

March 20, 2019

## Fed Policy Lagging Market Expectations

If the market was looking for assurances from the Fed about the sturdiness of the US or global growth outlook, today was a disappointment. Many of Powell's observations cited lagging data and statistics while highlighting uncertainties in China and Europe, including Brexit. The best Powell could muster during his press conference was that it was a "great time for the Fed to be patient" and that the FOMC would be in "watch and wait" mode.

The FOMC statement delivered several downgrades on US economic growth -- economic activity has slowed, payrolls are little changed, household spending has slowed along with business investment -- in arguing for patience and continued pause on the funds rate. As it was last quarter, the Fed is behind the curve. During his prepared remarks in the post-FOMC press conference Powell admitted, "Growth [since September] is slowing somewhat more than expected."\*

Equities quickly popped higher on the initial FOMC decision, only to give up ground shortly afterward, as Powell's press conference began. By the end of the afternoon, US equity indices across-the-board had made a near-roundtrip to the negative levels seen prior to the 2pm ET FOMC policy announcement.

Powell stated that balance sheet normalization would conclude by September 30. The balance sheet would likely end up around \$3.5 trillion. (It is about \$3.9 trillion today.) And today's 2.5% Fed funds rate (upper limit) is within the range of estimates the Federal Reserve considers "neutral."

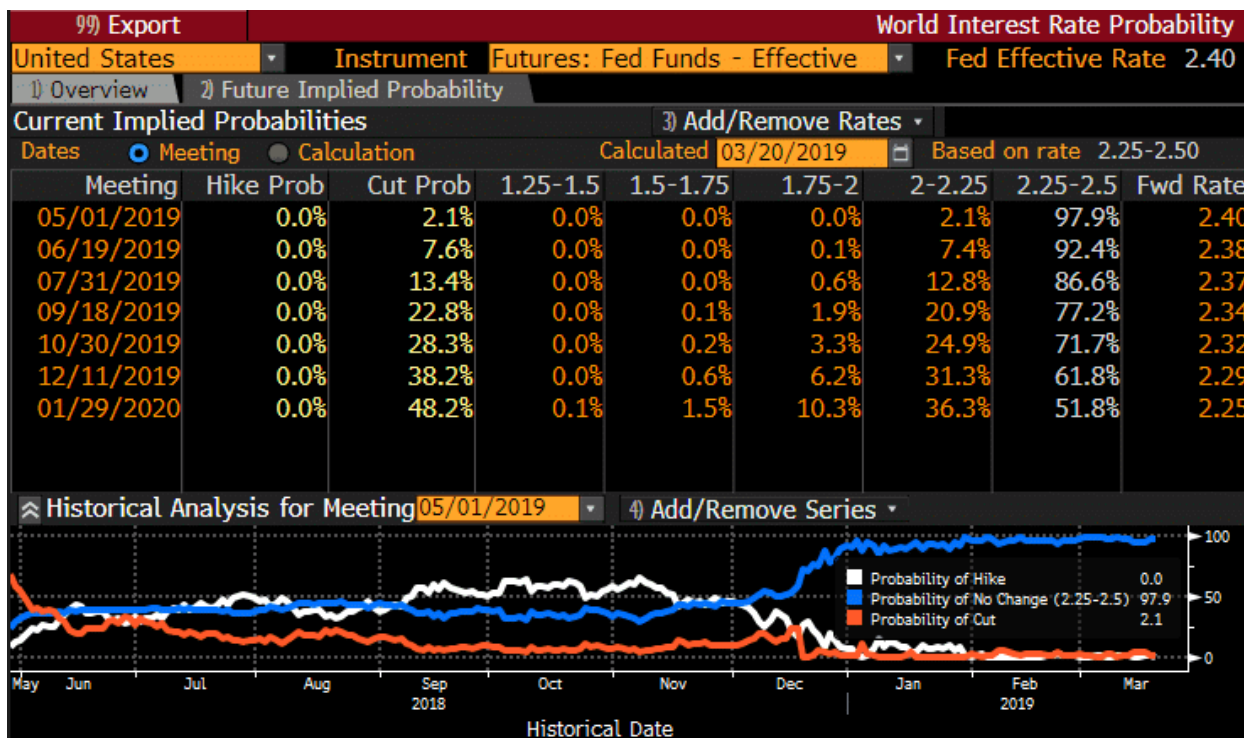
From the Fed's Summary of Economic Projections, there now is a solid majority against raising rates for the rest of 2019. Eleven members project no rate increase for 2019; four project a single quarter-point hike; two project two quarter-point hikes. We suspect the two uber-hawks are voting FOMC member John Williams (the NY Fed Chief, whose cavalier disregard for an inverted yield curve and inappropriate hawkishness make him BWR's "most dangerous man for 2019") and a non-voter, either Kansas' Esther George or Cleveland's Loretta Mester.

