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Fed Thoughts: **Poles Apart**

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The magnetic North Pole is moving south and east relative to the geographic North Pole at about 35 miles per year. Apparently, there is a tug of war beneath the earth's crust between two masses of magnetic magma, one under Canada and the other under Siberia. Siberia is winning, at least for the one-and-a-half centuries the game has been monitored.

This is an apt metaphor for the economic and financial outlook for two reasons.

For one, nothing is constant. A compass pointing to "true" North shifts over time. That may be rounding error for a Cub Scout on a weekend outing, but such perturbations matter for the Global Positioning System. Do not worry, the Uber or Lyft driver will still find their way, albeit with a wider margin of error.

For another, geophysicists understand the need to update measurements of the gravitational contours of the globe, which they do periodically in the World Magnetic Model. Except, the National Oceanic and Atmospheric Administration is closed right now because of the partial US government shutdown and the update has been put off.

An even further distance from the magnetic and geographic poles separates US political leaders, and the climate is equally frigid. The result has been the longest closure (albeit partial) on record.

Our forecast for US real GDP growth in 2019 was shaved 0.2 percent on the expectation of a long shutdown, but not this long. The theory was that each two weeks took 0.1 percent from the level of real GDP, as the one-third of the workers who were deemed nonessential in the two-fifths of the shuttered government did not contribute to output. On one hand, the Administration has creatively defined "essential" to get more people on the job. On the other hand, no one is being paid, whether working or not.

An increasingly relevant feature of the outlook is that American households, government workers included, operate with thin safety buffers. The most encompassing view of household balance sheets is the Federal Reserve's Survey of Consumer Finances (SCF), its latest vintage for 2016. As shown in the table, households have sizable asset holdings, obviously skewed toward higher-income ones, but most of that is held in illiquid forms. Financial assets, of the malleable sort to meet shortfalls in income, are much skimpier. When it comes to the most liquid asset, transactions accounts, the median household can cover at most one month's loss of income.

Median Value for Families with Holdings (Thousands of 2016 US dollars)

	By percentile of income					
	<20	20-40	40-60	60-80	80-90	>90
Assets	11.7	71.2	160.3	302.7	579.4	1935.5
Financial assets	0.9	5	18.7	63	179	818
Transactions accounts	0.6	1.7	3.8	8.2	18.7	62
Debt	10.2	23.5	42.4	102.9	172.2	299.3
Memo: Months of income covered by						
All financial assets	0.7	1.9	4.3	8.8	15.8	37.7
Transactions accounts	0.5	0.6	0.9	1.1	1.7	2.9

Source: Survey of consumer finances, 2016, Federal Reserve Board.

The shutdown has stretched past that number. The survey takers of the SCF also asked what households do when income falls short of expectation. When the question is posed hypothetically to all households, the answer is that they would eat into their buffer of savings and cutback current consumption. For those in the survey who actually had a shortfall in expected income (about 15 percent), they borrowed more and trimmed spending less than the responses to the hypothetical question. We take that as evidence the growth effect will remain limited, but duration matters for that judgment.

The two ruling tribes in the District of Columbia have staked their tent poles far apart. Our operating assumption—held with no great confidence—is that one or both participants will move toward the other as the economic and financial market dislocations become sufficiently evident. We do not know how to quantify "sufficient," but the next major news event is the January employment report published February 1 by the still-open Bureau of Labor Statistics (BLS). Monthly net job gains have been running 200,000, too few to offset 350,000 furloughed workers if they get caught in the BLS survey net. A negative print would break a ninety-nine month winning streak and be a focal point of concern. That said, initial claims have fallen, not risen, in recent weeks, so that a decline is not foreordained, and major equity prices are around their levels just before the shutdown started. Perhaps there is a way to go before hitting the pain thresholds of the combatants.

If the shutdown extends into next month, it will be time to take a butcher knife, not a paring knife, to the US real growth forecast because the drag on activity compounds and a dysfunctional government will be barreling toward March 1, when the limit on the public debt snaps back. Default is not on the horizon because the Secretary of Treasury will go as far down the list of gimmicks as necessary to honor the debt. However, the process would be ugly, during which it will not go unmentioned that President Trump brought up restructuring the public debt early in his term. Additional distractions in an already unsettled age would ultimately take their toll on spending intentions and risk-taking attitudes.

