July 2019

Fed Thoughts:
The Sound of Silence

Vincent Reinhart | Chief Economist & Macro Strategist

BNY MELLON | INVESTMENT MANAGEMENT

MELLON

A lesson from art criticism offers some hope for understanding the Federal Reserve's (Fed) communications; (and at this point any hospitable quarter of comparison is welcome). Spoiler alert: we will go from here, to a movie, and end with a song for help. But back to the lesson. When pondering a work of art, the relatively empty spaces in a crowded picture often command the most attention.

Once viewed as a secretive place, the Fed now unmoors boatloads of information about the outlook for the economy and monetary policy almost as frequently as a Staten Island Ferry leaves the terminal. The Fed Board of Governors' website lists 53 speeches, testimonies, and other remarks by senior officials thus far in 2019. Each of the four meetings of the Federal Open Market Committee (FOMC) are accompanied by the release of a statement from the group, an implementation note by the staff, opening remarks by Chair Powell for his after-the-meeting press conference, and subsequently a transcript of his exchange with reporters. Not counted are informal panel remarks and media interviews, nor what is said on the margins of The Fed Listens, a feel-good national tour of monetary-policymaking empathy, perhaps showing at a nearby venue.

Additionally, Staff at the Board of Governors routinely post research, with 63 working papers and 24 notes uploaded in the first seven month of 2019. Meanwhile, the twelve Reserve Banks mine that same vein of macro ore with remarks by Bank presidents and research by staff.

Back to the art world and empty spaces: the irony is that what is not said sometimes sends the most important signal from monetary policymakers. The most recent cycle around the semiannual monetary policy report provides a good case study. In four work days, we got the report to the Congress, testimony from Fed Chair Powell, about five hours of exchanges by Powell with Capitol Hill questioners, and the minutes of the June meeting.

There were two white spaces on the canvas of Fed communications. The first prevailed throughout all the talk, and the second was filled in at the last minute.

For the first white space, FOMC members were silent on the prevailing market sentiment that policy easing is imminent and will be more aggressive than the last Fed guidance. For those who believe central banks never lean against public opinion, consider the contrast with the European Central Bank (ECB) governing council's June meeting minutes, released on the same day as the FOMC minutes. The ECB pushback was considerable:

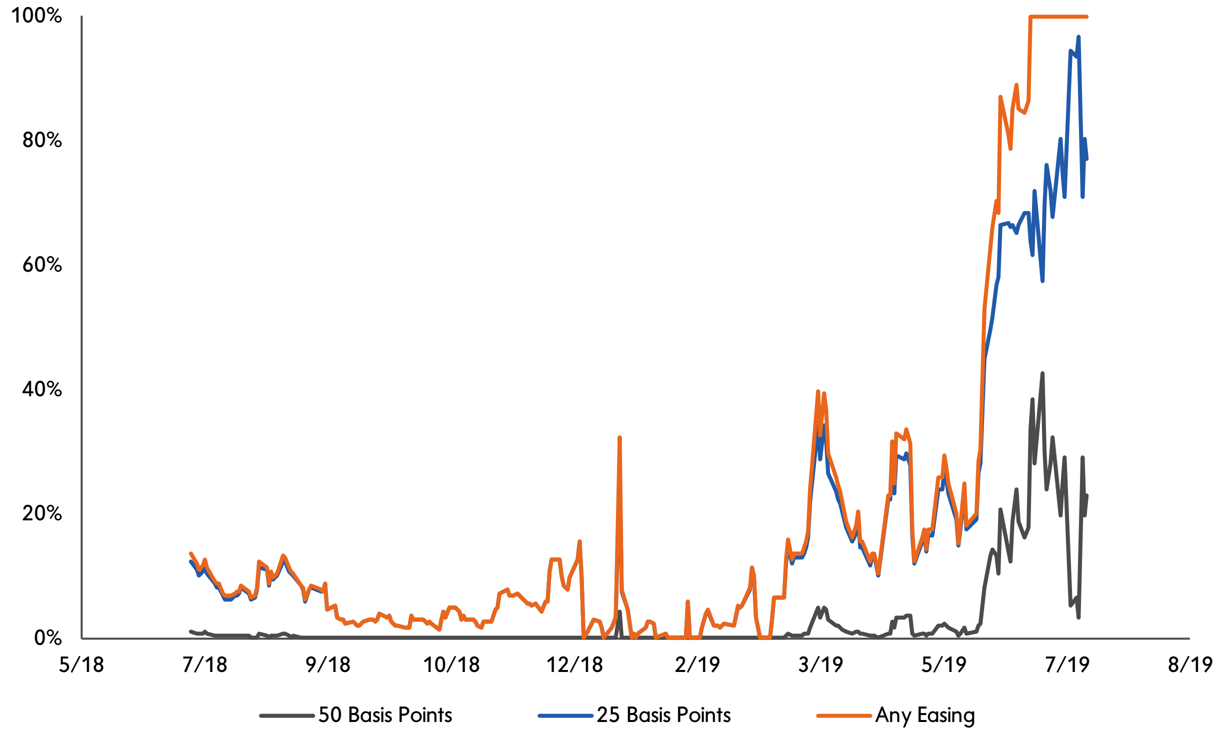
> *"Attention was drawn to an apparent dichotomy between economic projections and prevailing market perceptions of the outlook, as reflected in market prices, both globally and for the euro area. A view was expressed that markets might be prone to overreaction and overshooting, while economic projections tended to be somewhat sluggish in revising the outlook and subject to mean reversion. The point was made that financial markets tended to give greater weight to tail risks than the baseline."*

The governing council presumably did this, beyond their bewilderment of market pricing, because they did not want market participants to get overly hopeful given their limited scope for additional stimulus. In addition, they probably wanted to scale back expectations of easing to limit euro appreciation vis-à-vis the US dollar.

