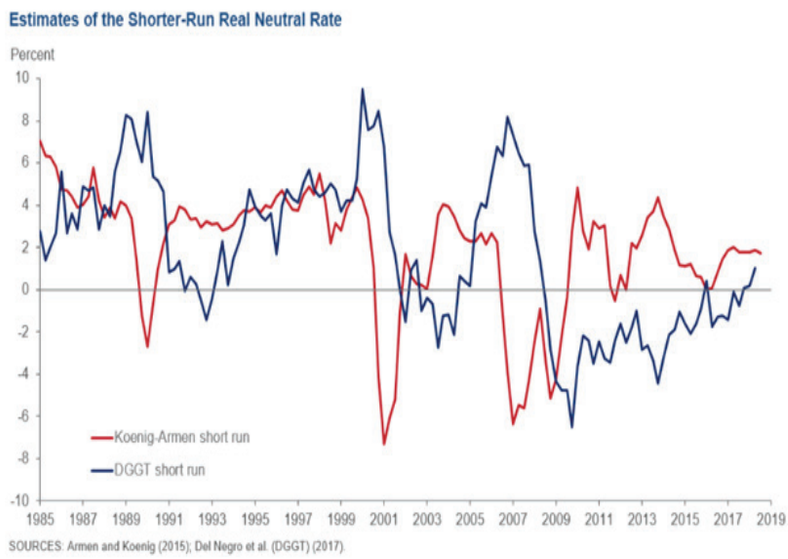
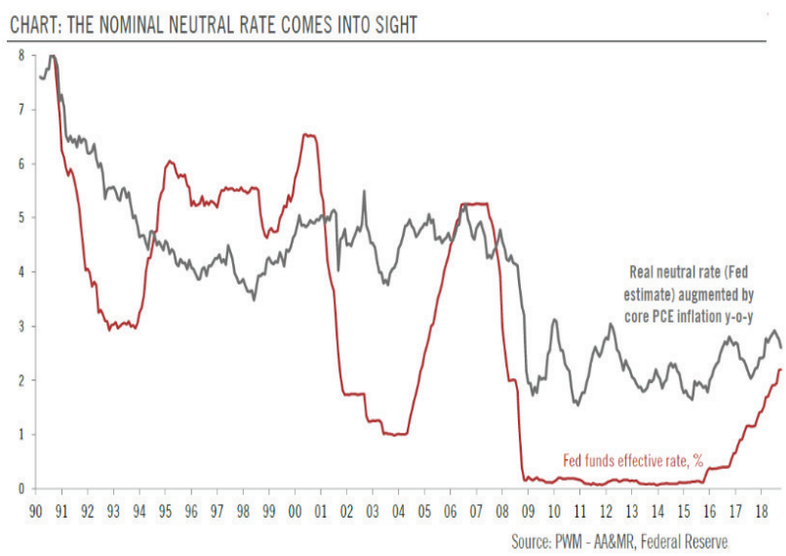
34 / The Fed walks back on it aggressive monetary policy stance: December hike is on, but 2019 may see slower tightening pace

Two weeks ago, Fed chair Jerome Powell walked back from his statement on early October that monetary policy is a "long way from neutral" to "just below neutral" On October 23 – all in less than 30 days, and accomplished without any actual adjustment of monetary policy. It was an amazing, and at the same time, an embarrassing volte-face for Mr. Powell, who crashed the stock markets will his ill-considered remarks in open Question and Answer session. The financial markets are still suffering from the severe market declines that followed his almost cavalier remarks.



Now, Mr. Powell probably regrets his early October remarks and is probably walking back those remarks by saying policy is now at almost neutral levels. Just what does that mean? The neutral rate, it is held, is one that is consistent with stable prices and a balanced economy. What is required is Fed policy makers successfully targeting the federal funds rate towards the neutral interest rate (R*), (*see 1st chart on this page)*.



The widely held belief by central bankers and many economists is that by means of suitable monetary policies, the US Federal Reserve can navigate the economy towards a growth path of economic stability and prosperity. The key ingredient in achieving this is price stability. Most experts are of the view that what prevent the attainment of price stability are the fluctuations of the federal funds rate around the neutral rate of interest *(see 2nd chart on this page)*. According to this thinking, which originated with Swedish economist Knot Wicksell in the late 19th century, there is a certain rate of interest on loans, which is neutral in respect to commodity prices, and tend neither to raise nor to lower them. Hence, the term "neutral rate".

