



February 2019

Fed Thoughts: **Pay No Attention To The Man Behind The Curtain (PNATTMBTC)**

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The most useful advice I have ever heard about predicting Federal Reserve (Fed) policy came from Larry Summers, currently at Harvard, who has held nearly every senior government role imaginable with the exception of Surgeon General. The advice was offered during an informal talk a couple of Fed chairs ago, so Professor Summers cannot be held accountable for my rendition today. The gist was that, because the Fed consistently tries to foster its mandate, one should pay more attention to forecasting the economic outlook and its implications for policy than listening to how officials describe that future action.

Three reasons come to mind why the words of a high (or even the highest) Fed official might not trace an accurate map of future policy.

First, even though the institution devotes enormous resources to forecasting, it is sometimes slow on the uptake to changed circumstances, producing forecast errors in the economic outlook that set the path of the appropriate fed funds rate off track. The Fed's loyalty to the Phillips curve, for instance, led it to see disinflation in 2003 and 2004 and inflation lurking around the corner since 2016. Part of the story might be that it habitually undervalues the rest of the world's role in shaping US economic performance.

Second, officials might dissemble at times, reluctant to reveal their true motives. For instance, some observers believe that Fed officials have an outsized concern about equity prices beyond their direct influence on the economic outlook. This underlies the talk of the Greenspan-Bernanke-Yellen put. Even if it were true, would Greenspan, Bernanke, or Yellen ever call out its strike price? If it were true, their description of the policy path in terms of macroeconomic variable was incomplete. Darker still, some believe that there are back-channel political influences on Fed policy driving a wedge between words and actions.

Third, officials sometimes use their discussion of the outlook to serve broader purposes, chief among them offering reassurance about economic prospects. Often these are vapid when taken out of context: the state of the Union is good, the Fed will do its job, or if economic circumstances change, then the stance of monetary policy will change. But context, as it relates to market sentiment, matters. Emphasizing a willingness to ease policy if the situation deteriorates, for example, consoles investors who are concerned that the Fed will tighten too much. Recognize, however, that when words are used to convey more than an accurate assessment of the outlook, then they no longer convey an accurate assessment of the outlook. In such circumstances, investors may take away a mistaken view of Fed policy, raising the odds that they will be wrong-footed later.

The case study of the moment is the most recent meeting of the Federal Open Market Committee (FOMC), held January 29 to 30. The FOMC was more dovish than expected, both as a group in its statement and as represented by its leader, Chair Jay Powell, in his press conference.

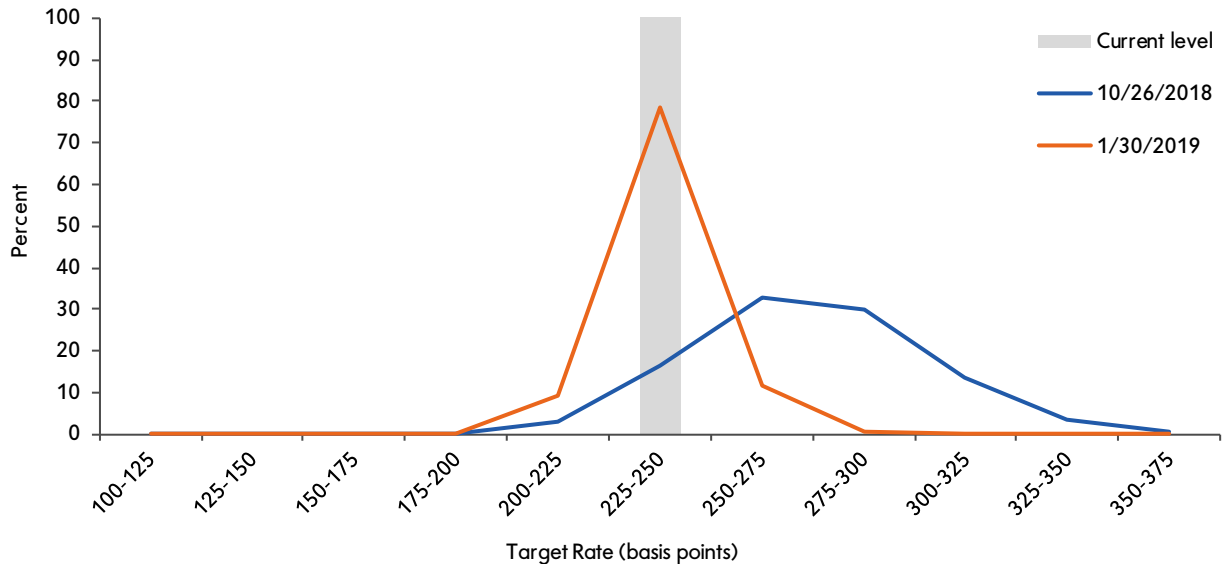
As for the statement, the FOMC included the well-telegraphed virtue of being "patient" to signal no action in March, and switched directional guidance from "further gradual increases" to the neutral "further adjustments." While the Committee was upbeat about the economy, its Chair emphasized "cross currents" of risks that "are going to be with us for a while." He also asserted that financial conditions are less supportive of growth and financial stability concerns are closer to balanced.

