June 2019

Fed Thoughts:
A Riot is an Ugly Thing

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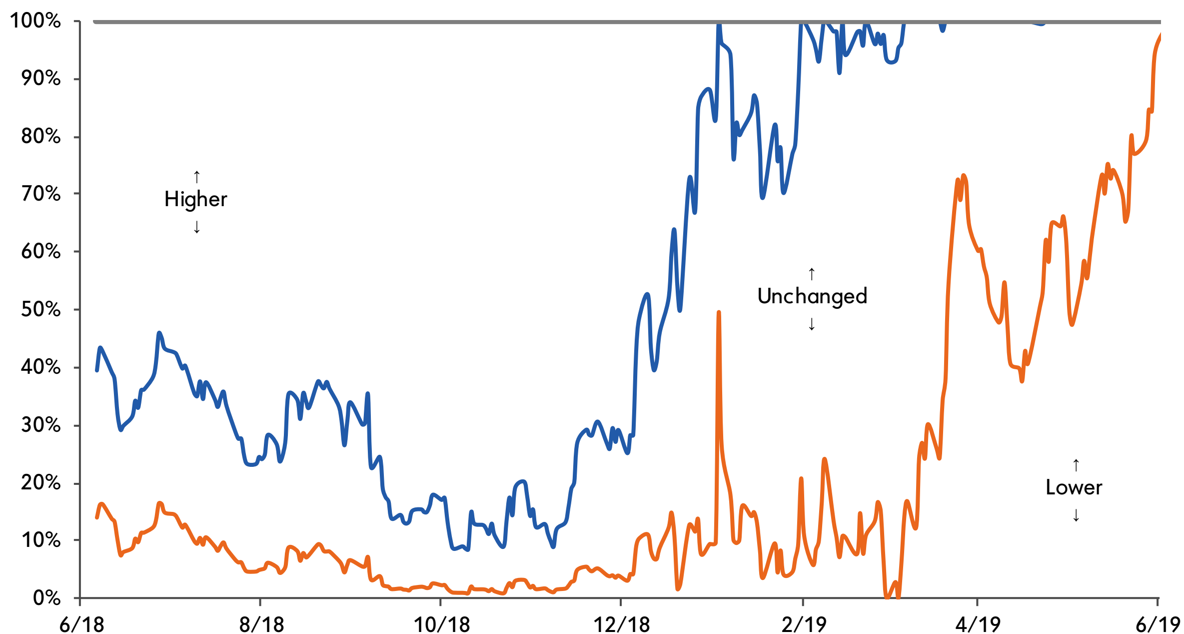
Federal Reserve (Fed) Chair Jay Powell was a junior at Princeton in 1974. One wishes that he took some time out from studying political science and playing guitar to hit the movie theaters. The most popular film showing then was *Young Frankenstein*, which is now appreciated as the Mel Brooks-Gene Wilder classic. The one-armed, dart-throwing Police Inspector Kemp offered advice relevant to the future central bank leader: “A riot is un ugly thing, und once you get one started there is little chance of stopping it.”

Fed Chair Powell either stuck to the dorms or did not heed the advice, because 45 years later he started the financial market equivalent of a riot with his pivot away from policy firming this January. We know why. At the end of 2018, market participants became convinced the Fed was in cruise control toward a macroeconomic cliff. Fed guidance implied that more tightening was in store and the balance sheet, to quote Fed Chair Powell, was on “autopilot.” This posture seemed overdone given the slowing in world trade, especially with disappointment in the economies of China and the Eurozone.[1] The sharp selloff in risk assets and downdraft in liquidity prompted a policy pirouette. (While this also coincided with the volume and virulence of presidential tweets, we are of the mind [and the hope] that correlation does not convey correlation. Best of luck on that.)

“Un ugly thing” ensued in financial markets as investors quickly took out any probability of policy tightening (the distance between the green line and the upper threshold at 100 percent in the chart below) and mobbed to the expectation of easing (as shown by the orange line).

