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The Powell Pivot

Implications for Rate Hikes

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On December 19, 2018, my family and I touched down in California at the very moment that the Federal Open Market Committee (FOMC) released its last statement of the year. The headlines were no surprise. The Fed raised interest rates for a fourth and final time, but revised down its forecast for growth and the number of rate hikes for 2019. The statement itself conveyed a more dovish tone, underscoring how the Fed would now incorporate shifts in financial and international conditions when making future rate decisions.

On the surface, it was all financial markets could have wanted. After a brief correction, markets rallied. Then Chairman Powell started his press conference to explain the shifts and markets again cratered.

I wrote up my initial reaction in a cab while en route to our destination. By the time I got there, I could see that something had gone terribly wrong. I watched the press conference. Markets were roiled because: 1) Chairman Powell's tenor about the economy was overly bullish; and 2) He said reductions in the balance sheet were on "autopilot." Powell blew it.

Minutes from the Fed's November and December meetings reveal a growing unease among the FOMC participants. Inflation was coming in weaker than the Fed had expected while trade tensions, tariffs and a slowdown in the global economy, particularly China, were taking a toll on business and consumer sentiment. It could be transitory, but given the lags in the data and the effects of recent rate hikes, it was becoming clear that the Fed might need to hedge downside risks.

Poised for a Slowdown

The government shutdown has delayed much of the data that determines real GDP growth. The data as of Friday, February 8 suggests that the economy ended 2018 on strong footing, with real GDP growth coming in just shy of 3%. Overall growth for the year is also expected to come close to 3%, with an increase in consumer spending driving overall gains.

Prospects for the first quarter are not as good. Real GDP is expected to rise at a 1.6% pace. Consumer spending is expected to slow as consumers feel the effects of lower-than-expected tax refunds, the government shutdown and the polar vortex. Many consumers had a drop in their withholding rates for last year; that means they essentially spent their tax cuts and then some. Their tax refunds may disappoint. Housing is expected to continue to soften, while business investment remains tepid. A slowdown in growth abroad and uncertainty surrounding the fate of tariffs has caused businesses to hesitate. Government spending will suffer from the shutdown.

Separately, the drag from trade should dissipate in the first quarter as imports slow in response to weaker first quarter consumer spending. China is also expected to make good on its promise to buy more soybeans, at least temporarily.

Growth should rebound to a 2.6% pace in the second quarter. Consumer spending is expected to pick up again, while government spending regains ground lost to the shutdown. Business investment is expected to increase modestly while the drag from trade continues. Growth abroad is slowing, while consumer spending is rebounding. This means fewer exports and more imports.

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This edition of **Economic Currents** provides some context for changes in the Feds thinking between October and January. The Fed revised down its assessment of economic growth, despite another month of blockbuster job gains and is now actively managing downside risks.

Evolutionary, not Revolutionary

October 3, 2018. Powell was almost giddy about the prospects for the economy. In an interview with veteran PBS reporter Judy Woodruff, he gushed “...there’s really no reason to think that this cycle can’t continue for quite some time, effectively indefinitely.”

But financial markets found it disturbing when Powell commented that the fed funds target was still “a long way from neutral,” the point at which rates are neither stimulative or detrimental to growth. These comments sent a shudder through financial markets because they feared the Fed would overshoot, triggering a recession.

Powell did acknowledge the potential for a slowdown related to tariffs but just hadn’t seen “anything in the numbers. . .yet.”

One issue is that the data collected by the government to assess the economy lags by at least a month or two - sometimes much longer with revisions. The problem was recently exacerbated by the partial government shutdown, further delaying the collection and dissemination of key reports.

By the time an economic slowdown shows up in the data, it may be too late to do anything to stop it from morphing into a recession. The risk is particularly high if the Fed is more intent on raising than cutting, rates when the growth is slowing.

November 8, 2018. The FOMC statement following the meeting said, “The Committee expects that further gradual increases in the target range for the federal funds rate will be consistent with sustained expansion of economic activity.”