In this concept, the main source of economic instability is the variance between the money market interest rate and the neutral rate.

If the money market rate falls below the neutral rate, investment will exceed saving, implying that aggregate demand will be greater than aggregate supply. Assuming that the excess demand is financed by the expansion in bank loans, this leads to the creation of new money, which in turn pushes the general level of prices up.

Conversely, if the money market rate increases above the neutral rate, savings will exceed investment, aggregate supply will exceed aggregate demand, bank loans and the stock of money will contract, and prices will fall. Hence, whenever the money market rate is in line with the neutral rate, the economy is in a state of equilibrium and there are neither upward nor downward pressures on the price level.

That is why, according to the proponents of this concept, it is desirable to bring central bank monetary policy in line the level of the neutral interest rate. Proponents of this concept say that to establish whether monetary policy is tight or loose, one also needs to compare money market interest rates with the neutral rate.

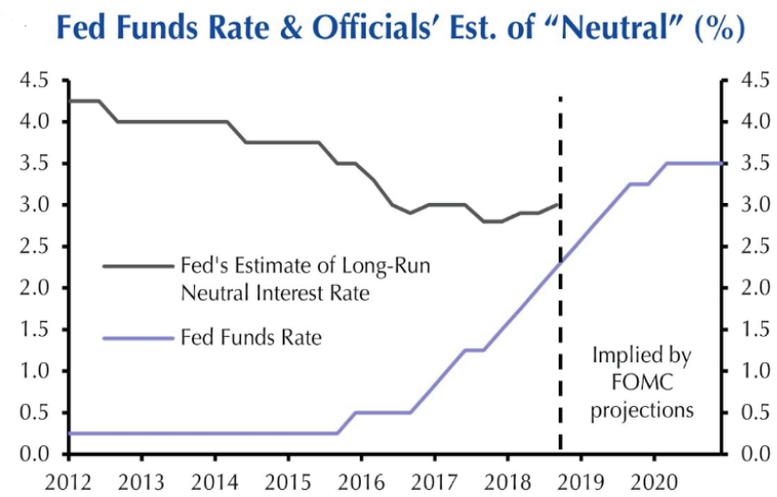
Thus, if the market interest rate is above the neutral rate, then the policy stance is tight. Conversely, if the market rate is below the neutral rate, then the policy stance is loose.

There are many detractors of this concept, who point out that as presented by mainstream economics, it does not originate from the facts of reality but rather from the imaginary construction of economists. **None of the figures that underpin the intersection of supply and demand curves (which determines *R) originate from the real world; they are purely imaginary.** Yet, economists heatedly debate the various properties of these unseen (even unreal) curves and their implications regarding government and central bank policies.

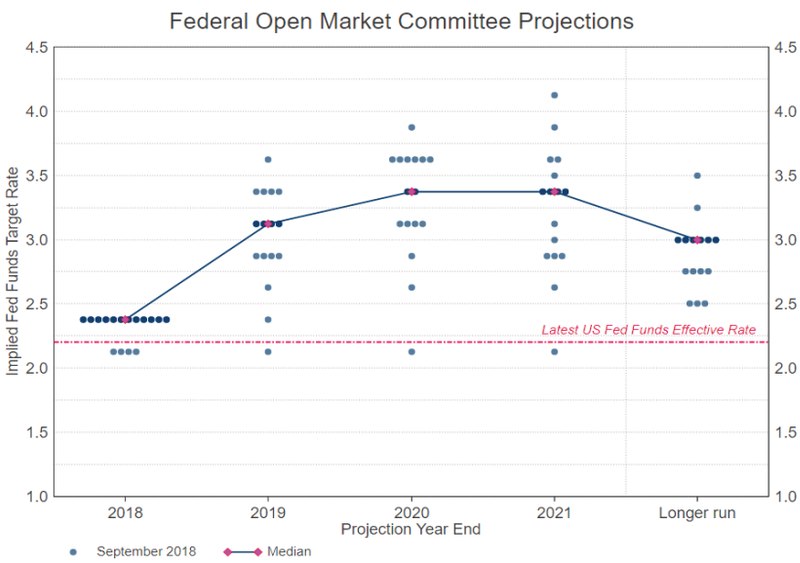
Nonetheless, the Federal Reserve uses the construct to determine whether monetary policy is, indeed, relatively loose or not. And now Mr. Powell is invoking this concept to claw back some of the overt hawkishness that he and other FOMC members have been espousing just a few weeks ago.

