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Fed Thoughts: **Silence in the Mountains**

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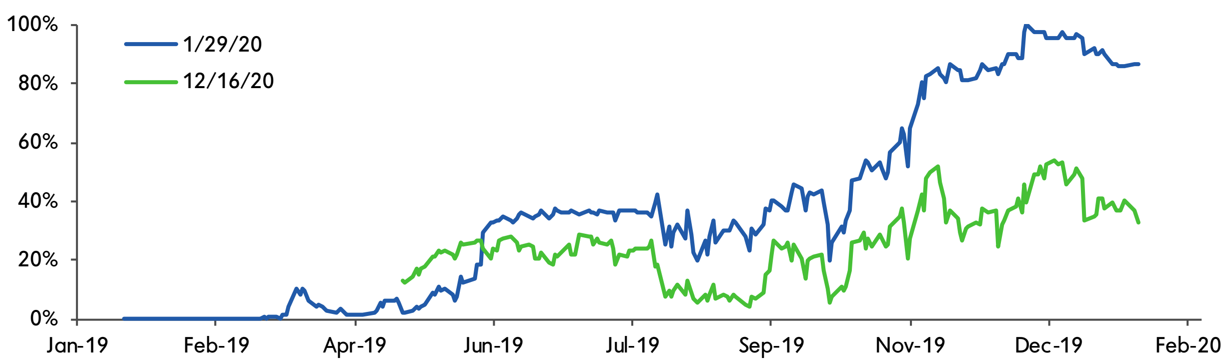
Perhaps all the talk about climate change crowded out other topics, but discussion at the 50th anniversary of the World Economic Forum in Davos never really dwelt on global monetary policy. No attention was paid to the strategic policy reviews ongoing at the Federal Reserve (Fed) and about to start at the European Central Bank (ECB). Central bankers seem to be alone in their suffering as they weigh the benefits and costs of a negative policy rate, at least as judged by the silence in the mountains. We may find out that bubbles inflate quietly, but end less so, much like the snow accumulating on the mountain top. Or, perhaps not.

This is probably the correct alignment of attention. The "good place" where Fed officials believe they have positioned the US economy is also a boring one. Not even close relatives of Fed Chair Powell have reason to tune into the press conference after the January 28-29 meeting of the Federal Open Market Committee (FOMC). The Committee's decision to leave the policy rate at a target range of 1.50-1.75 percent was signaled up and down the flag line. The statement from the last meeting of 2019 foreshadowed no action at the first meeting of 2020. Indeed, the "dot plot" summarizing participants' views of the appropriate policy rate, set out in the Summary of Economic Projections, suggests a majority prefer to remain on the sideline for the entire year.

Recognize that the sideline is an accommodative place. According to the median FOMC participant, the cumulative 75-basis-point easing in 2019 puts the current nominal fed funds rate 75 basis points below its equilibrium level. Leaving this accommodation in place for the duration of 2020 is the right place to keep the economy in a good place—with real GDP growth a touch beyond its potential and pressures on resources only slowly sending inflation higher toward the FOMC's goal of 2 percent.

The message that the Fed's insurance-policy easing was limited to three installments of 25 basis points sunk into market pricing by October (chart below). Since then, the probability that the fed funds rate target would hold at its current range at the January meeting has hovered above 80 percent.

Implied Probability of a 1.50%-1.75% Fed Funds Rate



Source: CME Fedwatch Tool, accessed 1/22/2020.

Doubts about the Fed's resolve linger as time passes, however, with about two-thirds weight placed on modest additional policy easing by year end. Three thought streams probably converge.

First, Fed officials have grown tired of tightening on the theory that an unemployment rate below 4 percent portends a pickup in inflation, their rationale for two years' worth of tightening. They will need hard evidence that inflation and inflation expectations are nestled at target to be satisfied with their policy stance. Worries about the erosion of the latter might prompt easing action.

Second, even if inflation does drift higher and the expectations anchor holds, some suspect that there is a conspiracy afoot. The Fed's exercise in introspection, a strategic review of its policy, should be ready for prime time in the first half of 2020. One thread of market commentary is that the review offers officials a one-time opportunity to loosen its definition of price stability, perhaps by targeting inflation "over the cycle" or introducing a range. Moving the bullseye higher on the barn door may allow a few more arrows of easing to be taken from the quiver.

Third, inflation may be the least of our worries in an unruly election cycle. Equity prices, already in thin air where traditional valuations are concerned, might correct sharply if words are said that cannot be unsaid during the campaign or the voting results jar established order. While the notion of a "Powell put" is overdone, a material destruction in wealth and upsurge in uncertainty would warrant an expression of concern by monetary policy officials.

True, those are enough worries to push the expected fed funds rate lower. But our economic outlook is one in which sustained economic expansion in an economy where labor markets are already taut pushes up gains in domestic costs and is augmented by the external pressure of US dollar depreciation. We are inclined to the other side of the first bet because we worry more about inflation overages. Our Fed experience is littered with over-promises and under-delivery of communication initiatives. Change is made at best incrementally in a large group vertically mindful of precedent and horizontally concerned about status in the community of central bankers.

The third risk, that the center does not hold and things fall apart, is more evocative, but it is not our base case. The resilience of financial markets in the face of political tumult over the past few years cautions against overreaction.

More responsiveness in easing than firming is probably an accurate reading of the reaction function of Fed officials. But what they have to react to matters as well, which is why we lean the other way than current market pricing.

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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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