That comment was consistent with the verbiage used by the Fed to signal that it planned to raise rates at the next scheduled meeting in December, making the hike essentially a done deal.

November 28, 2018. Powell delivered a speech to the Economic Club of New York where he focused on financial stability and the Fed’s concerns about mounting corporate debt.

Powell also said that the fed funds target was now “just below” neutral, suggesting that the Fed was reassessing its rate hike trajectory from October. In response, the Dow Jones Industrial Average (DJIA) jumped more than 600 points, the largest rally in eight months.

November 29, 2018. The minutes to the November FOMC meeting revealed that participants had changed their views about the economy sooner than many expected. The list of downside risks, including tariffs, a tightening in financial conditions, slower global growth, a weakening in interest-sensitive sectors and a jump in corporate debt were building, even as current economic indicators remained strong.

Participants noted a need to change the verbiage in the post-meeting statement going forward to reflect their belief that the fed funds rate was closer to neutral than they had previously expressed. The minutes underscored the concept that there was no “pre-set course” for the trajectory of rates, a phrase that Powell later used to calm markets after his blunder following the December 19 FOMC meeting.

The Fed Pivots, Powell Fumbles

December 19, 2018. The FOMC raised rates a fourth time during the year, emphasizing the downgrade in its forecast for growth and the number of rate hikes it expected during 2019. The statement also underscored the need to monitor emerging risks to the forecast, which included global growth and recent shifts in financial markets. Credit conditions tightened in December.

> “The Fed’s pivot may not be enough to avert the next recession, but does provide reassurances that someone in Washington is awake at the wheel.”

The problem was how Powell conveyed the change in the forecast and shifting risks. His characterization of reductions in the Fed’s balance sheets being on “autopilot” rattled markets.

In an **interview** on CNBC on December 21, New York Fed President John Williams, who is the only president with permanent voting status on the FOMC, tried to clarify the Fed’s position and contain the damage. He explained that, “What we’re going to be doing going into next year is reassessing our views on the economy, listening to not only markets but everybody that we talk to.”

He also signalled that, although he believed that the economy was still strong, the Fed could be flexible and alter the trajectory of the balance sheet if need be in the year ahead. Financial markets briefly rallied as he spoke. His comments were overshadowed by the government shutdown, which started at midnight the same day.

December 23, 2018. As my plane touched down in Chicago, my phone lit up again. Treasury Secretary Steven Mnuchin released on Twitter a statement regarding bank liquidity. In an unusual move, he contacted the CEOs of the six largest banks in the country to confirm that they had ample liquidity to lend to consumers and businesses.

The move was designed to calm financial markets in the wake of the government shutdown and escalating trade tensions with China. It was reminiscent of Sunday night announcements made by the Treasury and the Fed during the height of the financial crisis designed to stabilize financial markets prior to their open in Asia.

Mnuchin’s plan backfired. No one was worried about bank liquidity until the Treasury Secretary raised the issue, agitating the markets on Christmas Eve.

All of this was going on at the same time that the UK looked as though it was moving closer to a “no deal” or “hard Brexit” from the European Union, escalating trade tensions with China and the realization that the government shutdown would last at least through the holidays. Uncertainty about the year ahead intensified.

Powell Hits the Reset Button

January 4, 2019. During a previously scheduled panel discussion with former Fed Chairs Janet Yellen and Ben Bernanke at the American Economic Association annual meeting, Chairman Powell started with a prepared statement to clarify the Fed’s position and hit the reset button on his off-the-cuff remarks that followed the December FOMC meeting.

He emphasized that the Fed would be “patient” in raising rates, which meant that they would pause before raising rates again and underscored that rates were not on a “preset course.” Then he went a step further and said the Fed would be flexible with regard to its balance sheet, and adjust reductions in its size if that became a problem for financial markets.