It began with Fed Chair Jerome Powell telling Dallas Fed chief Robert Kaplan in an on-stage interview that policymakers may need to "slow down" amid growing uncertainty, just as someone feeling their way through a dark room filled with furniture would need to do. Then last week, in minutes of the Fed's November meeting, policymakers were clear they are preparing to ditch a longstanding promise for "further gradual increases" to the Fed's policy rate. **As of just a few months ago, Fed policymakers had indicated they would probably increase interest rates three times in 2019. This is a remarkable transformation in the outlook of the Fed chief and of the FOMC.**

So we ask: just what economic indicators have been seen by Mr. Powell to make him do this embarrassing climb-down? Recent data have shown the housing market slowing, job gains are cooling, and inflation giving no signs of rising above the Fed's 2-percent target. Indeed, there are plenty of reasons for hinting at a slowdown in monetary policy in 2019, starting with a pause in March. Nonetheless, the market continues to bet on a Fed rate hike in two weeks, when policymakers will next meet and, importantly, release fresh forecasts for the rate path for next year and beyond. However, even a December rate hike is not a given anymore. The market, based on Federal Funds futures, has lowered the implied probability of a rate hike in December to 69% as of the market close on Thursday, falling as low as 60% at the lowest point of the market sell-off.



Source: Thomson Reuters Datastream / Robert P, Balan Models (c)



Source: Thomson Reuters Datastream / Robert P, Balan Models (c)

Not all FOMC members have been hawkish in their outlooks. St. Louis Federal Reserve bank president James Bullard repeated his call for the Fed to pause its current cycle of interest rate increases, saying the central bank may already be restricting the economy and noting that inflation expectations are drifting downward. Mr. Bullard, who next year, will be a voting member on the Fed's policy-setting committee said that with inflation contained and at no risk of breaking out, investors are nervous the Fed has gone too far. Recent market developments and an expected further interest-rate increase means there is a "real risk" the Treasury market yield curve could invert this month, according to Mr. Bullard. If the FOMC does slow its tightening scheduled next year, it will be a

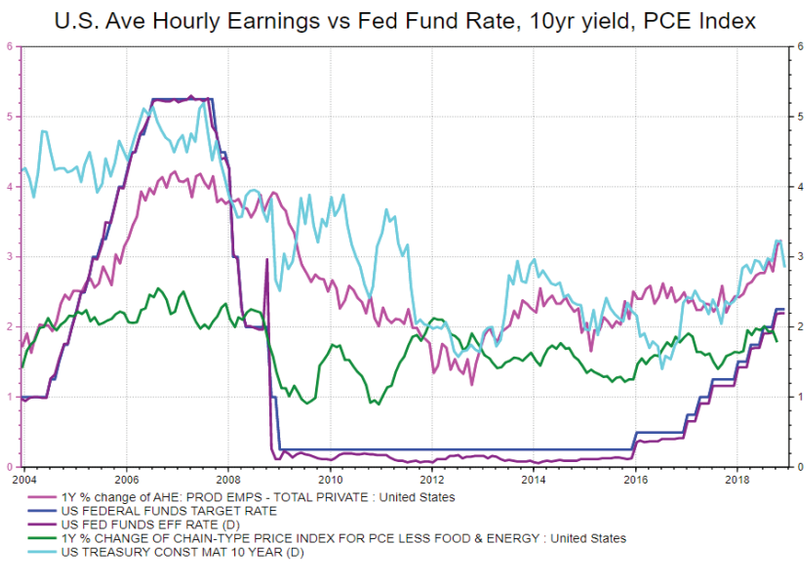
tremendous validation of Mr. Bullard's long battle to significantly slow the pace of the rise of policy rates *(see first chart on this page)*.

