Fed Patience Means No Conviction — For Now

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- **The best way that I can think of describing this short statement and the other accompanying communications is to label them as noncommittal —for now.** It's about buying time, rather than ending policy tightening. Powell made that abundantly clear when he bluntly stated in the press conference that the FOMC is **"awaiting greater clarity"** toward key risks. **He noted their altered stance is "not driven by a major shift" in the baseline economy but is more rooted in what he described as "crosscurrents"** including Brexit, trade policy uncertainty, whether this is the only government shutdown or whether there are more to come that could be associated with greater damage, and the outlook for inflation and broader financial market conditions that are themselves partly contingent upon these 'crosscurrents'. Overall, this reaffirms that we are at a different stage of the monetary policy cycle, having significantly tightened policy away from emergency levels of stimulus and now entering a highly data dependent stage that is conditioned by greater sensitivity toward event driven risks.

- I believe that the Fed is generally doing the right thing for now but retain cautious optimism toward their crosscurrents with concomitant implications for expecting further modest policy tightening skewed to the back half of the year. What I struggle with, however, is the moral hazard problem that central bankers risk revisiting by signalling a strong willingness to rescue policy missteps and bad behaviour in other spheres of influence particularly in terms of the galling risks that political divisions in the US and UK have been courting. The Fed is perhaps unintentionally or undesirably playing the role of a safety blanket to needless risks being courted by politicians and—while we're not there yet—it risks becoming an enabler to such behaviour.

- **Declaring the Fed to have waved the white flag and to have turned uber dovish in an end-of-hike-cycle and shutting down balance sheet unwinding sort of way is therefore going way too far.** This is a Fed that —like many in the markets—lacks conviction toward the evolution of what Powell describes as "crosscurrents" including Brexit, trade policy uncertainty, and the further risk of shutdown effects especially—I would add, but Powell didn't reference—if the dysfunction in Washington catches up to debt ceiling concerns. This is a Fed that feels no great urgency to pre-judge such concerns given where inflation sits. This is a Fed that—despite Powell's assertion—still very much has a put in play with a solid eye on market volatility. This is a Fed that wants much greater clarity on such developments before it contemplates further policy adjustments**. The signal is that if they get that clarity and risks evolve constructively, then it could well be game back on for resuming rate hikes.**

- Specifically, the Fed adopted this change in stance by doing the following in the statement (also see the attached statement comparison):

    - **Adding "patient"** in the second paragraph while stating in the press conference that the length of the patient period "will depend entirely upon incoming data. We can't label it."

    - **Deleting forward rate guidance** regarding "some further gradual increases" that are no longer mentioned.

- **Referencing lower market-based measures of inflation compensation**, while repeating that survey-based measures are little changed.
- **Deleting reference to the balance of risks**. That's a sign it really doesn't know with great conviction whether they are negative, positive or balanced.
- **Inserting reference to 'muted inflation pressures'**.
- **Slightly downgrading reference to economic activity** as rising at a "solid" rather than a "strong" rate. That's largely just a reflection of the post-stimulus downshift from 3–4% growth to something tracking 2-handled in Q4 and suffering a modest Q1 setback from the shutdown.

- It is important, however, to note that **the baseline understanding of the economy's performance is not what has changed here**. That's true of both the statement and the press conference. That was signalled in the following sentence within the statement:

  "The Committee continues to view sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2 percent objective as the most likely outcomes."

- **That leads me to think this is not old-school dovishness returning.** That would have been informed by a marked deterioration in the economy. That's not what is happening and not what the Fed is signalling. This is a conditioned degree of near-term dovishness related to elevated uncertainty toward event-driven risks that Powell emphasized in the press conference and by the evolution of inflation data with the two considerations hardly mutually exclusive.

- Note that the FOMC issued this statement on balance sheet normalization. In essence, **the only change is to codify reference to how balance sheet plans are conditional upon developments in the economy and markets.** That should surprise no one and not just because they've indicated as much verbally already. It would be a total misinterpretation to take this as a signal of appetite toward changing reinvestment plans or balance sheet plans given known information to date. Specifically, note the final paragraph of the statement that is repeated below. I believe the sole purpose of this is to assuage market concerns that the Fed would march blindly onward toward hiking and shrinking regardless of developments in the economy which should be treated as common sense. The Fed is saying they don't believe this is a material risk at this point and so the signal is that balance sheet unwinding remains on schedule barring severe developments.

  "The Committee is prepared to adjust any of the details for completing balance sheet normalization in light of economic and financial developments. Moreover, the Committee would be prepared to use its full range of tools, including altering the size and composition of its balance sheet, if future economic conditions were to warrant a more accommodative monetary policy than can be achieved solely by reducing the federal funds rate."

- **When asked if the Fed is at neutral, Powell's response was** to point to how the fed funds target range is presently at the low end of the range of estimates for neutral (2.5–3.5%), that he thinks the policy stance is appropriate for now, and that he thinks it is highly uncertain where neutral resides and that the Fed's data dependence will inform this estimate such that "we're going to know in hindsight." This is a common response by global central bankers toward questions about where the neutral rate sits.

- **Asked in the press conference whether the next rate move is up or down, he replied that "I would want to see a need for further rate increases and a big part of that would be inflation, not the only thing, but a big part of it."** Again, I'd add that the concerns on his mind are inextricably interwoven; there will be no emphasis upon rising inflation if event driven instability tanks commodities, sharply tightens financial conditions, damages the economy, creates spare capacity and with that potential disinflation.