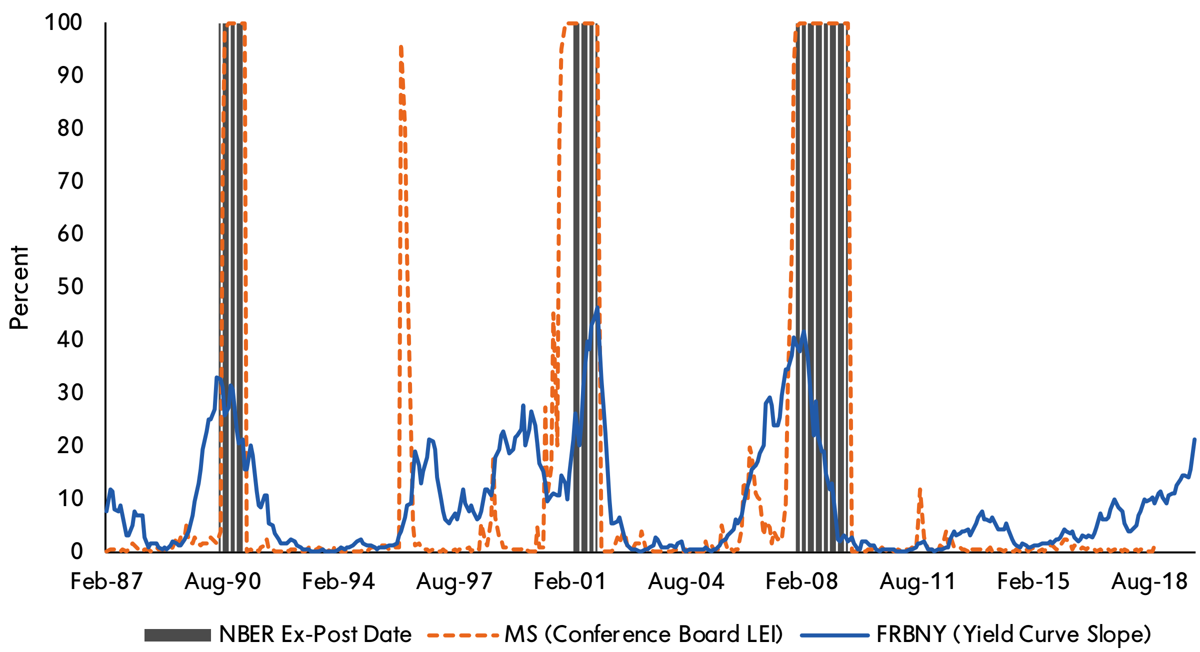
Although he would never admit it, a government shutdown (limited in size and duration) makes life a little easier for Federal Reserve (Fed) Chair Jay Powell. The discussion of the federal budget has crowded monetary policy out of the headlines, giving investors a chance to cool their overheated concerns about the Fed. The fourth quarter got ugly for Powell and company as market participants increasingly came to believe that global activity was slowing precipitously and the Fed's policy plan of further firming would tip the US economy into recession. Fed officials were slow out of the blocks in assuaging these concerns, probably because they were confused on two counts.

Plan, what plan? The official mantra has always been that monetary policy is data dependent and made meeting by meeting and that the guidance from the Summary of Economic Projections is conditional on the economic outlooks of individual participants of the Federal Open Market Committee (FOMC). They do not have a plan to raise rates. They have the expectation, based on what they know right now, that they will have to raise rates to sustain the economic expansion.

Recession, what recession? Real GDP growth tracks at about 3¼ percent in 2018, almost double their estimate of its trend when its level is already above trend. About 200,000 workers are added to payrolls, on net, per month, and financial conditions are still accommodative, albeit less so that in the middle of last year.

Still, financial markets appear priced for heavy economic weather. By way of example, the chart below plots two estimates of the probability of recession derived using a roughly similar statistical approach applied to two different variables—the slope of the Treasury yield curve (by staff at the Federal Reserve Bank of New York) and the Conference Board's index of leading indicators (by researchers at Morgan Stanley). The entirely financial-market-focused approach using yields raises a higher-pitched alarm about recession risk than the one based on the Conference Board leading indicator, which includes seven real-side and three financial variables.

