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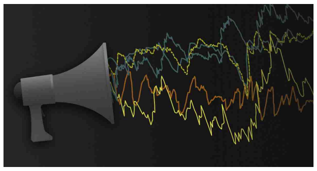

Around the Curve

It Is All Over But The Shouting

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Introduction

Federal Reserve (Fed) Chair Jerome Powell made the pilgrimage to Capitol Hill to deliver the semi-annual monetary policy testimony to both chambers of Congress. The chairman, along with the Federal Open Market Committee (FOMC) members, have turned increasingly dovish in the aftermath of weakness in financial markets at year-end 2018, when financial conditions tightened. At that time, the S&P 500 fell around 20% from the beginning of the prior quarter of 2018 to Christmas Eve, while the U.S. 10-year note hit a 5-year high of 3.3% on November 7, 2018. The market verdict was that the Fed had gone too far in its normalization policies, with rates too high and the balance sheet reduction potentially constraining U.S. economic growth—a view we also held. Those policies had boosted the U.S. dollar and had a global impact.

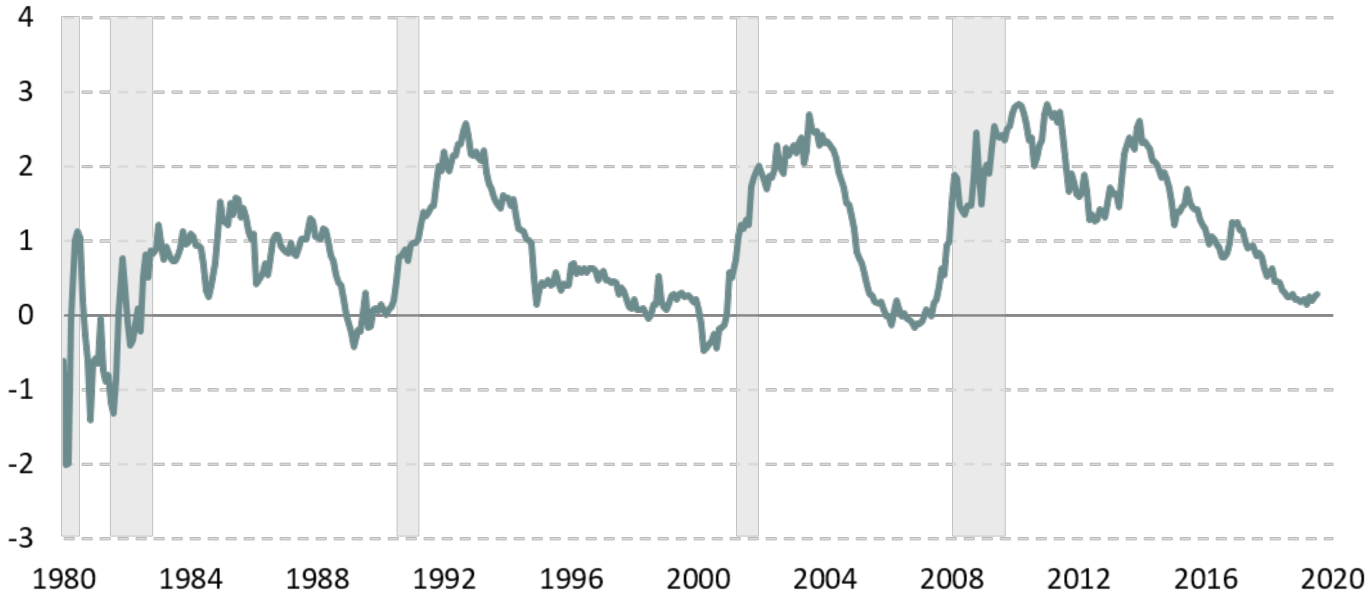
Now, financial markets have recently “lobbied” for a return to accommodative monetary policy, although the fundamental supports for an aggressive round of accommodation remain mixed. We have posited the Fed could start easing as early as July, so let’s look at several signals below to see to what extent they support Fed dovishness, or even serve as reliable indicators after years of unprecedented policymaking and market conditions.

