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FED SHADOW

Will the Powell Fed Rewrite the Playbook?

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It's time to admit policy isn't easy anymore – but that's not to say the "old normal" is back.

We should be prepared for some volatility Wednesday if the FOMC makes potentially seismic shifts in key forward guidance language, some of which has been in place *verbatim* in every meeting statement for two-and-a-half years. *The minutes of the May meeting* (see "Data Insights: FOMC Minutes" May 23, 2018) *gave fair warning that big language changes are coming – but as with everything else with the Powell Fed, if they even follow through, it will be difficult to know what any possible new language really means, because we can't be certain that the Powell Fed is capable of basing policy on meaning or, if so, expressing that meaning to markets.* We hate to keep beating up on our new Fed chair – but we're dealing with a dilletante so amateurish that he couldn't remember three of the questions asked him in March at his first FOMC press conference, and had to ask that they be repeated. Not even ECB Governor Mario Draghi does that, and he takes the questions, and answers them, in a language other than his native one.

The first potentially seismic shift would be to a phrase in a sentence that has been repeated *verbatim* ever since the December 2015 meeting at which the funds rate first "lifted off" from zero. We've heard the seven key words in this phrase in 20 consecutive FOMC statements now, and in innumerable speeches. From the May minutes:

> *"…some participants noted it might soon be appropriate to…modify the language stating that 'the stance of monetary policy remains accommodative.'"*

- It's about time, as far as we're concerned. *The funds rate has, in fact, been neutral for many months.* To repeat what we pointed out Friday, the prevailing funds rate was set at the March FOMC meeting 8.4 bp *above* the neutral rate implied by PCE inflation and the Laubach-Williams model's estimate of "R-star," and a hike this Wednesday will leave the funds rate about 6.2 bp *below* – both are within rounding error of neutral (see "Will the ECB Kill Italy?" June 8, 2018").
- *So for us it's just a fact that the funds rate does not "remain accommodative." But what will it mean, if anything, for the FOMC to finally acknowledge it?*
- We'd default to a dovish interpretation (because we think a non-independent Fed chair like Powell will always skew dovish – see,

Update to strategic view

US FED: The minutes of the May FOMC indicated that there could be big changes Wednesday to longstanding and fundamental forward guidance. The FOMC may acknowledge for the first time that policy is now neutral, not accommodative. We would take that as dovish, because it means no more hikes are necessary unless improvements in inflation and R-star drive them. More mysterious is a possible change to the commitment to keep rates, for some time, below the longer-run neutral rate. The minutes' rationale for such a change is nonsensical, but it would be very hawkish if it means that the FOMC suddenly believes that the "new normal" is over thanks to a tax cut and a little defense spending. If only it were that easy.

[Strategy dashboard]

among several along this line, "On the March FOMC" March 21, 2018).

- *Specifically, by acknowledging that the funds rate is now neutral, there is an implicit acknowledgement that any further hikes (without concomitant advances in inflation or R-star) would be to tighten beyond neutral and into the restrictive range. This would be a relief, because we've always worried that a risk of excessive hawkishness could be imparted by the false belief that policy needs to be tightened to even get to neutral.*
- Markets seem to have gotten increasing comfortable that Powell is not the hawk he was originally mistaken to be (see "On Jerome Powell's Testimony" February 27, 2018). There is a chance that a dovish interpretation of declaring policy to no longer be accommodative could complete the market's reorientation to our view that any non-independent Fed chair is automatically a dove – and trigger another bout of irrational fears of the resurgence of above-target inflation. We will argue that policy is only neutral, and that there is nothing here to be feared – besides, haven't we desperately wanted more inflation for the better part of a decade (see "Inflation Fears are Over-Inflated" February 15, 2018)?
- But we suppose someone in the media or Wall Street will take the other view – they will look at the "dot plot" pointing to more rate hikes, and the money-market curve pointing to more rate hikes, and conclude that, if we are at neutral now, it must be the Fed's intention to become restrictive with those hikes. Maybe that's right, but we think it's more likely that those *anticipated hikes mirror anticipated advances in inflation and R-star – which would keep policy neutral even as the nominal funds rate ticks higher.*
- But it's never that simple with the Powell Fed. The full sentence in which the phrase that's subject to change is embedded reads, per the May FOMC:

  "The stance of monetary policy remains accommodative, thereby supporting strong labor market conditions and a sustained return to 2 percent inflation."