Recession Probabilities



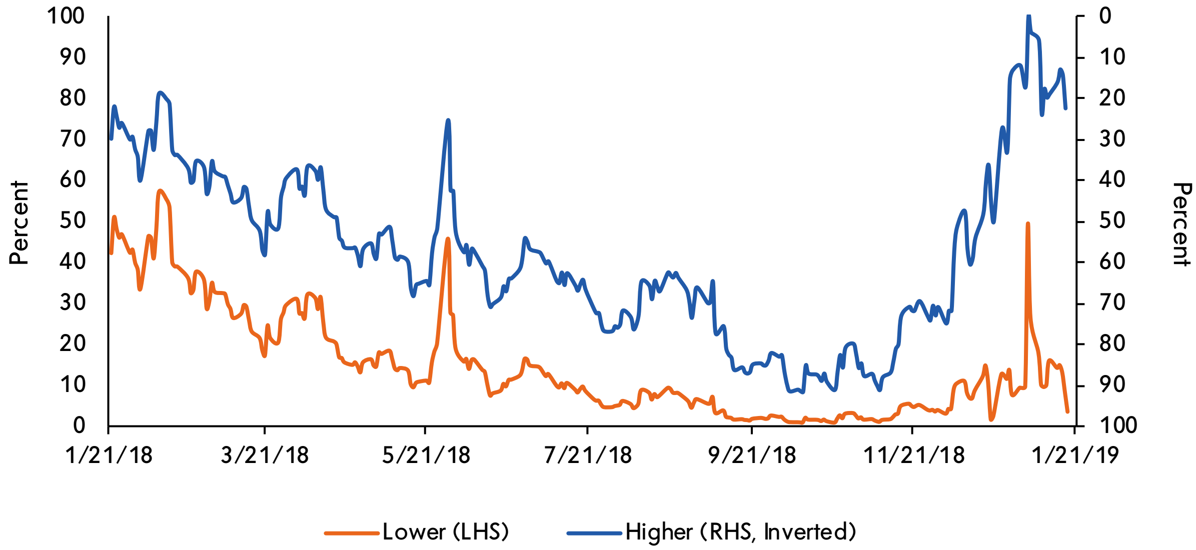
Source: Bloomberg, accessed 1/18/19. NBER is the National Bureau of Economic Research.

Fed officials ultimately got the message from markets and put the bow tie of "patience" and "prudence" around a more reassuring description of data dependence. Why the Fed's force of repetition that they will do their jobs reassured investors is puzzling on the surface. We expect policymakers to be patient and prudent all the time. The news would be if Chair Powell announced the opposite—"This year we will be neither patient nor prudent. Let's roll the dice." In effect, this would be giving President Trump the just cause he currently lacks to fire the Fed chair.

In fact, the word "patience" is freighted with meaning because of its special role in the doctrinal history of the Federal Reserve. It was first inserted into the FOMC statement in January 2004 (with yours truly as Secretary holding the pen) to signal that policy will be on hold at the next FOMC meeting. It was not meant to convey a longer-term commitment, only a speed bump on the path of policy action. While patience was not mentioned in the December 2018 statement, it was repeated enough since to be operative for the upcoming meeting, which is why interest rate futures imply a 99.5 percent chance that the FOMC holds the policy rate steady this month. Given that so many officials repeated the same characterization of policy so close to the upcoming FOMC meeting, expect to see the introduction of "patience" in its statement. If so, the Fed is contracting that it will take a pass at its March meeting, breaking the string of nine consecutive quarters in which it firmed the stance of monetary policy.

The Fed's problem is that investors appear to have a more encompassing notion about what precisely was said. That is, "patience" must mean "screeching stop" because almost all expectations of policy firming by year-end leaked out of market prices. That said, they also seem reassured that the Fed will not be making a mistake since the expectation of policy easing in the next twelve month was taken out as well.

Federal Funds Rate Target in December 2019 Relative to 2¼ percent Target



Source: CME FedWatch tool, accessed 1/21/2019.

Based on our economic outlook, we think the Fed would be making the opposite mistake if it matched those expectations of inaction for the year. The government shutdown does crimp first-quarter growth, to be sure. However, as long as politics does not ride us off the rails, we believe the economy will rebound to grow modestly above its longer-run trend over the remaining three quarters of 2019, keeping pressures on resources intense. Reassured about the momentum to spending and seeing a pickup in costs, in our view, the Fed will be inclined to restart the firming process. There is, however, a problem in hitting the restart button. The Fed had been on a steady roll, showing that a body in motion stays in motion. The flip side of Newton's first law, though, is a body at rest stays at rest. The Fed will have to see enough of the economic rebound to be convinced it has legs, and that probably will not be as soon as it April-May meeting (which is unseasonably early in 2019). Having put patience in the first two statements of the year, they probably do so again, effectively taking the June meeting off the table.