This comparison shows that it was certainly within the ability of Fed officials to try to disabuse investors about the prevailing policy notion. Rather, they chose not to, both as to the speed and scale of action embedded in futures prices. This was reflected in fed funds futures prices in two ways. First, the probability of a policy ease remained slammed at 100% (next page). Second, more market chips were pushed on a bigger ease, with the probability of a 50 basis point cut rising to about 25 percent post Powell. This Fed built this world, so they must want to live in it. In particular, if they left 50 basis points on the table, then 50 basis points is on the table.

Probability of FOMC Action in July

Inferred from Interest Rate Futures



Source: CME Fedwatch tool, accessed July 14, 2019.

For another, monetary policymaking, like a certain 1960s movie, apparently means never having to say you are sorry. (Fed Chair Powell went to Princeton, but he presumably would have been at ease on the Harvard quad in *Love Story*.) The minutes, report, and testimony stuck to a script describing a nimble Fed buffeted by late-breaking shocks associated with trade tensions and a global slowdown. All was unexpected. There was no regret that, perhaps, the tightening at the tail end of 2018 was overdone, given the failure of inflation to subsequently rise as was expected at the time. That is, unsaid was that the neutral rate of interest may be lower than had been expected concomitant with a lower natural rate of unemployment.

To his credit, Powell tacked in the last day of his testimony, filling in one space of the crowded canvas. The chair admitted that, "...we are learning that the neutral interest rate is lower than we had thought and ... the natural rate of unemployment rate is lower than we thought. So monetary policy hasn't been as accommodative as we had thought." Note that this puts 50 basis points more assuredly on the table in late July. Vague concerns about activity (even as 224,000 jobs were created in June) in light of divergent political possibilities may point to a 25 basis point cut for insurance. In contrast, if the neutral rate has fallen, risking lower inflation expectations because policy is not as accommodative as thought, more significant easing might be called for. Moreover, if the neutral rate did drop, it elevates the importance of advice from research to move forcefully, at the earliest opportunity, in advance of the possibility of the zero lower bound to nominal interest rates. We take that late-minute addition by Fed Chair Powell, interjected by him in the discussion (watch the hearing), as revealing to current Fed thinking.

Policy advice takes the form of wish, should, and will. As for wish, if Powell could travel back in time, he would explain that the prior incremental tightening was not threatening to economic activity as long as the Fed was nimble in correcting course, if necessary. Holding policy here would be appropriate.

However, he cannot travel back in time and has to deal with the current setting of expectations. Should, definitely, is situational advice in our view. The best course now would be to dig a "firebreak," in the Alan Greenspan precedent. Outstrip expectations with the 50 basis point cut and declare that this insurance balances the evident risks. Going forward, the Fed would be nimble to risks on both sides. This might stanch growing expectations as to the extent of ease and limit the pain later as the macro data show that these concerns are outsized.

It might appear that the low-risk strategy, the will do, is to meet modal expectations of a 25 basis point move. The risk is that this feeds the beast, in that barely meeting expectations adds to expectations of future action. Media reports about "When will the Fed do more?" should be more troubling than "Is the Fed done?" in their effect on the dynamics of expectations.

The incoming data are mostly in favor of the modest course, as the Fed might find it hard to justify more than a 25 basis point ease in light of strong job gains and higher-than-expected consumer prices. But, most of them must be leaning to a 50 basis point cut (especially after Fed Chair Powell's performance). This raises the question, if not now, when? We hope they get it over with by cutting rates 50 basis points this month, putting about half the odds on that outcome.

For the other half of the probability space, we delegate the explanation to Paul Simon, slightly revised from the original. Fed Chair Powell would be well served to plunk out this song on his guitar (perhaps accompanied by Vice Chair Clarida, the more polished musician on his team) for the greater Fed community:

…in the naked light of cable TV I saw
Ten thousand people, maybe more
People talking without speaking
People hearing without listening
People writing songs that voices never share
No one dare
Disturb the prevailing view

"Fools" said I, "You do not know
Policy cuts like a cancer grow
Hear my words that I might teach you
Let the message of excess ease reach you"
But my words like silent raindrops fell
And echoed in the wells of silence

And the people bowed and prayed
To the neon god they made
And the sign flashed out its warning
In the words that it was forming
And the sign said "The words of the prophets
Are written in a Chicago futures pit
And repeated by anchors with wit
And amplified in the sounds of silence"

Vincent Reinhart
Managing Director, Chief Economist & Macro Strategist

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.

Disclosure

For more market perspectives and insights from our teams, please visit www.mellon.com.

BNY MELLON | INVESTMENT MANAGEMENT

MELLON

www.mellon.com