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TRENDMACRO LIVE!

On the December FOMC

Wednesday, December 19, 2018
Donald Luskin

The "not-dovish hike" is a scary echo of Yellen's bull-headed lift-off error in 2015.

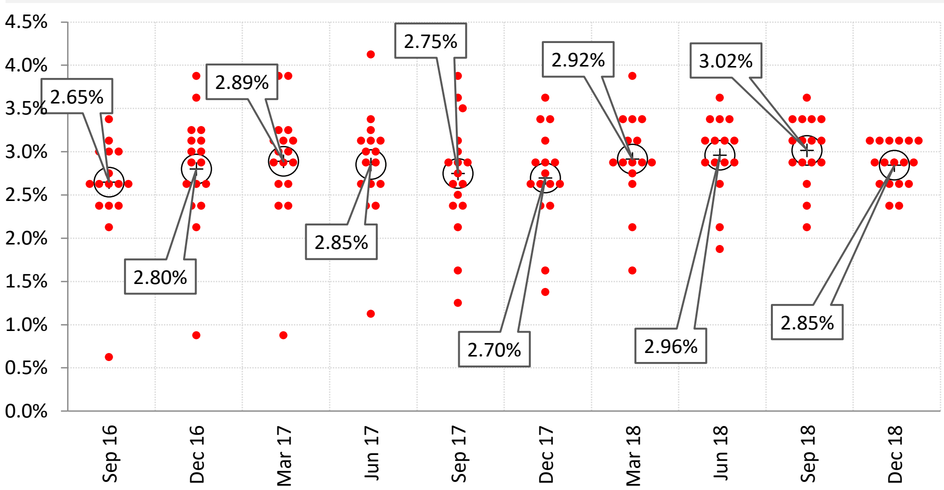
The FOMC hiked the funds target range by 25 bp, as generally expected. *But it hiked the rate paid on overnight excess reserves by only 20 bp, so this was only four-fifths of a rate hike in terms of where we can expect the effective funds rate to trade.* Nevertheless, today's FOMC statement *barely* – and we're being generous – honors the commitment made in the minutes of the November meeting to emphasize that further rate hikes would be strongly data-dependent, which we think was reasonably understood by the market as "this one, and then done, until further notice" (see "Data Insights: FOMC Minutes" November 29, 2018). *This is not the widely expected "dovish hike"* – *it's really not dovish at all*.

- The only dovish new language in the statement – indeed, virtually the only substantive change – was this phrase:

  "The Committee…will continue to monitor global economic and financial developments and assess their implications for the economic outlook."

- In his prepared remarks at the post-meeting press conference, chair Jerome Powell elaborated that this refers to slowing non-US

Summary of Economic Projections optimal funds rate 2019
Individual projections and mean at each FOMC meeting



Source: Federal Reserve Board, TrendMacro calculations

Update to strategic view

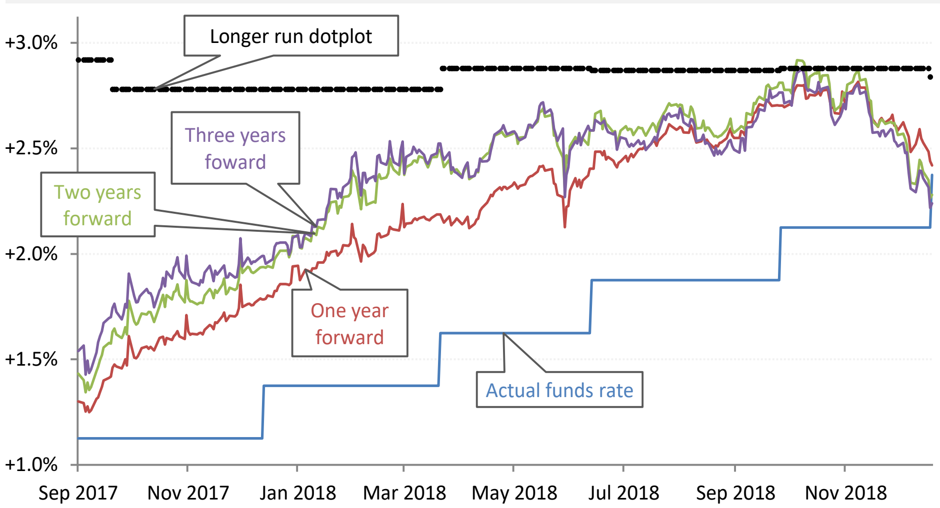
US FED, US MACRO: This is not the promised "dovish hike." The interest rate of overnight "excess reserves" was hiked by only 20 bp, so it's only four-fifths of a hike in terms of the effective funds rate. But the statement language was not strongly changed to indicate a high-bar of data dependency for any future rate hikes, which we believe had been promised in the November minutes, and which surely markets were expecting. This reminds of Yellen's lift-off mistake in December 2015 when she hiked in the face of falling inflation, bond yields, oil prices, stock prices and forward earnings – plus systemic risk in China – and nearly triggered a recession. We think Powell already gets the message that he blew it. It will be a test of the man to see what he does to make up for it.

[Strategy dashboard]

economic growth, and market volatility. He appears completely oblivious to the reality that measured inflation and inflation expectations have sharply contracted – insisting more than once in the press conference that inflation is only "a touch" below target.