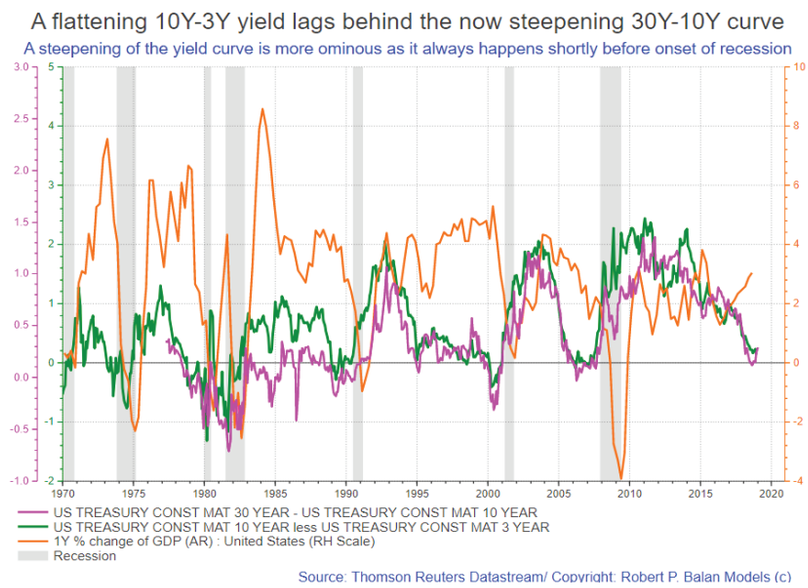
Fed hawks have long contended that financial stability risks call for further rate hikes to tamp down dangerous risk-taking. Also, stopping after just one or two more rate hikes, when rates would be at most between 2.5 percent and 2.75 percent, would make the Fed's job harder by giving it less leeway to cut rates to offset any future downturn. Moreover, with unemployment at 3.7 percent, some economists think upward pressure on inflation is only a matter of time.

Average hourly earnings increased 3.2% year-over-year last month. Obviously, once again that was the highest increase in almost a decade. Other than October, the last time BLS data counted 3% hourly wages was May 2009. The 6-month average for the volatile series is pressed right up against 3%.

These numbers seem impressively supportive of the hawkish case, but they are not. The only way 3% is good is if the labor market is on its way to more normal 4%, or, which would be consistent with a labor shortage of the sort that has been described over the last year or so, 5%. Just passing 3% while the unemployment rate has itself been 3.7% for three straight months is, indeed, remarkably unremarkable. The wage growth was the rationale du jour only a few weeks ago for espousing tighter policy. But the markets and even the media don't really care as much about this one data point as they used to, in the light of the perceived slow-down of the US economy.

The new market meme and focus, which is scaring the wits of everyone, is yield curve inversion. Because of inversion, many investors are now forced to confront another interpretation of the economy. Inversion of the yield curve has been consistently a harbinger of an economic recession.





Historically speaking, however, an inversion of the yield curve does not "immediately" coincide with a recessionary onset, and the lag between inversion and recession has been from 15 months to 28 months.

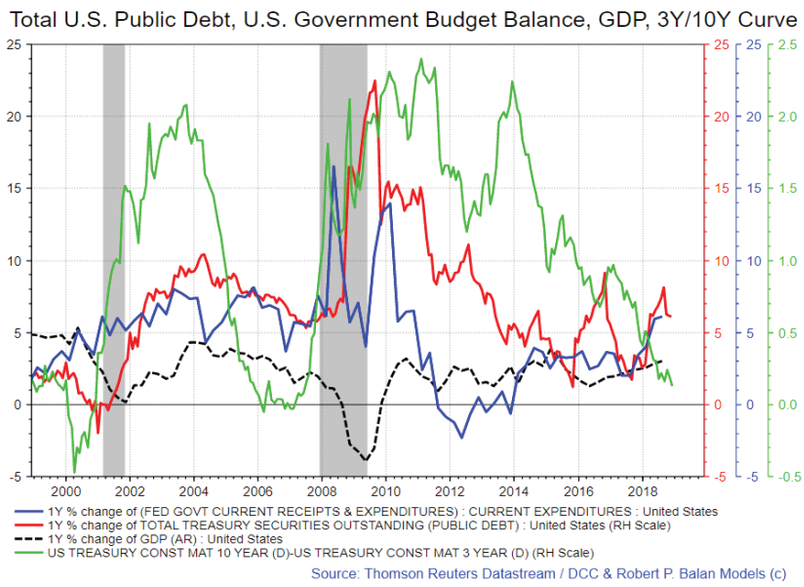
In fact, some of the best equity market bull phases in history have taken place during an inversion of the yield curve. And this is why it happens: the relentless flattening of the yield curve is caused by the pressure exerted on the front end by the Fed tightening regime – the faster the pace of the tightening, the steeper the flattening of the yield curve. The Fed tightens the most when economic growth grows too quickly for their comfort. But these are the conditions that are conducive to significant upmoves in the equity markets *(see 2nd chart in this page)*.