Federal Funds Rate Target in December 2019

Relative to 2¼ Percent Target

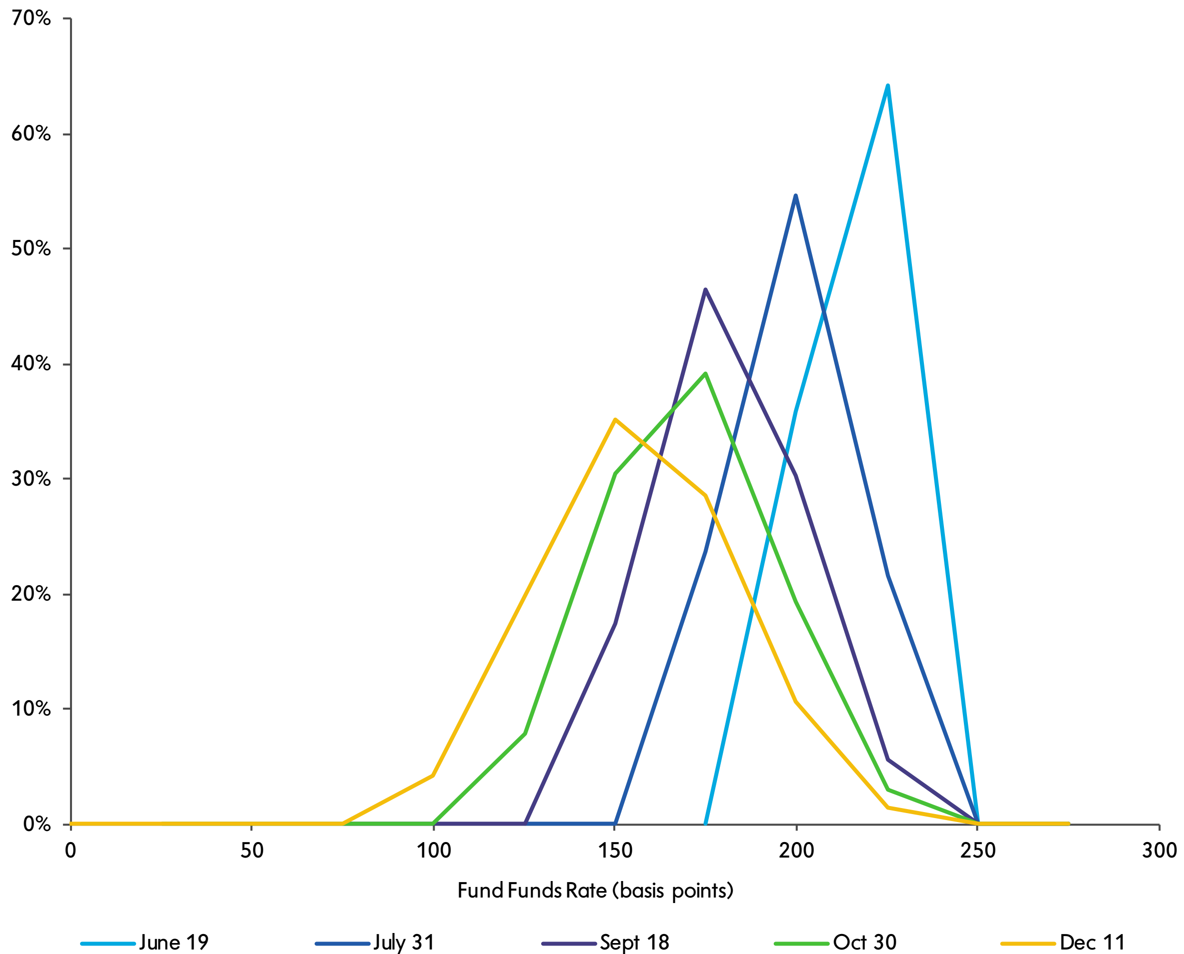


Source: CME FedWatch tool, accessed June 7, 2019.

Fed funds futures put easing this year as a certainty, probably one of the few in our uncertain world.

Indeed, the sequence of futures prices maps to aggressive policy cuts at this year's remaining Federal Open Market Committee (FOMC) meetings, seen as the probability distribution below. About one-quarter of the probability mass rests on easing at the upcoming meeting and the most likely outcome for December is a fed funds rate 75 basis points lower than the current target.