Market participants leapt to the conclusion that this firming cycle was over, pushing equity prices substantially higher. Fed funds futures are consistent with the view that policy is on hold through year-end, with a small, symmetric chance of a cut or a hike. The reception of Chair Powell's comments was far chillier, bordering on hostile, in the press and investment community. The short summary was that, in executing the most consequential U-turn

in the direction of policy without direct economic evidence, Chair Powell whipsawed observers. This raised the possibilities that he was caving into equity market complaints (writing the Powell put) or conceding to political pressure. That is, he met the first or second description of why words need not predict deeds. He either recently became less enamored on the Fed’s analytic framework, the Phillips curve relating excess demand and inflation, or wilted under outside-of-his-mandate pressures from markets or politicians.

Federal Funds Rate in December 2019

As implied by futures



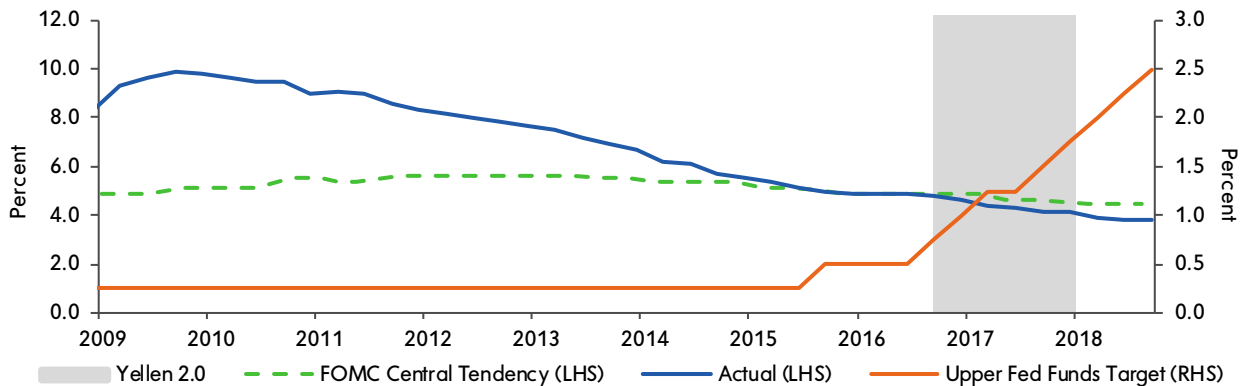
Source: CME FedWatch Tool, accessed January 2019.

We choose door number three. Guiding market participants to the most likely outcome for Fed policy this year—a couple more quarter-point rate hikes—threatened investor confidence and made the Fed a lightning rod for criticism. Learning from this, Chair Powell got out of the guidance game. True, choosing reassuring words meant his words were less informative about the direction of policy, and investors ran with it, with gusto.

