Trend Macro™

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TRENDMACRO LIVE!

On the September FOMC

Wednesday, September 26, 2018
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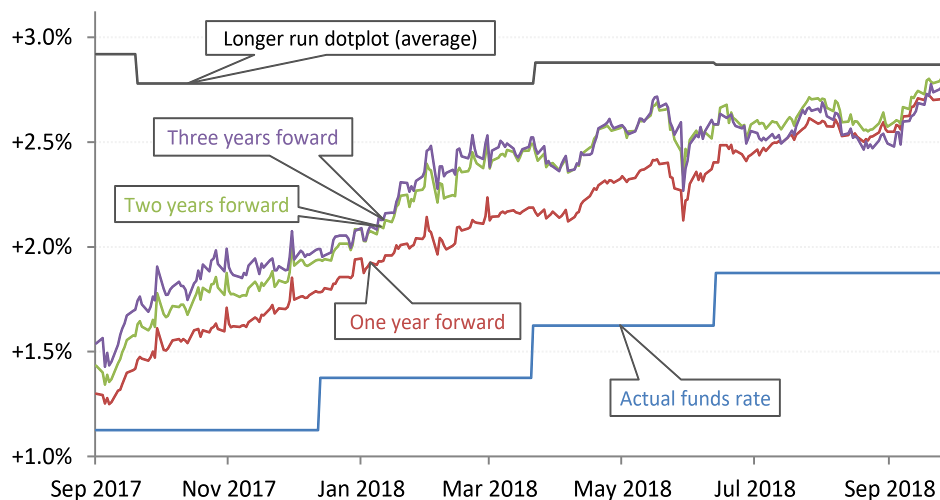
Short-term the Fed is optimistic. Long-term, it fears secular stagnation lives on.

Today's FOMC statement changed not a word from that of the August meeting – except to announce a well-expected 25 bp rate hike, and to eliminate the long-standing language that "The stance of monetary policy remains accommodative, thereby supporting strong labor market conditions and a sustained return to 2 percent inflation." This has probably been true for a while, and we've been expecting if (see "The Powell Fed Rewrites the Play-book" June 11, 2018).

Other than that, the statement still sees the economy as "strong" – indeed using the word "strong" or a version of it six times in the first paragraph, as it did in August.

- *That said, the* FOMC participants' Summary of Economic Projections *moved a bit toward the pessimistic for the long term – as though to imply that the committee sees the present higher rates of growth as only a temporary vacation from "secular stagnation*."
- The "dot plots" confirm another rate hike in December, and three in 2019 – nothing new. But the *average* "longer run" optimal funds rate rose only 1 bp, reflecting no improvement in the long-term view of the economy in equilibrium (please see the chart below).

Actual, forecasted and market-implied forward funds rate



Source: FRB, Bloomberg TrendMacro calculations

Update to strategic view

US FED, US MACRO, US BONDS: Gone is the language that policy is accommodative – this matches the facts, and was well anticipated, as was today's rate hike. There was no substantial change in the "dot plots," except that they weakened in the out-years, and despite the present improvement in growth and inflation, there was no upgrade to the average "longer-run" equilibrium funds rate – suggesting no improvement in hopes for an end to "secular stagnation." Today's rate hike, and the three anticipated next year, will only be indexations to anticipated growth – not policy tightenings. Powell highlighted the supply-side effects of the corporate tax cuts, but relegated them to an uncertain future. Powell is watching the yield curve, and looking to the 10-year to ratify and give permission for further hikes. We see nothing hawkish in today's FOMC, and expect growth, inflation and the 10-year yield to continue to improve.

[Strategy dashboard]

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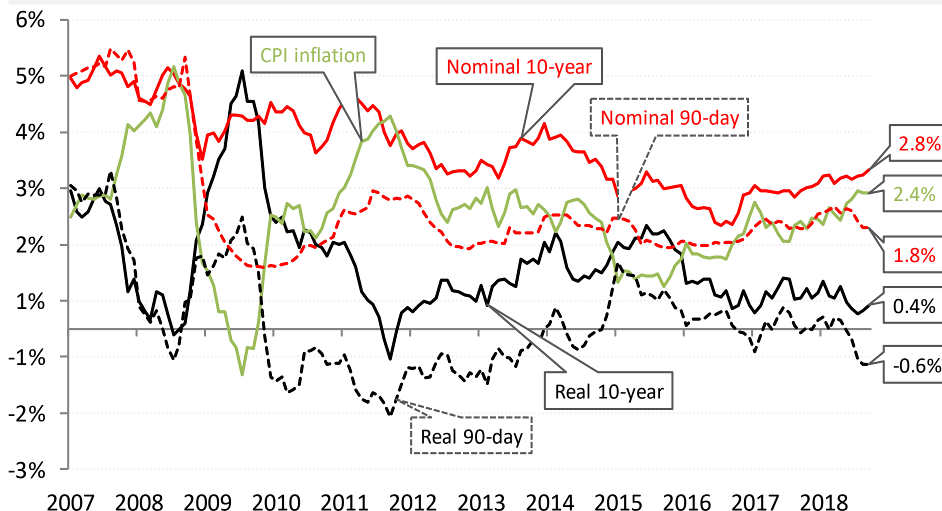
- The *average* value of the optimal funds rate for 2020 fell by 3 bp, and the *average* for 2021 – introduced for the first time today – is 5 bp lower than that. (Note that most accounts report the *median* – but we think the *average* is more representative of the group psychology of the FOMC.)
- Estimates for GDP growth in 2021 – this too introduced for the first time today – show a slowing to 1.8%, down from 1.9% for 2020 and 2.4% for 2019 (see "Data Insights: Federal Reserve" September 26, 2018).
- But all that's in an indefinite future. In the meantime, for the shorter-term, we're not worried that the FOMC thinks the economy is strong, because the economy *is* strong. *And it is useful to have pessimism about the distant future if it keeps the Fed from over-reacting to optimism in the present.*
- We said at the prior FOMC meeting that we agreed with the committee's view that growth and inflation were improving – and therefore that further rate hikes would only be "indexing" to that, not actual tightening (see "On the August FOMC" August 1, 2018).
- It's all come true, and the money-market curve since then has built in another half rate hike or so over the coming three years, all front-loaded in the first year. At the same time, and also as we anticipated, 10-year Treasury yields have moved higher (admittedly, having been lower for a while first).
- We understand that the conventional wisdom is that this represents a tightening of financial conditions. We don't agree. For one thing, this year global inflation has risen faster than either global rates or global yields – so *real* rates and *real* yields have been coming down (please see the chart below, and "Data Insights: Global Real Rates and Yields" August 31, 2018)