- Wouldn't that seem to be saying that if policy is anything but accommodative – say, neutral – that it is *not* "supporting strong labor market conditions and a sustained return to 2 percent inflation"?
- Apparently not. The May minutes say, in the same paragraph suggesting the coming language change:

  "Participants indicated that the Committee…should conduct policy with the aim of keeping inflation near its longer-run symmetric objective while sustaining the economic expansion and a strong labor market."

- *The implication is that, in the mind of the Powell Fed, accommodative policy and neutral policy produce the same economic outcomes.* As far as we're concerned, vice chair nominee

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Recommended Reading

A Process for Capturing CO2 from the Atmosphere
David W. Keith, Geoffrey Holmes, David St. Angelo, Kenton Heidel
Joule
June 7, 2018

Are Emerging Markets the Canary in the Financial Coal Mine?
Kenneth Rogoff
Project Syndicate
June 6, 2018

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[Richard Clarida](#) can't get to Washington soon enough – we need an intervention.

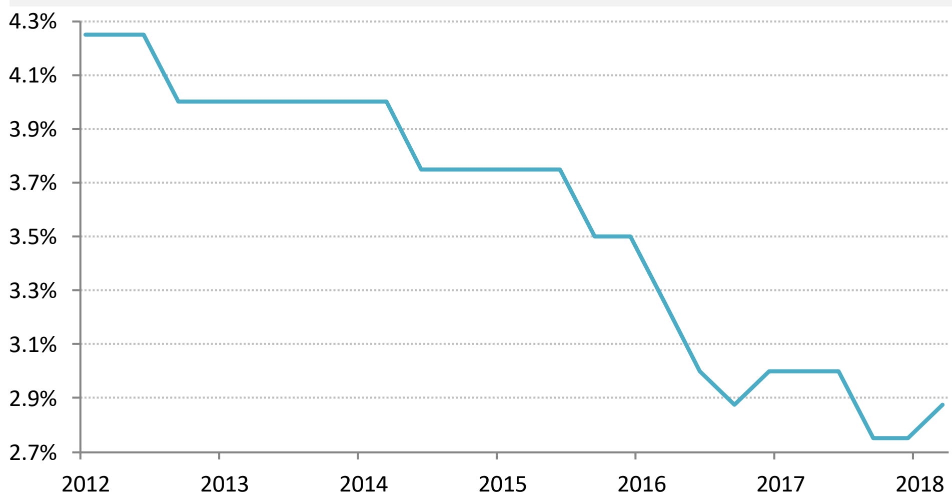
- *What worries us most about this is that as we talk to clients, we find that many believe accommodative central bank policy is the only thing animating global economic expansion and justifying current valuations. A language change dispensing with the claim of accommodative policy – albeit a myth in our opinion – could be a thought-contagion that undercuts confidence and could trigger some brief weakness.*

There is a second and thornier language-change signaled in the May minutes:

> *"…some participants noted it might soon be appropriate to revise the forward-guidance language in the statement indicating that the 'federal funds rate is likely to remain, for some time, below levels that are expected to prevail in the longer run'…"*