Taking the Summers suggestion on board, we believe it is wiser to Pay No Attention To The Man Behind The Curtain (PNATTMBTC), as Dorothy learned in *The Wizard of Oz*. The man behind the curtain is shaping the contours but not directing the ultimate outcome of policy. Economic forces determine the destination of the fed funds rate. For now, a two-quarter Fed pause shows that they feel everyone’s pain. Nonetheless, at the end of the year, we believe the fed funds rate will be 50 basis points higher because US economic momentum puts further pressure on resources and pushes up costs. The Fed will tighten to ensure that this does not translate into an overshoot of its inflation goal.

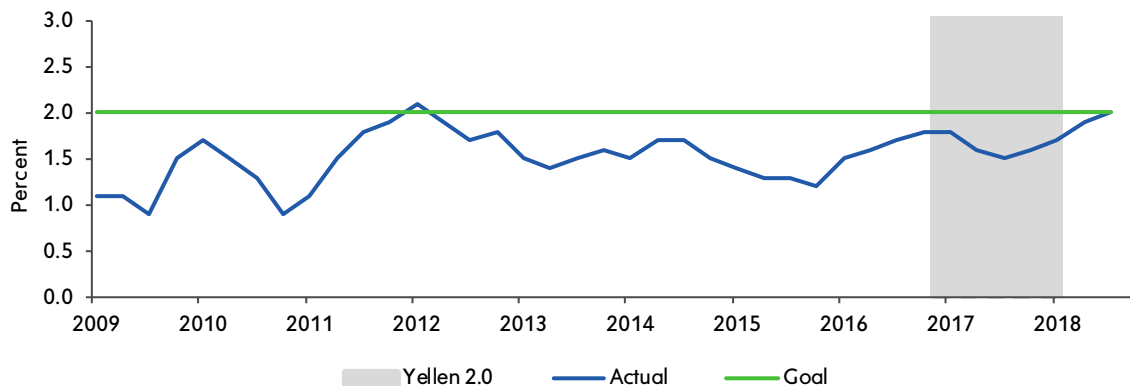
Our forecast of Fed policy owes to a two-out-of-three rule observed in the last year of Janet Yellen’s tenure (Yellen 2.0 as discussed in [Fed Thoughts: Passive Aggressive](#)) and the first year of Chair Powell’s helm. As depicted in the charts on the next page, the FOMC tightened policy nine quarters in a row beginning in December, 2016 (counting the decision to start balance-sheet shrinkage in the tally), even as inflation was below goal. The unemployment rate, however, was under the central tendency of FOMC participants’ assessment of its natural rate, and falling. Two-out-of-three triggers were sufficient to tighten on the theory that the Phillips curve still lived.

Unemployment Rate: Actual and FOMC Central Tendency



Source: FRED, as of December 2018.

Core PCE Inflation and the FOMC Goal



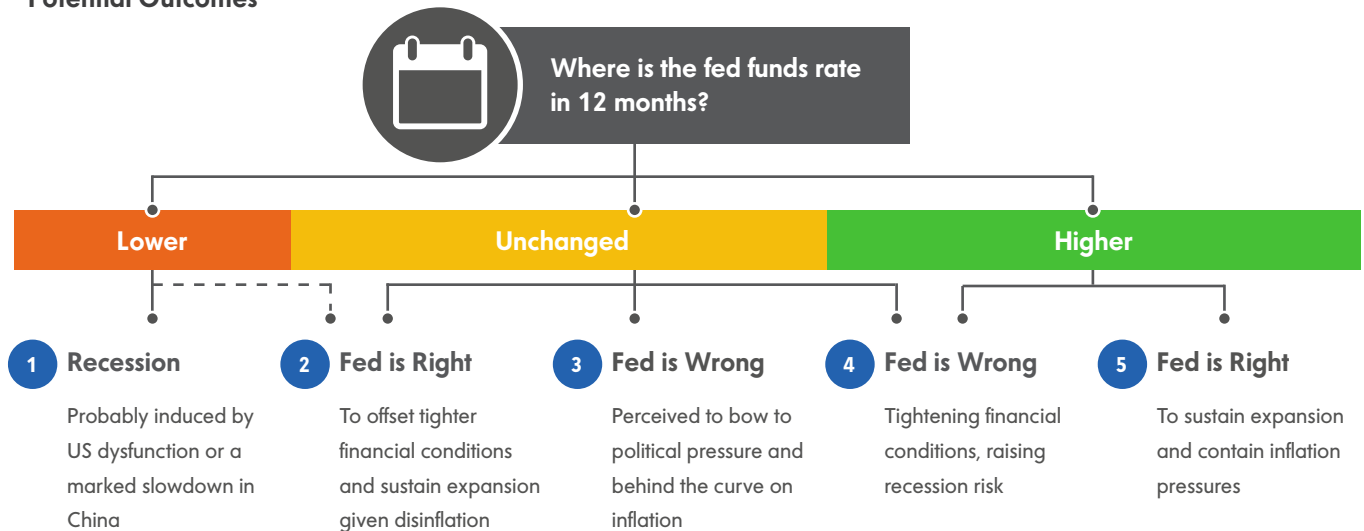
Source: FRED, as of December 2018.