Implied Probabilities of Fed Action -2019 Meetings



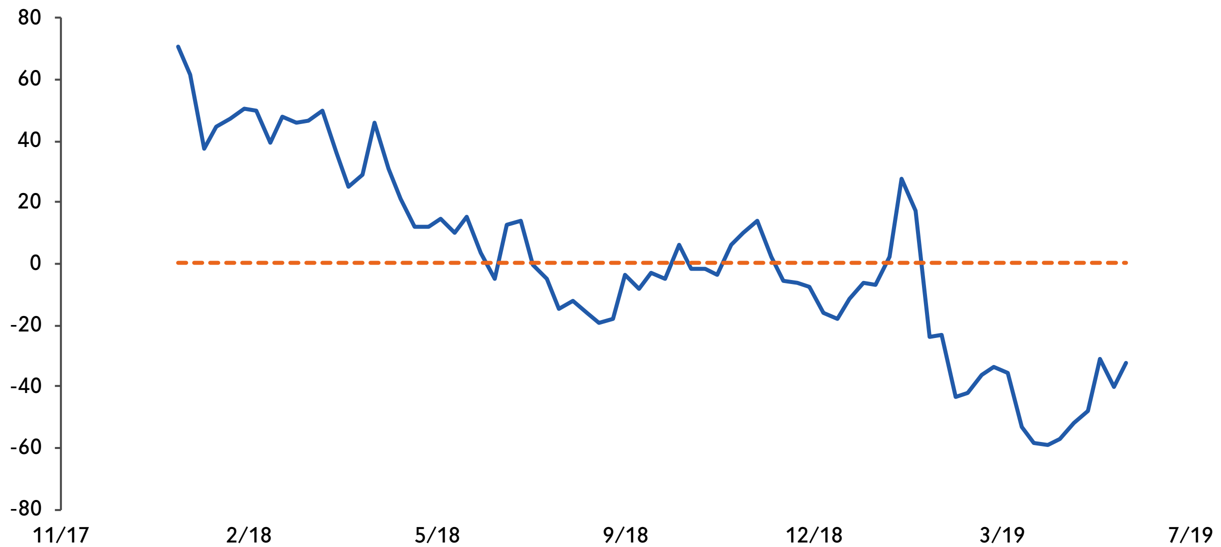
Source: CME FedWatch tool, accessed June 7, 2019.

As with reanimating pieced-together corpse fragments, we believe this is wrong on so many counts and in so many different directions that it is hard to know where to start. Probably the most efficient line of attack is from the far-forward prediction back to now. The Fed easing 75 basis points in the next six months would not represent the tactical purchase of insurance. Rather, it would eventuate by serious recession concerns. That is hard to square with the current pricing of risk. If we are in an economic recession, or about to teeter into one, a more significant selloff in equities and widening of credit spreads should have already occurred.

Yes, the momentum of US economic activity has flagged. Economic surprises (or actual releases relative to survey expectations) have run in the red and purchasing managers' spending intentions (PMIs) are dropping toward the neutral barrier of 50. President Trump has a hammer of tariffs and trade sanctions and, apparently, sees a lot of nails sticking out. These are, respectively, indicators of a slowing expansion and a risk to the global outlook.

Economic Surprise Index

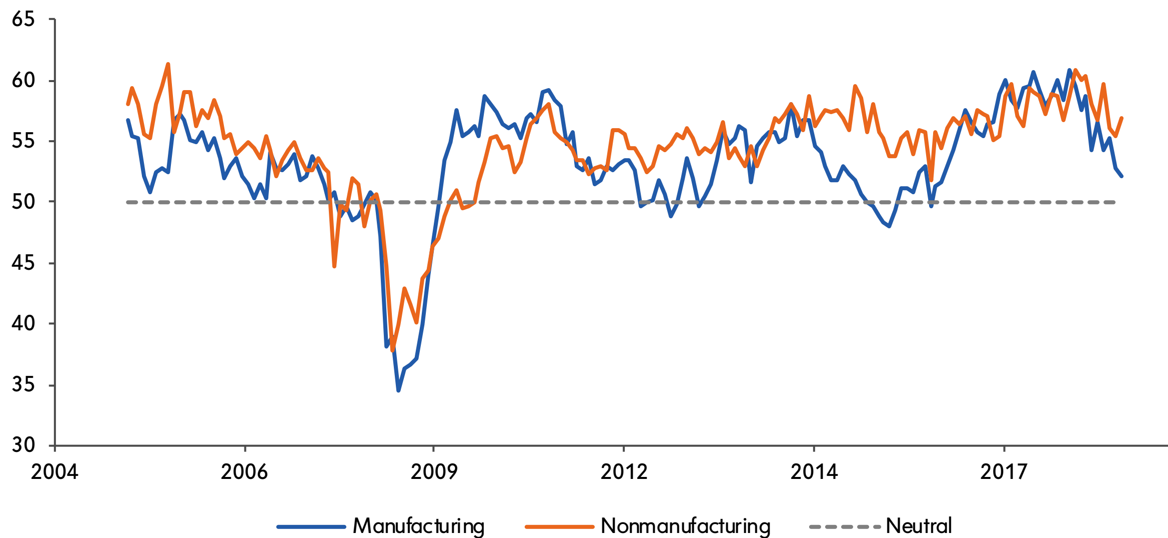
Neutral = 0



Source: Citi Markets and the Institute for Supply Management, accessed via Bloomberg, June 6, 2019.