Global real rates and yields (GDP-weighted US, EA, UK, JP, CH, BR, IN)



Source: Bloomberg, TrendMacro calculations

- We also understand that it is conventional wisdom that, as the economy and inflation continue to improve, further hiking expectations drive the 10-year yield upward. That thought model

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Recommended Reading

The Fault Lies in R-Star and in Ourselves
Kevin Warsh
Wall *Street* Journal
September 26, 2018

[Reading home]

seems to hold that the long end of the yield curve simply sits on a platform raised and lowered by the short end. We think it should be obvious that is not so, or else the slope of the yield curve would never change, and we would never have to worry about it inverting.

- *We think the reality is that, with the economy still barely awakening from secular stagnation, if additional expected rate hikes were seen as excessive, then they would be seen by the long end of the curve as deflationary and contractionary, which would move long rates lower relative to short rates, and flatten the curve.* But as the front end has built in another half rate hike over the last several weeks, the 2-10 spread has actually steepened a bit.
- *That tells us that the 10-year is ratifying today's rate hike and more – or, to put it another way, giving Powell permission to do it.* Remember, Powell is using the 10-year as a version of r*, and as a policy rule. In question-and-answer sessions in both the Senate and House in July, he said:

  "…longer run rates also tell us something…about what the longer run neutral rate is. That's really, I think, why the slope of the yield curve matters. So I look directly at that...

  "…in other words, if you raised short term rates higher than long term rates, then maybe your policy's tighter than you think…"

- We're not sure that the 10-year is really the same thing as r*. But as policy rules go, this probably isn't a bad one. One of its virtues is that it is a market-driven "price signal," potentially aggregating the wisdom of the global economy in guiding monetary policy. It's perfect for non-economist Powell, who has conspicuously turned away from model-driven approaches (see "The Fault is in R-Star" September 17, 2018).

The post-meeting press conference today was a non-event. If we may be permitted a subjective impression, it felt dreary and dull to us. The media seemed intent on focusing on potential problems, and Powell resolutely refused to engage on them, keeping everything at a very superficial level. The result was highly tedious, and we dread next year when events like this will follow all FOMC meetings rather than alternate ones.

But we note that we were delighted to hear Chair Jerome Powell speak to the long-term supply-side effects of the large US corporate tax cuts. In his own words, he articulated exactly the path of incentive effects that we have written about so often – the potential for firms to make productive new capital expenditures based on higher after-tax anticipated returns made possible by lower tax-costs (see, among many, "Tax Cuts: Smells Like Victory (For Some more than Others)" December 18, 2017).

- Powell spoke to the long-term and uncertain nature of these effects. We take that as indicative that he and other FOMC participants, and their staffs, are pretty much ignoring that engine of growth in their long-term outlooks. They are likely making the

mistake that most observers make on this subject – obsessing on the demand-side effects of the tax cuts as a one-time “stimulus” to the economy, rather than a permanent pro-growth structural reform.

- Since the tax cuts were passed, through mid-year, US non-residential fixed capital formation has already grown by $126 billion at an annual rate, equaling in two quarters 2017’s entire growth over four quarters.
- Since the tax cuts were passed, through the present, S&P 500 forward CAPEX per share has grown by 14.4%, almost equaling the red-hot 17.4% growth rate of earnings.

Bottom line

Gone is the language that policy is accommodative – this matches the facts, and was well anticipated, as was today’s rate hike. There was no substantial change in the “dot plots,” except that they weakened in the out-years, and despite the present improvement in growth and inflation, there was no upgrade to the average “longer-run” equilibrium funds rate – suggesting no improvement in hopes for an end to “secular stagnation.” Today’s rate hike, and the three anticipated next year, will only be indexations to anticipated growth – not policy tightenings. Powell highlighted the supply-side effects of the corporate tax cuts, but relegated them to an uncertain future. Powell is watching the yield curve, and looking to the 10-year to ratify and give permission for further hikes. We see nothing hawkish in today’s FOMC, and expect growth, inflation and the 10-year yield to continue to improve.