“If we came to the view that the balance sheet normalization plan - or any other aspect of normalization - was part of the problem, we wouldn’t hesitate to make a change,” he said.

Powell’s camaraderie with his former colleagues was evident. They understood better than others the challenges of communicating the Fed’s intent. He explained that the Fed thought reductions in the balance sheet should be a non-event for financial markets, like “watching paint dry.”

It didn’t hurt that the employment report, which was one of the few data points funded during the government shutdown, was released earlier that day. The initial December report showed that more than 300,000 jobs were created during the month, well above expectations.

It is worth remembering how much the Fed miscalculated reactions to balance sheet reductions, which began under Chair Yellen in 2017. At that time, the Fed had announced the reductions in advance of enacting them, providing a roadmap to the markets of how they would ramp up over time. The Fed really believed, despite warnings from market participants and outside economists (including myself), that financial markets had fully priced the effects of the balance sheet roll off into market valuation.

Moreover, long-term interest rates were falling instead of rising at the very moment balance sheet reductions peaked in the fourth quarter of 2018. The Fed assumed long-term bond yields would spike if reductions in the balance sheet were disrupting market valuations.

January 9, 2019. The December 19 FOMC meeting minutes were released. There had been substantial discussion about problems that may be emerging in response to shifts in the Fed's balance sheet. There were also discussions about the deteriorating quality of corporate debt and the blow to market sentiment that they were witnessing.

The Fed was already clearly pivoting; Powell just failed to convey by how much during the December press conference. To be fair, Powell was trying to balance the good economic data that had been reported to date with the negative shift in market sentiment.

If he sounded too negative about the economy, he risked fueling further panic and conveying more than the Fed actually knew about the trajectory of growth going forward. Instead, he erred on the side of sounding too optimistic, raising concerns that the Fed would overshoot.

"Risk Management" Mode

January 30, 2019. The FOMC statement for the meeting on January 29-30 revealed a Fed in full-on risk management mode. The Fed dropped any reference to the gradual pace of rate hikes, downgraded its assessment of economic growth from "strong" to "solid" and used the word "patience" to characterize future hikes.

"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," the statement said.

The Fed also released a revised statement on its balance sheet operations. It did not change the course of reductions, but signaled willingness to "adjust" the size of its balance sheet if needed.

The message: The Fed is flexible. The Fed is willing to halt reductions in its balance sheet if those changes are disruptive to financial markets. It is willing to increase the size of its balance sheet to stimulate the economy if conditions warrant.

Powell opened his press conference, the first to occur without presenting a change in the Fed's consensus forecast, with a well-structured, prepared statement. He started by stating the Fed's primary goal, "to sustain the economic expansion, with a strong job market and stable prices, for the benefit of the American people."

This reframed what the Fed does beyond rumor and innuendo. The Fed is working to fulfill its legal mandate of full employment and price stability; it is not changing policy in response to political or market pressures.

The "economy is in a good place, and we will continue to use our monetary policy tools to help keep it there," he said. But "cross-currents and conflicting signals about the outlook" are emerging. These include a slowdown in China and Europe, uncertainty about trade policies and Brexit, tighter financial conditions in the US and damages resulting from the self-inflicted government shutdown.

He also noted that those risks were likely to last for a while. "At such times," he said, "common sense risk management suggests patiently awaiting greater clarity - an approach that has served policymakers well in the past."

If inflation was picking up, it would be harder for the Fed to move to the sidelines. However, inflation is currently below the Fed's 2% target.

Powell also made clear that the Fed's outlook for solid growth was contingent on its pivot in policy. He prepared well and he stuck to his script, careful to leave no room for misinterpretation.

Fewer Rate Hikes for 2019

March 19-20, 2019. The FOMC is scheduled to meet and release an update to its consensus forecasts for growth and rates. Look for the outlook on growth to hold at 2.3% - the same as the Fed's December forecast. But that is a downgrade from the Fed's previous forecast for 2019 growth, which was made last September.