The Guiding Signs

The recession signals. Today, the Fed’s policy rate stands at a range of 2.25-2.50%. The tightening over the course of four years has contributed to an inversion of the yield curve, as measured by the difference between the 10-year Treasury note and the 3-month Treasury bill. This inversion has typically harkened a recession. However, another yield curve indicator of recession—the difference between the 2-year Treasury note and the 10-year yield—remains positive (**Chart 1**), albeit the curve has flattened dramatically. All told, the two yield curve measures of inversion tell conflicting stories: one measure is flashing recession, the other is not, yet both measures are a cause for market concern. The signal embedded in the yield curve may now be distorted by years of unconventional monetary policy, meaning the yield curve message may be not be the same one as in the past.

Chart 1: Yield Curve, 10 Year Less 2 Year

Interest Rate Spread: 10 Year versus 2 year, As of 7/15/2019



Shaded grey areas indicate recession.
Source: Macrobond

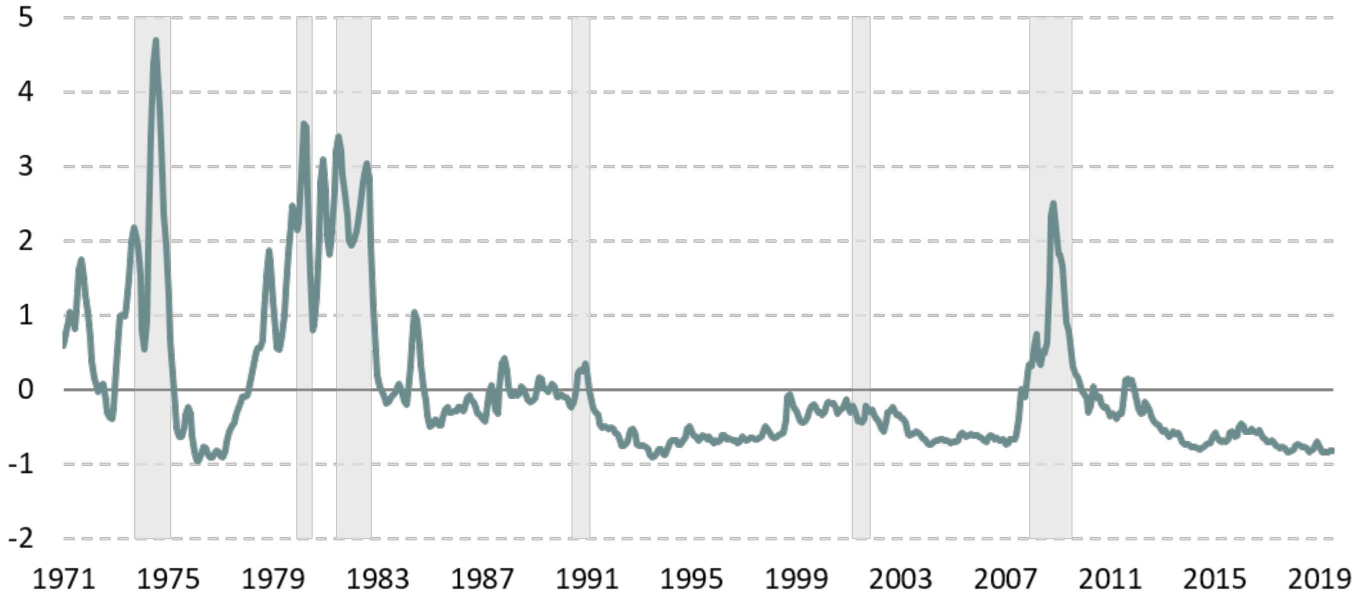
The Fed is now less data dependent. Chair Powell's opening statement to Congress contained a rather sanguine view of the U.S. economy, as he reviewed recent growth and the labor market temperature. He did note that a growth slowdown likely occurred in the second quarter and that appears to be confirmed by the Atlanta Fed's GDPNow forecast of just 1.6%. However, this isn't a great revelation given that neither inventory investment nor trade will replicate the contributions they had to GDP in the first quarter. The U.S. economy recorded surprisingly strong job growth in June. Non-farm payroll employment rose 224,000 in June, surprising analysts. The unemployment rate stands at 3.7%, well below most estimates of the unemployment rate when the economy is at full employment.