This became more difficult around the turn of the year as economic growth slowed and the unemployment rate stopped falling. The pause will likely persist until cost pressures intensify and consumer price inflation turns up. When that happens at midyear, if our forecast eventuates, the Fed pivots back to firming.

In selecting door number three, we remember the Monty Hall Problem—evidence confirming or disconfirming the other choices are reasons to change your mind. Listen, for one, to Randy Quarles, the Vice Chair for Supervision, who appears out of sync with Chair Powell’s characterization that financial risks are better balanced. That is hard to square with Quarles’ testimony of a month ago and harder still if improved investor sentiment serves as wind under the wings for the further upward flight of the already elevated market for collateralized loan obligations. Also, pay attention to the March FOMC meeting, but not for the rate outcome that is foreordained as unchanged by the incantation this month of “patient.” (As in the previous [Fed Thoughts](#), we think that this promise persists in the statement through June.) The interesting issue is the pesky “dot” plot. Unless the economic and political environments change materially and quickly, most FOMC participants should report that at least one firming is appropriate this year (and in many cases two). Such a result would strengthen our forecasting resolve. A major and inexplicable downward shift in the dots would incline us to door number one or two.

A feature of this forecast that might be especially difficult to wrap our arms around is the role of the counterfactual in setting monetary policy. Fed officials will firm policy this year even as real GDP growth slows and inflation ticks only modestly higher because they will not like the outcome in 2020 were they to do otherwise. The schematic below might help. It is based on a forecast with complete certitude, that, at the end of this year, the federal funds rate will be lower, unchanged, or higher relative to its current level.

Potential Outcomes



Harder to say is whether that setting will prove opportune.

Historically, the Fed only cuts its policy rate, usually substantially in a short period, as the economy enters recession. That is, the far left outcome of a lower policy rate is much more likely to be associated with an output contraction than a tactical Fed correction (which is why the line connecting to that happy event is dotted). With the labor market clocking in at a quarter million jobs created on net each month and lingering financial and fiscal accommodation in place, a blow to the economy would likely be external, either from a blowout in domestic politics or a shudder in the second-largest economy of the world. In this scenario, no risk asset is safe, and Treasury yields and breakevens are lower.

If the current market consensus is correct that the funds rate stays in its $2^{1/4}$ to $2^{1/2}$ percent range with sustained economic expansion and low, or even falling, inflation, the environment would be conducive to risk taking and low Treasury yields.

Except, of course, the prevailing consensus might be wrong and an unchanged funds rate is a mistake. There are two flavors of Fed error: being behind the curve as inflation rises (presumably, because it bowed to political pressure) or not offsetting flagging economic momentum (creating a 2020 recession).

The lonely outlier is at the right, where the Fed tightens modestly to contain inflation risks and sustain the expansion into 2020. This is our forecast.

Playing it by the numbers, investors will most likely nestle at scenario 2 during the first half of the year. With Chair Powell following, not leading events, we get to scenario 5 in the second half of the year only after inflation pressures emerge to draw the Fed back into the game. Connecting the dots, the journey from 2 to 5 goes through 3. Until cost pressures emerge, the Fed Chair is silent behind the curtain or should not be listened to anyway.



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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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