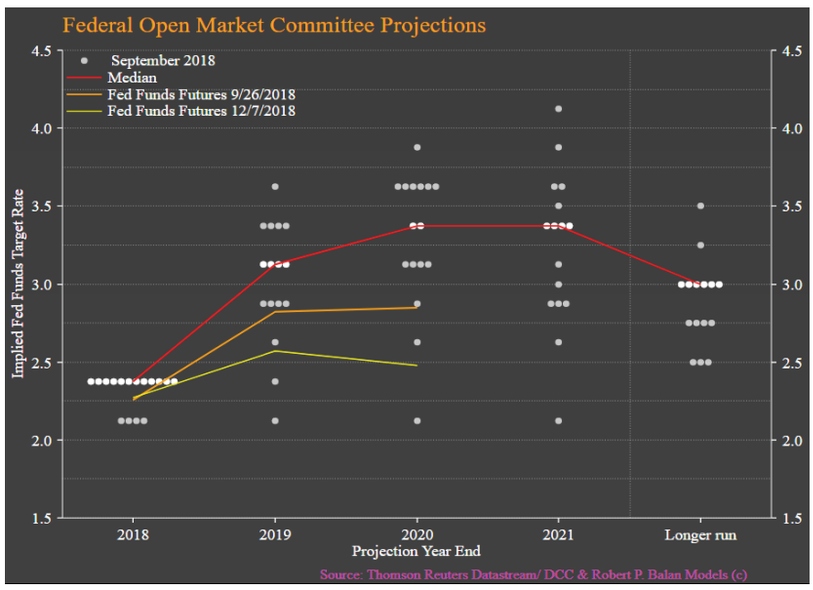
Also, a surge in U.S. short-dated debt issuance has altered the dynamics of the Treasury market and has certainly will help speed up the inversion of the yield curve. As the Trump administration ramps up debt sales to cover a budget deficit projected to hit $1 trillion next year, it has crowded the front of the yield curve with far more new bonds than the back end. The U.S. Treasury Department has increased supply of two-year notes by $82 billion since February, far exceeding $22 billion in 10-year notes it issued over the same time frame. That serves to pressure front-end rates, compressed the spread between the 3yr and 10 yr yields, which had contributed to the significant flattening of the yield curve. That also means that a recession being signaled by a yield inversion may occur significantly farther off than the usual

15 to 28 month time lag *(see 1st chart on this page).*

In reality, the yield curve's current slope itself does not yet present a threat to the U.S. economy, but it does reflect investor expectations about Federal Reserve actions and about the durability of the U.S. current economic expansion. While the curve is not inverted as yet, the trend of the spread maybe warning from the bond market that the Fed's tightening regime may indeed be starting to constrict the economy and may lead to a halt to the expansion.

The market fears are well-founded: there have been absolutely ZERO times in history that the Federal Reserve has begun an interest-rate hiking campaign that has not eventually led to a negative outcome. Simply put, every Fed tightening in history has ended with a recession. And there is no rationale to believe that it will be different this time around. The only detail yet to be resolved is when will the recession take place, and for how long? Most likely however, a recession following an inversion of the yield curve this time around could take longer to manifest than the historical that we have seen in the past several decades.





Summary:

We believe that the Fed will still raise rates in December, but the central bank will modify the rate hike regimen over the next two years that was previously set forth by the SEP Dots *(see 2nd chart on this page)*. The market has now increased the odds to 80% that the Federal Funds rate will be at 2.75% or below by the end of 2019. That means most likely just two rate hikes left. Looking at the market's expectations for monetary tightening another way, Eurodollar futures suggest just 16 basis points of tightening for all of 2019 (*see 2nd chart on this page*).

These are evolving numbers, but the data highlight the change that is occurring with regards to the Fed's policy outlook in the medium-term. The Fed could end up modifying the monetary policy path to more moderate slopes. That should give heart to investors currently being battered by crisis of confidence on the Federal Reserve. That means 2019 is far from a lost cause, and in fact could see a sharp positive move for risk assets after mid Q1.