Small business optimism, although slipping in June, remains at a historically high level. Small businesses still find it difficult to fill job openings. June retail sales tell the story of a strong consumer and core inflation broke through 2.1%. While the consumption deflator is only rising 1.5%, inflation expectations have rebounded recently, as measured by 2-, 5-, and 10-year break evens. Rather than domestic data, what is perhaps instead driving the Fed is the increasingly uncertain global economic outlook created by trade tensions and the resulting slowdown in international trade. Would these global forces spillover into the U.S. economy? Being sensitive to that potential outcome may have tempted Chair Powell to depart from his dual mandate of full employment and price stability. Considering monetary policy against this backdrop suggests a move toward risk management, with the Fed using any rate reduction as an insurance policy.

The financial system is stressed and monetary accommodation needs to relieve that stress. Again, the data appears to be inconclusive and depends on how an analyst might measure financial stress. Fortunately, the market has filled the void and a number of measures are available. Some Fed regional banks have constructed indices of financial conditions or financial stress. Private sector analysts have also added to the research. Let's talk about two of them, the Chicago Fed's National Financial Conditions Index (FCI) and The Goldman Sachs Financial Conditions Index (GSI). The Chicago Fed produces the more comprehensive index that includes over a hundred variables, grouped in three sub-indices that cover risk, credit, and leverage. The series is updated weekly. The other measure is a simpler construct, comprising just five variables, including the trade-weighted dollar, and is available daily. Charts 2 and 3 below show that financial stress is below average.

Chart 2: Chicago Fed National Financial Conditions Index

As of 7/14/2019



Shaded grey areas indicate recession.
Source: Federal Reserve Bank of Chicago/Macrobond