- On this latter point, however, one would be remiss in failing to note that **Powell did not at any point repeat prior reference to the inflation risks that could be derived from some of the crosscurrents he identified**. BoC Governor Poloz has done a better job at that in my view by cautioning that a reversal of decades of trade liberalization that kept a lid on inflation could well complicate monetary policy by returning stagflation scenarios to the forefront of policy discussions. We're clearly not there yet, but should the Fed's trade fears truly blossom, it's unclear that rates wouldn't move higher at least through the inflation side of the dual mandate.

- During the press conference, **Powell dodged questions regarding his estimates of the optimal size of the balance sheet and reserves**, and guided that "in coming meetings" they will come to a judgement on possibly altering where to reinvest along the curve with implications for duration late in the normalization cycle.

- **When asked about the risk to the US of a hard Brexit, Powell replied** that "it wouldn't be a huge first order thing in terms of economic effects unless you saw financial turmoil" and that "It starts with US financial institutions with a presence in the UK or EU or both." Powell noted "I would expect that we would feel some of that, probably not material to our economy, but we'll be watching carefully and it is certainly possible there is a resolution short of a hard Brexit."
- **On the optimal level of reserves, Powell noted** "Our estimate of the amount of reserves needed has moved up over the past year. Then we would want a buffer. You can't operate too close to the point of scarcity" So the message is that the Fed wants to pad the equilibrium demand for reserves, is uncertain where that resides, and that, as Powell noted, the only way to tell is to survey and rely upon market intelligence.
- **When asked if there is a "Powell put", perhaps not surprisingly Chair Powell's response was dismissive** in that he only wishes to do the right thing as the only consideration. **My personal belief is that there is indeed a Powell put.** The FOMC knew about most of the factors they cite as risks at the December FOMC meeting including the March risks, soft European growth, below target inflation etc. What changed was market volatility since the December FOMC especially over the holiday season when it was entirely possible that wild market gyrations were a function of tax loss selling, thin trading and algo trading. The Fed remains highly reactionary to market developments in the weeks leading up to decisions. A 'put' is still in place which begs the question that if stocks continue to rise as they have been doing this year, will that option suddenly swing in the other direction into summer? That's quite possible.
- When asked if Trump's direct attacks on the Fed influenced their decisions, Powell simply stated that they are not political and their only aim is to do the right thing for the American people.
- The FOMC re-issued an unchanged statement of their longer-run goals and monetary policy strategy (here). There is literally not a word that has changed compared to the prior iteration.
- **Overall, I don't judge the broad suite of communications as inconsistent with our forecasts for the resumption of rate hikes around mid-year, being 2-3 hikes away from calling it quits in this cycle, continuing along the path of reducing the balance sheet with no change to its reinvestment caps this year and hence still considerably distant from deciding upon whether to essentially twist reinvestment along the curve.** Clearly we're all dealing with the same uncertainties that drive the Fed's decisions. Our own forecast has always been presented as conditional upon cautious optimism toward matters like trade negotiations, Brexit, US government funding and the debt ceiling issues and risks into a Presidential election year.

RELEASE DATE: JANUARY 30, 2019

Information received since the Federal Open Market Committee met in December indicates that the labor market has continued to strengthen and that economic activity has been rising at a ***solid*** rate. Job gains have been strong, on average, in recent months, and the unemployment rate has remained low. Household spending has continued to grow strongly, while growth of business fixed investment has moderated from its rapid pace earlier last year. On a 12-month basis, both overall inflation and inflation for items other than food and energy remain near 2 percent. ***Although market-based measures of inflation compensation have moved lower in recent months, survey-based measures of longer-term inflation expectations are little changed.***

Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. In support of these goals, the Committee decided to maintain the target range for the federal funds rate at 2-1/4 to 2-1/2 percent. ***The Committee continues to view sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2 percent objective as the most likely outcomes. In light of global economic and financial developments and muted inflation pressures, the Committee will be patient as it determines what future adjustments to the target range for the federal funds rate may be appropriate to support these outcomes.***

In determining the timing and size of future adjustments to the target range for the federal funds rate, the Committee will assess realized and expected economic conditions relative to its maximum employment objective and its symmetric 2 percent inflation objective. This assessment will take into account a wide range of information, including measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial and international developments.

Voting for the FOMC monetary policy action were: Jerome H. Powell, Chairman; John C. Williams, Vice Chairman; Michelle W. Bowman; Lael Brainard; James Bullard; Richard H. Clarida; Charles L. Evans; Esther L. George; Randal K. Quarles; and Eric S. Rosengren

RELEASE DATE: DECEMBER 19, 2018

Information received since the Federal Open Market Committee met in November indicates that the labor market has continued to strengthen and that economic activity has been rising at a ***strong*** rate. Job gains have been strong, on average, in recent months, and the unemployment rate has remained low. Household spending has continued to grow strongly, while growth of business fixed investment has moderated from its rapid pace earlier in the year. On a 12-month basis, both overall inflation and inflation for items other than food and energy remain near 2 percent. ***Indicators of longer-term inflation expectations are little changed, on balance.***

Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. ***The Committee judges that some further gradual increases in the target range for the federal funds rate will be consistent with sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2 percent objective over the medium term. The Committee judges that risks to the economic outlook are roughly balanced,*** but will continue to monitor global economic and financial developments and assess their implications for the economic outlook.

In view of realized and expected labor market conditions and inflation, the Committee decided to raise the target range for the federal funds rate to 2-1/4 to 2-1/2 percent.

In determining the timing and size of future adjustments to the target range for the federal funds rate, the Committee will assess realized and expected economic conditions relative to its maximum employment objective and its symmetric 2 percent inflation objective. This assessment will take into account a wide range of information, including measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial and international developments.

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