The FOMC is expected to downgrade its consensus for rate hikes from two to one in 2019. Remember, Powell

made it clear that the forecast for solid growth is now contingent on a more measured pace of rate hikes. The Fed is expected to slow reductions in its balance sheet in 2019, but not until later in the year.

We have a slightly more conservative forecast, with the Fed sidelined the entire year. We are more skeptical that China will be able to stimulate its own economy and come to a lasting agreement with the US on trade. Any agreement we get will include triggers for additional tariffs if China violates the terms of the agreement, which is highly probable.

We are more concerned about trade tensions with Europe and the timeline for getting the new NAFTA agreement passed by a split Congress. The administration continues to lobby Congress to increase its ability to levy tariffs, which suggests an intent to increase tariffs instead of reduce them over time.

The primary difference shows up in our 2020 forecast, which includes a recession and a drop in the fed funds rate back to zero. Powell has not ruled out a move into negative territory on rates if the economy falters. **Research** within the Fed now suggests the expansion may have been stronger and inflation warmer if the Fed had pursued a negative rate policy in the wake of the crisis.

The problem is that the Fed does not control the whims of political leaders, which is where the risks of an economic misstep are greatest. We need to see a turnaround in trade policy and meaningful reforms to China's economy to avert a larger global slowdown. Movement on a major **infrastructure** project at home could also help. Infrastructure investments are one of the few policies that actually lift the trajectory of growth for the US and unite instead of further divide rural and urban Americans. They also have a level of bipartisan support.

Bottom Line

The Fed is now more worried about sustaining the expansion than combating inflation and has shifted policy accordingly. The Fed's pivot may not be enough to avert the next recession, but does provide reassurances that someone in Washington is awake at the wheel. Now the challenge is to bring the rest of Washington along. Our elected officials are playing with fire by focusing on political instead of economic wins. The challenge is to get them to put down their flamethrowers and focus more on fostering long-term growth. That is a tough proposition on the eve of another presidential election year.