- This exact phrase, too, first appeared at the December 2015 "liftoff" meeting, but a substantially identical version originally appeared at the March 2014 meeting, Janet Yellen's first as chair. So we've seen this language in 33 consecutive FOMC statements now.
- This phrase has always had some mystery about it. On the one hand, and most superficially, it seems to be a long-form way of saying that the funds rate will be accommodative for a very long time. But "accommodative" is actually a function of the funds rate versus the *contemporaneous* neutral rate, *not* the "levels that are expected to prevail in the longer run." So we have always understood this language to mean that the contemporaneous neutral rate itself is expected to linger "below levels that are expected to prevail in the longer run." No, even more: we've understood it to at least suggest that the longer-run neutral rate itself may have become permanently lower than in the past – that's

Longer-run projected funds rate policy path Median of FOMC participants



Source: FOMC Summary of Economic Projections, TrendMacro calculations certainly what the FOMC's own longer-run "dot plot" has grudgingly come to say over the last six-and-a-half years (please see the chart on the previous page).

- So what would a change in this language be, or mean? If it is changed to "the federal funds rate is *not* likely to remain, for some time, below levels that are expected to prevail in the longer run" – *would that mean that gradualism is off the table? Would that mean a serious tightening above the longer-run rate is in the offing? Or would it mean that the "new normal" of "secular stagnation" is definitely over and that the longer-run neutral rate itself is now capable of moving up to historical norms?*
- The May minutes aren't very helpful. They only say:

  "…a few [participants] observed that the neutral level of the federal funds rate might currently be lower than their estimates of its longer-run level."

- Which is to state only the obvious: that R-star today at 0.14% (per Laubach-Williams) – which is very slightly above the 0.06% average since the Global Financial Crisis – is below 2.88%, the FOMC's estimate of the longer-run neutral rate (again, please see the chart on the previous page).
- For that matter, 2.88% – which, at 2% inflation implies an R-star of 0.88% – is itself is far lower than the 4.25% estimate of six-and-a-half years ago, which implied an R-star of 2.25%. And *that* is even lower than the pre-crisis long-term average R-star of 3.66% given by Laubach-Williams. So why would any language-change be driven by the stale news that the funds rate is lower than estimates of its long-term level? Only if that phrase in the minutes means that somehow the FOMC has forgotten – and is treating now as mere conjecture – what has long been a self-evident and admitted truth about longer-run equilibrium rates (again, please see the chart on the previous page).
- Seriously? Is this what happens when Powell, in his first public speech as chair, says "headwinds the U.S. economy faced in previous years have turned into tailwinds"? *"Secular stagnation" is over, just like that?* Is all it took a tax cut, some deregulation, a little defense spending, and a dash of protectionism? If only it were that easy.
- Perhaps, as an excessively loyal servant of the Trump administration, Powell believes he has to say that. Democratic Fed Governor Lael Brainard – a considerably cannier person who had been one of the most steadfast "new normal" believers on the FOMC – may have her own motives for suddenly turning 180-degrees and agreeing with the chair. *While Powell sees his duty as bragging about an accelerating expansion, Brainard sees hers as tightening it into a recession in time for the 2020 election.*
- *Don't kid yourself that these people don't play these games.*

Having gone through all this decryption of the coded speech of the Powell Fed, we fear we have overdone it, because our first-order belief is that *the Powell Fed doesn't know how to encrypt policy clues in the first place.*

Maybe markets have come to think the same thing – while we are a little worried about volatility this week if there are big language changes, markets didn't move an inch when the May minutes clearly warned about them. See you on Wednesday afternoon.

Bottom line

The minutes of the May FOMC indicated that there could be big changes Wednesday to longstanding and fundamental forward guidance. The FOMC may acknowledge for the first time that policy is now neutral, not accommodative. We would take that as dovish, because it means no more hikes are necessary unless improvements in inflation and R-star drive them. More mysterious is a possible change to the commitment to keep rates, for some time, below the longer-run neutral rate. The minutes' rationale for such a change is nonsensical, but it would be very hawkish if it means that the FOMC suddenly believes that the "new normal" is over thanks to a tax cut and a little defense spending. If only it were that easy.