ISM Purchasing Managers Index

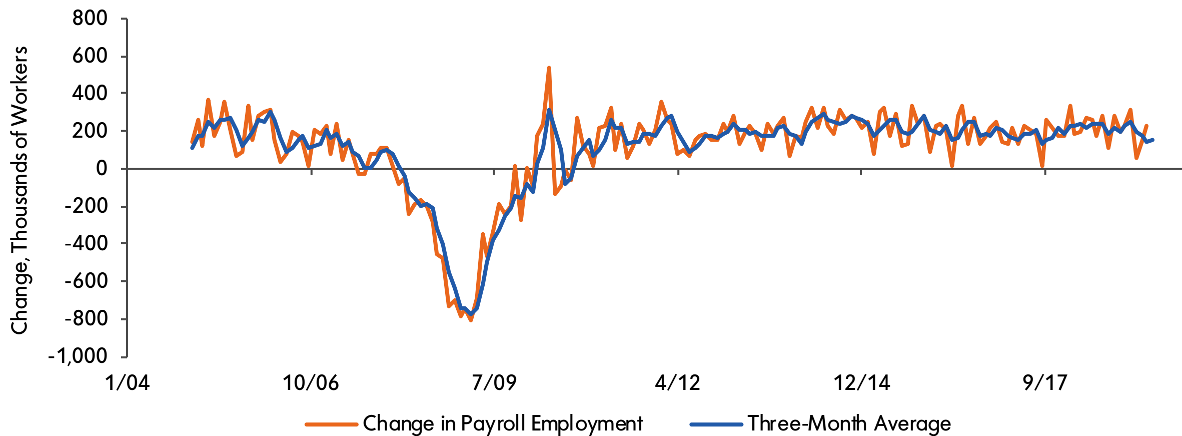
Neutral = 50



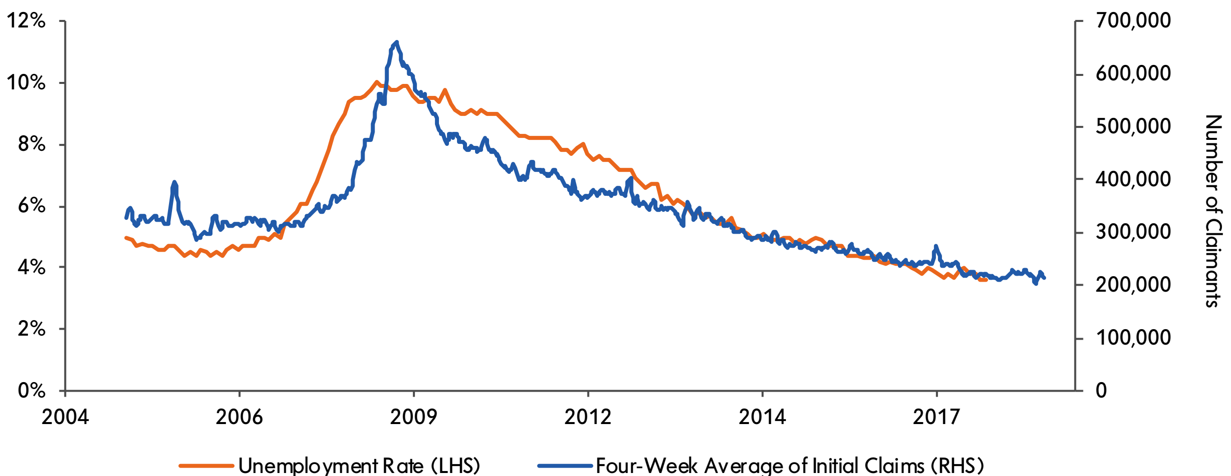
Source: Citi Markets and the Institute for Supply Management, accessed via Bloomberg, June 6, 2019.

The PMIs appear consistent with an inventory correction in manufacturing, where production and sales track the twists and turns of tariff talk. Even with the weak May employment report, job gains are averaging close to 200,000 on a 12-month basis. The unemployment rate, at 3.6 percent, remains low and aligns well with the higher-frequency readings on initial claims. With financial conditions remaining accommodative, on net, this does not appear to be an economy about to roll over.