Six FOMC members believe the "longer-run neutral rate" (running to 2021) is 2.5%, precisely where it is today. They represent the vanguard of a budding new dovish consensus, which likely includes St. Louis Fed Chief and 2019 FOMC voter Jim Bullard.

Although not as pronounced and dangerous as it was in Q4 2018, the expectations gap on future policy between the market and the Fed remains a source of volatility for markets. Twice during the Q&A session of Powell's press conference, the fact was raised that Fed funds futures suggest almost a 50% probability of a rate cut in January 2020, while the FOMC suggests a rate hike.

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Powell showed little interest in acknowledging or discussing the market's stance vis-à-vis the Fed's, mostly repeating lines that the data are "not signaling" a move in either direction and the Fed will remain patient as it watches what economic developments occur.\*



The gap is reflected not only in fed futures, but also the 10-year yield, which is declining nearly in step with rising odds of a rate reduction. Today, the yield dropped to 2.53% from a close of 2.61% yesterday, the biggest one-day drop in almost a year.

Without Fed jawboning the removal of a rate hike from the future schedule altogether, the 10-year yield could easily drop lower. Indeed, we are probably just one major financial disruption away from a rate cut on the Fed's menu and/or an inverted yield curve.

A flat-to-inverting yield curve could produce troubles of its own that could swell to significant disruptions down the road. Certainly, for US financials that require a positive spread to gird profit margins, a flat-to-inverting yield curve is an unwelcome phenomenon and could hurt the availability of credit to cash-poor companies hoping for access to capital to expand. This may explain the recent underperformance of the US Financials ETF (XLF) and the Russell 2000 ETF (IWM), as portions of the yield curve have inverted. The two have been nearly joined at the hip since Q4 2018.

For now, reported slowdowns in China and Europe have put their respective central banking institutions in dovish mode. China is applying fiscal stimulus and it is emerging

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in Italy and France, while Germans are debating it. **Bottom line: it's not exactly clear anything must break in the near-term.**

## 3 Notable Positives to Powell's Q&A:

**Encouraging More Labor Force Participation.** As in his Humphrey-Hawkins testimony in February, Powell argued for greater labor force participation. This is a clearly dovish signal. Recall this is the series Janet Yellen repeatedly referred to in pushing back against the march to higher rates in 2014 and for much of 2015. The pre-Great Financial Crisis level for LBF was about 67%; today it is closer to 62%. If it becomes Powell's litmus for "full employment," this would furnish a lower-for-longer argument.

**When Will Americans Get a Raise?** Citing Vice-Chairman Richard Clarida's argument during his PIMCO days that real wages could rise faster than productivity without risking inflation because the growth would mean a higher labor share of income, Bloomberg's Matt Boesler asked if Powell was prepared to allow wage growth to rise above long-term interest rates. (This was a sophisticated way of asking Powell, "When will Americans get a raise?" It's the same question labor-champion Denny Heck (D-WA) has raised in recent years.)

Wage growth, as represented by hourly earnings in the following chart, has been moving up nicely. So long as the Fed refrains from trying to slow the economy with higher rates, we expect this positive trend to continue. Demand-siders would view this as a consumption-led expansion.



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Powell did not address the issue in the affirmative or negative, stating only that consistent with its mandate, the Fed does not explicitly target “wage inflation.” But he referred to “wage inflation” as “good,” which was also welcome.

**Tariffs Not Killing Global Economy.** Powell responded to CNBC commentator Steve Liesman’s question about tariffs affecting the global growth outlook by stating that while tariffs may have some impact, it is not the main factor with China. We completely agree.

Xi has fashioned himself as the second coming of Chairman Mao in his bid to deliver heavy-handed significant changes to the Chinese economy, including a severe corruption crackdown, pollution crackdowns, shifting to consumption-fueled growth model from an export-led one, and a tough deleveraging meant to reduce the number of suppliers of goods and resources to the economy, which Powell correctly notes as the primary driver of the 2018 slowdown.

Trade truce aside, China’s exported goods to the US, estimated at \$567bn, represent about 4% of China’s \$14 trillion in GDP. The idea that an embattled Xi Jinping is willing to overhaul China’s national development and trade strategies on that basis does not sound compelling to us.

More likely, we believe an era of “managed hostility” on trade can continue, i.e., higher tariff schedules on China, with some retaliation back, but in an asymmetrical pattern.

Arguably, the mutual decision between DC and Beijing to postpone any trade deal to June suggests Beijing is prepared to accept higher US tariffs on Chinese goods as the cost of doing business with the US. In that context, any further delays in trade talks serves only to “bake in” the Administration’s practice of raising and extending tariffs to an increasing number of Chinese goods. This could be the new norm with China.

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\*clarifications from transcript.

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