguably hawkish – econobabble about "avoiding an overheated economy."
- Powell is no economist (he's the first non-economist to helm the Fed since the disastrous brief tenure of G. William Miller in the late 1970s). But sophisticated enough so that he shouldn't have made *that* unforced error. In the few speeches on economic matters that he's give in recent years, in at least four cases (June 2016, November 2016, February 2017 and June 2017) he explicitly embraced Yellen's doctrine. In *his* words,

  *"…the so-called neutral real rate or r* has declined significantly… One important implication is that today's low rates are not as stimulative as they may seem – consider that, despite historically low rates, inflation has run consistently below target… Higher growth would increase the neutral rate and help address these issues."*

- So it is disappointing that, unlike Yellen before him, in Powell's prepared remarks at the post-meeting press conference today, he failed to mention this keystone of what we think is now embedded doctrine. *Obviously this raises the question of whether, under Powell, it will remain embedded. While we hesitate to read too much into small market vibrations, this failure may be why equity markets initially reacted well to the FOMC statement, but then declined a but when the presser began.*
- The topic came up when Powell was asked in the press conference whether he believes the neutral rate of interest is rising, and his reply was adequate if uninspiring, and somewhat stumbling. He replied,

  *"Longer run values like the neutral rate of interest…are pinned down by slow-moving forces over time. They don't move around very much… Is it possible that the neutral rate of interest would*

*move up because of, for instance, greater fiscal expansion? There's literature that says that… As you know it did tick up one tenth, in the median… Generally speaking the committee sees the neutral rate of interest is still quite low, and is not seeing it as having moved up, but it's open to the idea that it could move up."*

- *So we needn't worry that he's suddenly decided that the era of "secular stagnation" is unambiguously over, requiring an immediate return of the funds rate to the higher levels typical in the past.*
- *But we note that for the 2020 "dot-plot," one FOMC participant posited a funds rate at the way-out-of-pattern high level of 4-7/8%* (again, see "Data Insights: Federal Reserve"). *Should we be wondering if that is Powell, fretting about "overheating"? Probably not, but the problem is that nobody really has a deep basis for guessing what moves him.*
- We have been tough on Powell since the beginning. He was far from the most qualified man being considered for the job (see "Warsh the Reformer, Powell the Plodder" October 3, 2017). We suspect he was chosen because he will be politically compliant – which means the risk with him is not that he will be too hawkish (as everyone seems to fear) but that he will be too dovish (as was the last non-independent chair, Miller).
- *If that's right, as it plays out, it will be supportive of improving growth and inflation expectations, which should support higher long-term yields.*
- *But it remains an important risk to near-term sentiment that Powell seems to be unanchored to any coherent policy framework. We're very happy with the Yellen doctrine centered on the idea of the neutral rate, and we'd like to see Powell hew to that framework. But at the moment he's not hewing to any framework. He's still a work in progress, and a risk.*

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**Bottom line**

As markets expected, a rate hike and all the dots move up. But this is not tightening, it's indexing the funds rate to the gradually rising neutral rate, rising along with growth and inflation expectations. Policy is no tighter today than it was after the prior rate hike in December. Powell didn't compound his February blunders by failing to repeat Yellen's key guidance language in the FOMC statement. In the post-meeting presser, he failed to explicitly embrace Yellen's doctrine of tracking the neutral rate of interest. But he answered a question about it sensibly, and at least there was no nonsense about "overheating." Powell has stumbled into a hawkish image, but as the first non-independent Fed chair since Miller, the risk is that he will be too dovish. Seeing through the risks arising from his seeming lack of a governing philosophy, this supports improving growth and inflation expectations which should, in turn, support higher long-term yields.