Chart 3: Goldman Sachs U.S. Financial Conditions Index

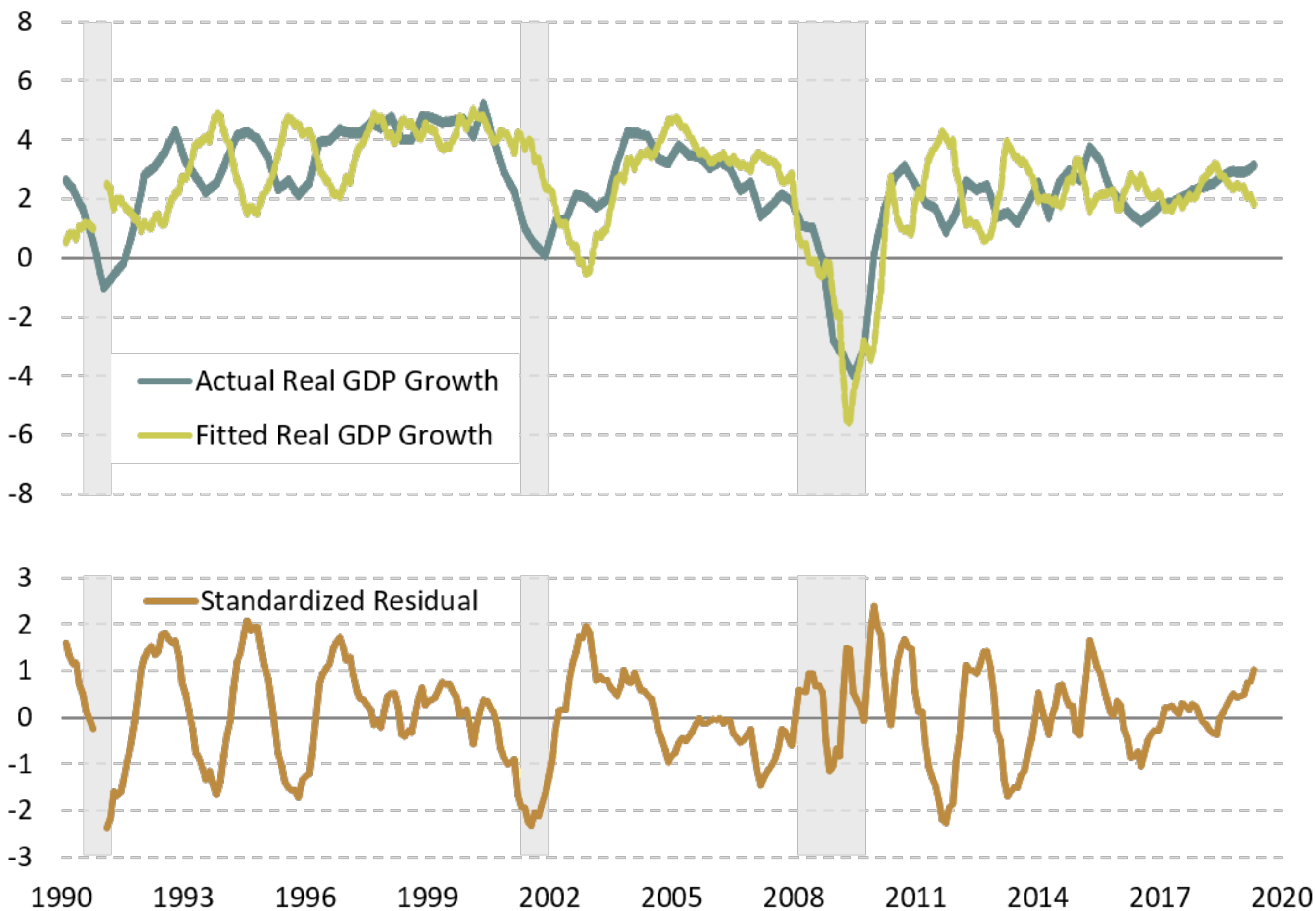
As of 7/15/2019

Shaded grey areas indicate recession.
Source: Bloomberg Finance

In both indices, financial stress is measured against average conditions. For the FCI, a reading above zero indicates tightening conditions, while for GSI, 100 is the demarcation between tightening and loosening financial conditions. First, increasing financial stress occurs in recessionary periods and, second, current financial conditions do not reveal financial stress in the system. Lastly, let's include these stress variables in a regression that includes real gross domestic product (GDP) growth as the dependent variable. The two independent variables are both lagged. Chart 4 compares the actual GDP growth with the fitted value generated by the model. The model suggests growth should be a bit lower, based on current financial conditions, but there isn't sufficient financial stress to generate deteriorating economic growth. Therefore, all we could be looking at is a normal mid-expansion slowdown, in which case, it could provide the Fed with a reason to exercise its "insurance" policy.

Chart 4: U.S. Financial Conditions Model

As of 3/31/2019



Shaded grey areas indicate recession.
Source: Macrobond, Bloomberg Finance

Conclusions

Agustin Carstens, General Manager of the Bank for International Settlements, has recognized the potential vulnerabilities created by monetary policy and cautioned central bankers the effectiveness of monetary policy has been reduced and could create vulnerabilities in the financial system. This observation may have resonance, given Chair Powell's emphasis on uncertainties, which may tilt U.S. monetary policy towards being more prospective. U.S. economic data is not overly supportive of lower interest rates, putting the Fed's focus instead on risk management and taking out an insurance policy against global uncertainties. The U.S. financial system does not appear particularly stressed and in need of monetary accommodation, but market anticipation of easier policy could have alleviated any system stress. The reduced term premium for U.S. Treasuries can be explained partly by shifting foreign demand, suggesting an inverted yield curve should not warrant extreme caution.

While some of these traditional recessionary signals may have lost some of their potency, their embedded message shouldn't be ignored; perhaps this is the reason why a 25 basis point reduction in the federal funds rate has become a near certainty on July 31, with markets now appearing to price in a total of three rate cuts for 2019. In spite of this market exuberance, a purely data-driven central bank would be justified in waiting to cut rates. In a few days, we will see whether market expectations were met or misaligned, as they were at the Fed's May meeting.

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