Economic forecast — February 2019

	2018 (E)	2019	2020	2018:4 (E)	2019:1	2019:2	2019:3	2019:4	2020:1	2020:2	2020:3	2020:4
National Outlook												
Chain-Weight GDP*	2.9	2.3	0.3	2.4	1.5	2.5	2.1	1.7	-1.7	-1.9	1.7	1.7
Personal Consumption	2.7	2.6	0.6	3.6	1.6	2.1	2.3	1.9	-1.0	-1.4	2.0	2.0
Business Fixed Investment	6.8	3.4	-1.9	4.2	2.5	3.8	2.9	1.7	-4.8	-7.7	-0.7	-0.1
Residential Investment	-0.2	-1.1	-1.5	-3.0	-2.1	2.1	0.4	1.5	-2.2	-7.5	-2.8	6.1
Inventory Investment	33.9	60.9	-13.7	64.7	58.9	60.0	64.1	60.5	-12.0	-38.6	-12.7	8.4
Net Exports	-768.5	-843.8	-765.6	-834.8	-840.0	-842.9	-849.7	-842.6	-786.6	-749.5	-751.6	-774.6
Exports	4.0	3.9	3.7	3.1	5.6	4.7	5.6	5.9	4.6	1.8	0.1	2.0
Imports	4.9	5.4	0.3	8.1	4.8	3.8	5.0	3.5	-3.5	-3.2	0.3	4.5
Government Expenditures	1.7	2.2	0.9	3.4	2.0	2.4	0.7	0.5	0.8	1.7	-0.2	0.2
Federal	2.9	3.7	0.5	5.1	3.6	6.0	0.7	-0.5	0.1	2.8	-2.4	-1.8
State and Local	1.0	1.3	1.1	2.4	1.0	0.3	0.7	1.1	1.2	1.1	1.2	1.4
Final Sales	2.8	2.2	0.7	2.7	1.6	2.4	2.0	1.8	-0.2	-1.3	1.1	1.2
Inflation												
GDP Deflator	2.2	2.1	2.3	1.9	2.1	2.1	2.1	2.3	2.4	2.5	2.2	2.1
CPI	2.4	2.0	2.1	1.8	0.9	3.1	2.6	2.2	1.9	2.1	1.7	1.1
Core CPI	2.1	2.2	2.3	2.0	2.4	2.3	2.2	2.3	2.3	2.4	2.1	2.0
Special Indicators												
Corporate Profits**	6.8	0.0	-0.5	6.8	4.6	2.0	-1.3	0.0	-2.3	-4.7	-2.2	-0.5
Disposable Personal Income	2.8	2.5	0.9	2.8	3.5	1.8	1.9	2.0	0.7	-0.7	0.3	1.3
Housing Starts (mil.)	1.3	1.2	1.1	1.2	1.3	1.3	1.2	1.2	1.2	1.1	1.1	1.2
Civilian Unemployment Rate	3.9	3.7	4.3	3.8	3.8	3.7	3.6	3.6	3.8	4.2	4.5	4.7
Total Nonfarm Payrolls (thous.)***	2650.4	2094.5	-1475.3	648.1	707.5	564.0	454.4	368.7	-114.7	-300.5	-714.9	-345.1
Vehicle Sales												
Automobile Sales (mil.)	5.5	5.1	4.3	5.5	5.4	5.2	5.0	4.7	3.9	3.8	4.6	4.7
Domestic	4.0	3.7	3.2	4.0	3.9	3.8	3.7	3.5	3.0	2.8	3.5	3.5
Imports	1.5	1.3	1.1	1.4	1.5	1.4	1.3	1.2	0.9	1.0	1.1	1.2
Lt. Trucks (mil.)	11.8	11.5	10.4	12.1	11.6	11.6	11.6	11.3	10.5	9.6	10.3	11.0
Domestic	9.5	9.3	8.5	9.7	9.3	9.3	9.4	9.2	8.6	8.0	8.5	9.0
Imports	2.3	2.2	1.8	2.4	2.3	2.3	2.2	2.1	1.9	1.6	1.8	2.0
Combined Auto/Lt.Truck	17.3	16.6	14.6	17.5	16.9	16.8	16.6	16.0	14.4	13.4	14.9	15.7
Heavy Truck Sales	0.5	0.4	0.3	0.5	0.5	0.5	0.4	0.4	0.3	0.3	0.4	0.4
Total Vehicles (mil.)	17.8	17.0	14.9	18.0	17.4	17.3	17.0	16.4	14.7	13.7	15.3	16.1
Interest Rate/Yields												
Federal Funds	1.8	2.4	0.7	2.2	2.4	2.4	2.4	2.4	1.7	1.0	0.1	0.1
10-Year Treasury Note	2.9	2.8	2.5	3.0	2.7	2.8	3.0	2.7	2.6	2.3	2.4	2.5
Corporate Bond BAA	4.8	5.1	5.5	5.1	5.1	5.1	5.2	5.1	5.6	5.8	5.3	5.1
Exchange Rates												
Euro/Dollar	1.2	1.2	1.2	1.1	1.1	1.1	1.2	1.2	1.2	1.2	1.2	1.2
Dollar/Yen	110.4	109.7	106.1	112.8	110.4	110.1	109.5	108.7	107.6	106.6	105.5	104.5

* In 2017, GDP was $17641.4 billion in chain-weighted 2012 dollars.
** Corporate profits before tax with inventory valuation and capital consumption adjustments, quarterly data represents four-quarter percent change.
*** Total nonfarm payrolls, quarterly data represents the difference in the average from the previous period. Annual data represents 4Q to 4Q change.
Quarterly data are seasonally adjusted at an annual rate. Unless otherwise specified, $ figures reflect adjustment for inflation. Total may not add up due to rounding.

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