- Powell repeated what he said at the New York Economics Club two weeks ago, that the funds rate is now at the low end of the range of estimates of the neutral rate. He went on to say this means that, now, "we will let the data speak to us" – which, objectively, means precisely nothing at all. He said only that it indicated there is "more uncertainty" about the path of future rate hikes.
- *Well, there's sure more uncertainty about how this Fed chair makes decisions. And that's about as dovish as this hike gets, people.*
- *The* Summary of Economic Projections *of FOMC members moved down the "dot plot" for the optimal funds rate at all tenors. For 2019, it fell half-a hike, from 3.02% at the September FOMC to 2.85% today* (please see the chart on the previous page, and "Data Insights: Federal Reserve" December 19, 2018). That still implies two more hikes – but that embeds all kinds of assumptions about the economy which may or may not play out.
- Be that as it may, *it differs sharply from the consensus, which after the meeting shows only a 25% probability of even a single additional rate hike in 2019, and a 65% probability of a cut from today's level by 2021* (please see the chart below).

Actual, implied and projected funds rate



Source: Bloomberg, FRB, TrendMacro calculations

This not-so-dovish hike is a disappointment to the consensus, which only gave a 75% probability to any hike at all. *That makes this the only hike in recent memory that was not completely agreed in advance by the market*. Indeed, based on conversations with clients and the media chatter, this has surely been the most closely-watched and fearfully anticipated FOMC meeting since the dark days of 2008 and 2009. This meeting has brought out the nervous doves– even our hawkish friends at the *Wall Street Journal* editorial page came out yesterday calling for a pause, in doing so grudgingly agreeing with President Donald Trump.

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Recommended Reading

How Peter Jackson Made WWI Footage Seem Astonishingly New
Mekado Murphy
New York Times
December 16, 2018

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We, too, have been saying – for quite some time – that the Fed should pause (see, for example "Like It or Not, Trump is Right about the Fed" July 20, 2018). And we thought the chance of today's hike was only 50% (see "On the November Jobs Report" December 7, 2018). *So this is a disappointment to us – and as of this writing, it is obvious that it is a disappointment to markets as well, with stocks making new lows, long-term Treasury yields falling, and the yield curve narrowing.*

We can be sure that Trump will have something to say about this – and he'll be right, whether or not you think he ought to express his feelings publicly.

- Even by Chair Jerome Powell's own policy framework – if the first non-economist Fed chair since G. William Miller even *has* a framework – there should have been a pause.
- In July, in a question-and-answer session following his debut semi-annual Senate testimony, *Powell said he believed the 10-year Treasury yield was a message from the market about the level of the neutral interest rate. So at 3.26% in early October, it was ratifying another rate hike. At 2.82% pre-meeting it was surely not. Yet Powell went ahead anyway, and as of this writing it's fallen further to 2.76%.*
- *In this sense, today's move reminds us of former chair Janet Yellen's bull-headed "lift-off" in December 2015, when she went ahead with a well-advertised hike off the zero-bound even though bond yields, inflation, oil prices, forward earnings and stock prices were all falling – and markets were focused on systemic risk in China –all very much as now* (see "On the December FOMC" December 16, 2015)*. She nearly helped cause a recession* – and while one was officially avoided then, the following quarter was a rough one, and things didn't stabilize until she admitted her error in March 2016 in a seminal speech at the New York Economics Club.
- That was the same forum at which Powell three weeks ago walked back (sort of) his gaffe of ten weeks ago about the funds rate being "a long way from neutral" (see "Trump 1, Powell 0" November 28, 2018). But unlike Yellen in 2016, Powell in 2018 didn't have the grace to pause further hikes after the walk-back. *Today he went ahead and did it.*
- It's pure speculation, but is it possible this almost inexplicable departure from the market expectations he himself engendered was some public gesture of independence from Trump – this from a man who took the job not expecting to be very independent – even though he knew in his soul that the price of the gesture was a policy error? We can't quite bring ourselves to think so badly of him. But who knows what evil lurks in the hearts of men?
- It did strike us that, whatever was going on in his heart, Powell's body language at the press conference was nervous and defensive, and paced as though he were hurrying to get through it and get it over with. *We think he knows he did not deliver for the markets as promised – and he knows he didn't really have a robust explanation for it. It will now be a test of the man to see how he lives with that, and what he does about it.*

- We're not calling for recession now (we *were* in December 2015), but we are on alert for it (see "Recession Risk at Last?" November 20, 2018). ***Today's FOMC decision is definitely not helpful***, but it's not clear to us that it will be negatively decisive – especially as the hike itself, guidance disappointment aside, was widely expected.
- Let's just say this significantly sets back our hopes that the closing days of the year will be redemptive. We will conclude only by saying that while we have generally supported most of Trump's economic initiatives, we appear to have been right all along that Powell was a very poor choice for Fed chair.

Bottom line

This is not the promised "dovish hike." The interest rate of overnight "excess reserves" was hiked by only 20 bp, so it's only four-fifths of a hike in terms of the effective funds rate. But the statement language was not strongly changed to indicate a high-bar of data dependency for any future rate hikes, which we believe had been promised in the November minutes, and which surely markets were expecting. This reminds of Yellen's lift-off mistake in December 2015 when she hiked in the face of falling inflation, bond yields, oil prices, stock prices and forward earnings – plus systemic risk in China – and nearly triggered a recession. We think Powell already gets the message that he blew it. It will be a test of the man to see what he does to make up for it.