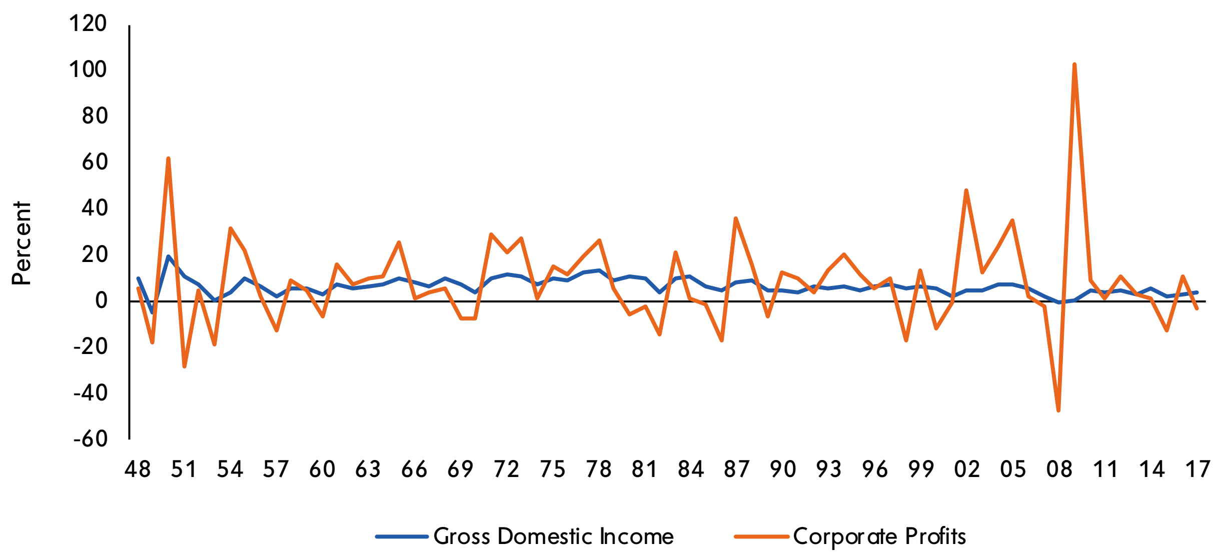
Here is where the partial government shutdown may be a blessing in disguise (albeit well hidden) for Jay Powell. If these were normal times, the headlines associated with a pause would intensify widespread worries about the economy that Fed officials probably do not sincerely share, imply that the Fed has some secret equity price target, and insinuate a backing-down in response to presidential criticism. These are not normal times. The partial government shutdown, even if resolved shortly, creates a first-quarter pothole, clouds the economic data Fed officials are so dependent upon, and makes investors more skittish toward risk taking. All are plausible reasons to pause policy tightening without sending as negative a signal about the medium term. Moreover, that the reason to stop firming was idiosyncratic makes the process easier to restart when the threat goes away. In our forecast, the pivot comes toward the middle of the year when evidence of a rebound is obvious.

The Fed chair will have some work to do in realigning market expectations to that new reality, but he has the opportunities provided by a press conference after every meeting and his semiannual testimony on monetary policy. We also expect the repetition that all decisions are data dependent to take on a different interpretation by investors when incoming information surprises to the upside and costs pressures push up inflation. At that point, Jay Powell only has to say, "Put me in coach, I'm ready to play." That is, we expect they drop the mention of their favorite of the seven virtues in July to tighten 25 basis points in each of the last two quarters.

In our view, the revival of the gradual, well-telegraphed removal of monetary policy accommodation will tighten financial conditions, slow economic growth from its above-trend pace, and keep inflation from overshooting the Fed's goal. This is unlikely to go as smoothly as it sounds, in part because investors have to be weaned from the notion that there is an attractively priced "Powell put" and the Fed will wait until the evidence is compelling that further firming is necessary. This should be associated with a step up in the implied volatilities of financial prices that puts upward pressure on term premiums.

Another implication for risk assets is that the slowing in real GDP necessary to keep inflation from moving above the Fed's goal will be associated with a shaper deceleration in profits. Note that the cyclical amplitude of the growth of corporate profits is about four times greater than that of gross domestic income. At this stage of the cycle, firms will have to handle faster increases in costs and rising short-term interest rates.

Gross Domestic Income and Corporate Profits



Source: Bureau of Economic Analysis, accessed via FRED.

The forces supporting economic growth are stronger than investors appreciate. In fact, they are strong enough to require further Fed firming. As a consequence, the selloff in risk markets of late was overdone—fundamentals are better than expected. Going forward, we believe the mismatch between fundamentals and current valuations narrows as economic activity slows back to its trend. All this, unfortunately, depends on the ability of US politicians to cooperate. As of now, the case is not proven.

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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.

Endnotes

1. By the way, recessions occurred in about 15 percent of the quarters in the post-war period so that the yield-curve-based indicator suggests average, not elevated, risk.

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