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FedWatch: Bullard Cleans Out the Hawks

We hope the Trump Administration caught current St. Louis Fed Chief Jim Bullard on CNBC Thursday morning. He delivered a reasoned, sensible case for abandoning all hawkishness. Not only is a dovish stance appropriate given the global interest rate environment, it would allow the current expansion to continue for at least several more years, according to Bullard.

Given Bullard's prescient admonitions during Q4 2018 that the Fed was going in the wrong direction with rate policy and that a 2.25% Fed funds rate was "too tight," much of today's appearance resembled a victory lap.

Certainly, he should be on the Administration's short list for candidates (along with Herman Cain) to fill the remaining two vacancies on the Fed's Board of Governors. In 2020, Bullard will lose his FOMC voting rights as the St. Louis Fed Chief. President Trump should simply promote him.

Bullard exposed the weakness of several arguments used by the Fed's hawks last year, which included: First, the idea that monetary policy must be "normalized" relative to previous eras. Second, using the Phillips Curve model as reference for contemporary monetary policy. Third, the idea that Fed policymakers can ignore signals from the global market on what kind of interest rate environment we are in.

First, on normalization, Bullard made clear at the outset, "[T]he message from my point of view is the normalization process in the United States is coming to an end."

To Bullard, interest rates have risen quite nicely from the near-zero bound and the balance sheet has been substantially reduced – mission accomplished.

On the balance sheet, he cited the 40% reduction in reserves as enough, pointing out the actual demand for reserves is "much larger" than what the FOMC originally thought due to factors such as Dodd-Frank.

Importantly, he reframed the reference point for "normalization." While US interest rates may be low compared to historical periods such as the 1980s or 1990s, we're not in the 1980s or 1990s. We're in a new rate environment. About $10 trillion in debt now exists under negative nominal rates (think Europe and Japan). By contemporaneous reference points, US rates are quite high (and not even close to ECB & BoJ norms).

Such an acknowledgement by Fed thought leader Bullard could portend a radical rethink on Fed policy and US Treasuries going forward.

Second, Bullard expressed confidence the Fed will not suddenly turn back to hawkishness if the economy improves further. Noting the "blockbuster" growth of the last

two years, with no threat of an inflation overshoot, Bullard believes the Phillips Curve sympathizers are now backing off on their belief that economic growth will produce an uptick in inflation.

Third, in discussing inflation, Bullard noted the Fed may again undershoot its inflation target this year, which it has done since 2012. His solution is to re-center its inflation target higher and not ignore the global interest rate environment. To Bullard, the risk-free rate has been in steady decline over the past 30 years to the point where it is now likely negative. By implication, a funds rate of 2.5% is too high.

Discussing the FOMC's abandonment of hawkishness soon after the December 19 decision, Bullard said for the record:

> [The December rate hike] was a step too far. I argued against that move. We did get a bad reaction in financial markets. I think the market started to think we were too hawkish, might cause a recession. You've got this yield curve issue hanging out there…with almost inverted, depending on where you look on the yield curve, so I think all of this weighed on the committee and got people to change their tune.

In fact, given the continued narrowing of the yield curve (with 10YR-3M spread just 20 bps), Bullard's über-dovish talking points on Thursday may be the start of a Fed effort to avoid an inverted yield curve. **Institutionally, Bullard's talking points clearly set the table for a future rate cut.**

10Y-3M UST spread considered the most accurate spread in predicting recession; just 20bps above inversion.

This may be one reason why stocks failed to rally Thursday. Given all the concern about deepening economic slowdowns in Europe, China and Japan, Bullard's belief that US

rates are “too high” could be raising question marks over the US growth outlook. At the least, such a strong hint that the next move on rates is down could be unsettling for investors conditioned to understand the Fed usually reduces rates once an expansion has been mortally wounded.

Certainly, if economic growth remains steady around 2%-3%, but the yield curve threatens to invert, Bullard and other doves could credibly argue for stronger moves on rates lower instead of the 25 bps increases witnessed since December 2015. Given the low (in some cases negative) interest rate environment, a 50-basis-point reduction in one meeting is no longer unthinkable. But it would likely send the UST 10YR yield below 2.5%.

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