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TRENDMACRO LIVE!

On the August FOMC

Wednesday, August 1, 2018
Donald Luskin

The strong economy has strengthened strongly. Did I mention it is really strong?

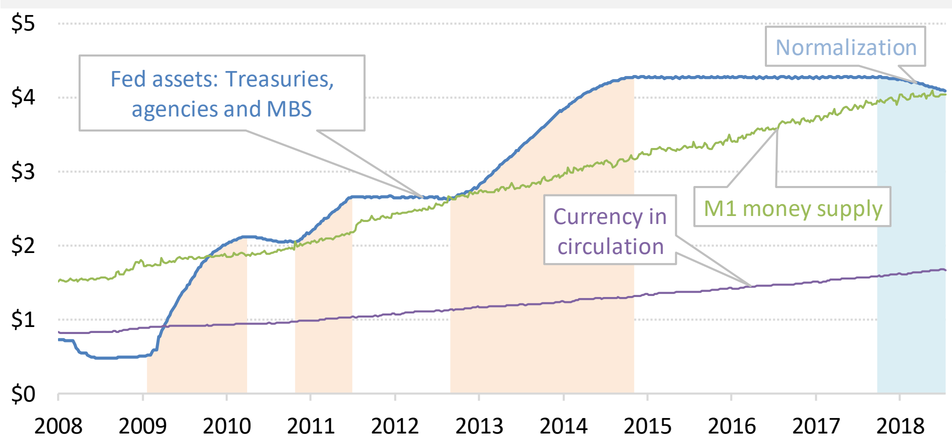
Today's FOMC statement used versions of the word *strong* six times – up from five at the prior meeting – adding a second one in the first sentence. Well, we never said rookie chair Jerome Powell is a polished literary stylist.

The statement says headline and core inflation "remain near" the Fed's 2% target – at the prior meeting, it was only said that they "have moved near." To our eyes, that's the only element here that could be construed as a hawkish change. But it is belied by Powell's statement in a PBS interview two weeks ago that "…we're really close to our target. I wouldn't say we've fully achieved it yet. We're not declaring victory there."

Still present is the familiar chant that the "stance of monetary policy remains accommodative" – despite discussion in both the May (see "Data Insights: FOMC Minutes" May 23, 2018) and June (see "Data Insights: FOMC Minutes" July 5, 2018) meetings of its increasing untruthfulness (see "The Powell Fed Rewrites the Play-book" June 11, 2018). *Based on the Fed's Laubach-Williams model's estimate of "R-star" at 0.14% and yesterday's reported 1.90% core PCE inflation, the mid-point funds rate target is actually only 16 bp below neutral. One more rate hike and, all else equal, policy is slightly tight.*

- The latest R-star estimate is based on Q-1 GDP and inflation, so the neutral rate is probably slightly higher now, given the burst of

The Fed's balance sheet assets: Build-up Normalization USD trillions



Source: FRB, TrendMacro calculations

Update to strategic view

US FED, US MACRO, US BONDS: The FOMC sees the economy as strong and strengthening, using versions of those words six times (up from five at the last meeting). The language claiming that policy is "accommodative" remains, but in fact the funds rate is only half-a-hike below the Fed's estimate of R-Star. When Q-2 data flows into that estimate, the neutral rate will likely move higher, giving the Fed more runway for gradual rate hikes before one of them actually becomes a tightening. We think the economy will continue to justify hikes, with continuing improvement in growth, inflation and long-term yields. Absent that improvement, Trump's controversial case for caution is right. For now, the yield curve remains near-flat, and the Fed's asset portfolio is days away from shrinking to the level of the M1 money supply, at which both QE2 and QE3 were launched.

[Strategy dashboard]

growth in Q-2 (see "Data Insights: GDP" July 27, 2018). This gives a little extra runway to the FOMC's characterization of policy as "accommodative."

But Powell admitted – in question-and-answer sessions last month following both his Senate and House testimony – that *the near-flat yield curve is saying there may not be all that much runway*. He said,

> *"…the yield curve is simply a – a way to identify what is really the important thing, which is where is currently policy and where is expected policy relative to neutral. …if you raised short term rates higher than long term rates, then – then maybe your policy's tighter than you think, or – or it's tight anyway."*

At the same moment, the Fed's balance sheet holdings of Treasuries, MBS and agency securities have now run down from their steady-state level of $4.27 trillion last fall to $4.079 trillion now (please see the chart on the previous page). That's not a big decline in the grand scheme of things, but its about to bring the level of holdings down to the level of the M1 money supply. Twice in the past that was a signal that new asset purchases must begin – giving birth to QE2 and QE3 (again, please see the chart on the previous page).

- As purely a technical matter, maturities of MBS are expected to run below the $20 billion per month cap that will become effective in the fourth quarter. *That means balance sheet shrinkage will be less than the market might have expected. But reports we've seen claiming this indicates a dovish policy change are simply wrong* (this was all explained clearly in the June minutes; see "Data Insights: FOMC Minutes" July 5, 2018).
- Aside from that technical consideration, by pointing out the convergence of the level of the balance sheet with the level of the M1 money supply we're not suggesting that normalization is about to stop or reverse, or that it ought to. When QE2 and QE3 began, risk tolerance, inflation and long-term yields were faltering – conditions today are nothing like that.
- Then again, the Fed has never been clear about the level at which balance sheet normalization will be deemed to be complete. So we'll count this as another thread in *a tapestry of information that ought to be making the FOMC think carefully about how good incoming data would have to be to justify more than a couple more hikes.*
- That, in essence, is President Donald J. Trump's controversial critique of Fed policy (see "Like It or Not, Trump is Right about the Fed" July 20, 2018).
- Nor are we suggesting that the Fed is about to make a hawkish policy error (we think that Powell, as a non-independent chair, is necessarily biased to make *dovish* mistakes). *Market expectations for further hikes – not extravagant by any means, with the money market curve only implying three more hikes over three years – likely have baked in some degree of improvement in growth, inflation and long-term yields, in which case those hikes would not*

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NBER Working Paper
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be tightenings at all, only the maintenance of today's near-neutrality.

- *We share those expectations for improving growth, inflation and yields, and indeed would expect more hikes in this cycle than the consensus does, because we expect more improvement.*

Bottom line

The FOMC sees the economy as strong and strengthening, using versions of those words six times (up from five at the last meeting). The language claiming that policy is "accommodative" remains, but in fact the funds rate is only half-a-hike below the Fed's estimate of R-Star. When Q-2 data flows into that estimate, the neutral rate will likely move higher, giving the Fed more runway for gradual rate hikes before one of them actually becomes a tightening. We think the economy will continue to justify hikes, with continuing improvement in growth, inflation and long-term yields. Absent that improvement, Trump's controversial case for caution is right. For now, the yield curve remains near-flat, and the Fed's asset portfolio is days away from shrinking to the level of the M1 money supply, at which both QE2 and QE3 were launched.