Nonfarm Payroll Employment



Labor Market Utilization



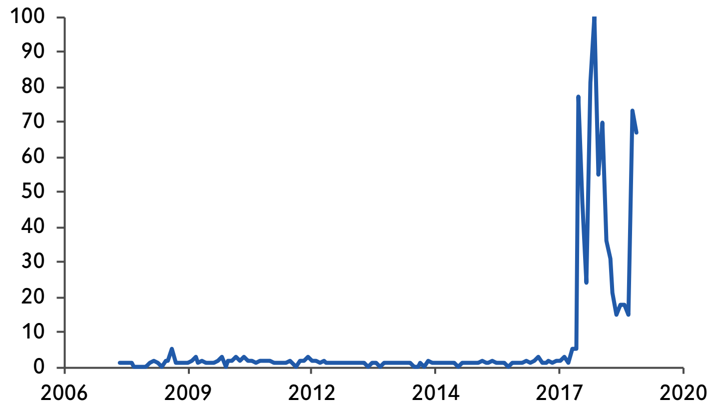
Source: Bureau of Labor Statistics and Department of Labor, accessed via FRED, June 6, 2019.

President Trump, of course, is the orange-haired elephant in the room. The White House might extend or open more fights on trade than it closes, slowing global trading activity and casting an ominous cloud over domestic investment. We have written a lot about trade policy (as here) because it is central to the outlook. In that view of the political economy, trade disputes are an instrument for the president to enliven his voting base, but they must be resolved before there is material damage to their interests, the overall economy and financial markets during the upcoming election window.

The last-minute deal with Mexico to avert a tariff hike is a good case study. The snap announcement of escalating US tariffs, triggered by the lack of progress in curbing migrant flows from Mexico, sparked intense domestic interest on the subject of tariffs, at least as judged by Google news searches on the topic.

Google US News Searches on "Tariffs"

Peak Interest = 100



Top Ten Interested States			
District of Columbia	100	Oregon	32
North Dakota	89	West Virginia	31
South Dakota	60	Colorado	30
Wyoming	45	Kansas	29
New Mexico	36	Alaska	29

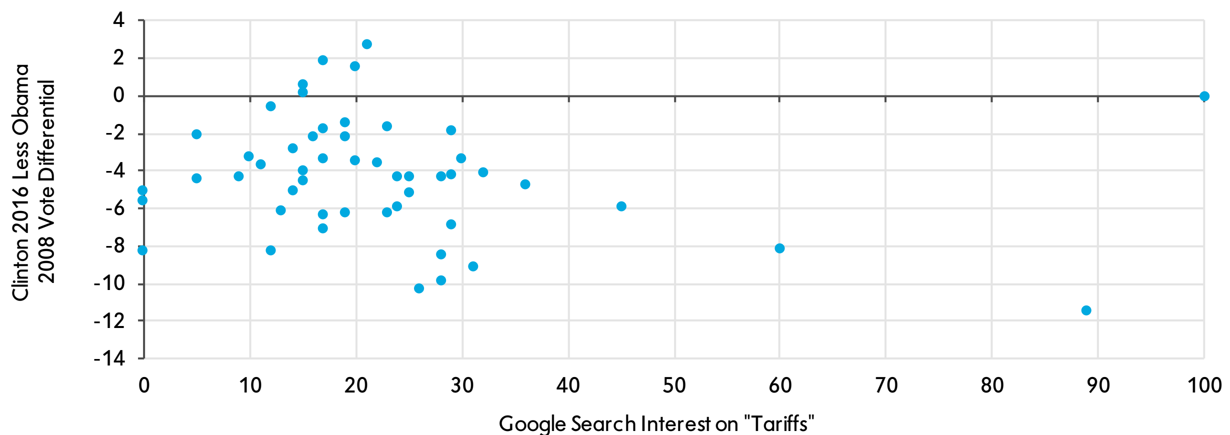
Source: Google, June 20, 2019.

The top-ten most interested US localities, aside from the policy wonk capital of the nation, the District of Columbia, are farming and resource-extraction states, part of the president's base.

Indeed, those states in the top 25 percent of peak interest were exactly where Donald Trump outpaced Hillary Clinton in the 2016 elections (measured as her vote share in the state relative to President Obama's performance four years earlier along the vertical axis). When trade talk evidently riled the president's base, he found merit in Mexican measures. We do not think this is a coincidence. The president will pick fights as a signaling mechanism and cut deals before it harms the electorate inclined to vote for him. Above all, President Trump wants a well-performing economy in the first half of next year.

Vote Share in 2016 Presidential Election and Search Interest

Percent and Index



Source: Federal Election Committee and Google Trends.

If so, we believe trade talk disrupts, not derails, economic momentum. Some slowing from the 3 percent pace of real GDP growth in the prior five quarters is in order, given that the unemployment rate is near 3½ percent, to prevent excesses from mounting. In our view, the surprising assertiveness of the White House on trade (in that there are more fronts and more rationales for action) provides a headwind that cools above-trend growth the Fed would otherwise have provided.

Didn't Fed Chair Powell open the door to ease? Please, what he said was that the Fed would act to sustain economic expansion, translated as the assurance that he would do his job. Not many other people on earth generate banner headlines by stating the obvious. Fed Chair Powell garnered so much attention because the words fit the narrative investors desperately want to hear. Six months ago, remember, he similarly promised to sustain economic expansion by raising interest rates.

If the back end of rate expectations is wrong, then the front end is even worse. How can I be so sure? The Fed is an institution where precedent matters, and I was there when the precedent was set. In my briefing on monetary policy alternatives the first and only time "patience" was excised from an FOMC statement, in May 2004, I suggested to the Committee:

"…'patience' was meant to convey two notions: that the Committee believed it could wait awhile before acting and that, once policy firming commenced, it could be gradual in returning the real funds rate to its neutral setting. It is the former, not the latter, that at the moment may seem to be confining."

The word in that statement was confining because the FOMC viewed it as contractual. The group must still believe it, if their word is to be believed. If so, the notion of "patience" in the outstanding FOMC statement (and not contradicted by an official source since) is a symmetric obligation not to act at the next meeting, either up or down. Therefore, do not expect down at the upcoming meeting.

There is another precedent. Janet Yellen's tenure as Fed Chair (during which Jay Powell was an undissenting governor) was noteworthy because her Committee's stated intention for the path of the fed funds rate was always more hawkish than market pricing, just as today if the FOMC is straight-lining its policy view. Yellen lived with it by disappointing near-term expectations but keeping the market flame of dovishness alive in her comments. Expect Powell to do the same. "Patience" is a comfortable constraint for now, and the Fed Chair Powell can assuage hurt feelings by talking up data dependence and a willingness to do his job. That means no Fed action in June and July, in our view.

If our political assumption and economic forecast are right, the data subsequently will make it easier to believe that there will be no action this year, implying that equity and credit markets are currently closer to being correct than Fed pricing. The latter's move into better alignment, however, will probably break some crockery in those former markets during the adjustment later this year. After his press conference, Chair Powell could not go wrong following the suggestion of Inspector Kemp to his colleagues, "Let's all have some sponge cake and a little wine…"

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Vincent is Mellon's Chief Economist and Macro Strategist. In this role, he is responsible for developing views on the global economy and making relative value recommendations across global bond markets, currencies and sectors.

Previously, Vincent served as the Chief US Economist and a managing director at Morgan Stanley. For the prior four years, he was a resident scholar at the American Enterprise Institute (AEI). Vincent also worked in several roles at the Federal Reserve over 24 years, including Director of the Division of Monetary Affairs and Secretary and Economist of the Federal Open Market Committee (FOMC). His responsibilities at the Federal Reserve included directing research and analysis of monetary policy strategies and the conduct of policy through open market operations, discount window lending and reserve requirements. Prior to these roles, he was the principal liaison with the domestic desk at the Federal Reserve Bank of New York and was responsible for preparing a document outlining policy alternatives for each FOMC meeting. He was Deputy Director in the Division of International Finance and Associate Economist of the FOMC and spent five years at the Federal Reserve Bank of New York in both the domestic and international research departments.

His academic publications primarily concern the conduct of policy and issues related to the monetary transmission mechanism as well as an analysis of alternative auction techniques and Treasury debt management. After an undergraduate training at Fordham University, he received graduate degrees in economics at Columbia University.

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Endnotes

[1] At the April-May FOMC meeting, Fed drafters opted to refer to Jay Powell the way they wrote about Janet Yellen, as the "chair". Goodbye to "chairman" and good for them, but it does give this sentence a Clint-Eastwood-at-the-Republican-convention tone.

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