

Tim Duy's **Fed Watch**

MAY 28, 2019

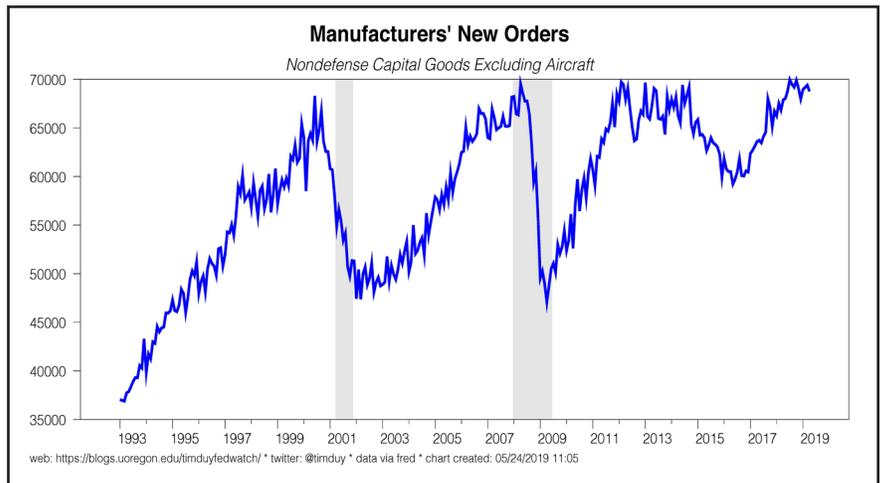
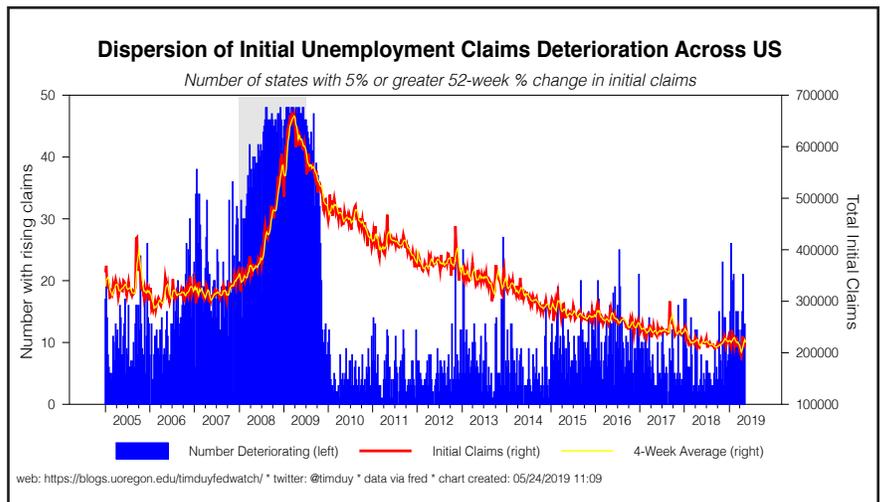
Fed Sticking With "Patient" Policy Stance

Recent Data

A few notable data points from last week. First, initial claims continue to hover around cycle lows. Recent data has been volatile; I think the best explanation for this volatility is the odd timing of holidays throwing off the seasonable adjustment factors. **Looking through the volatility, claims have leveled since the second half of 2018 while the dispersion of incidence of rising claims across the U.S. has risen a notch. Feels like a repeat of the patterns of the data around 2015-6.**

The 2015-16 weakness was concentrated in the manufacturing sector. We are seeing something of a repeat now, although less disconcerting at this point. **To be sure, core durable goods orders disappointed with a slight decrease. To date though, the overall pattern has been one of general flatlining of orders.** Clearly, the current weakness does not compare to 2015-6 let alone to a recessionary-type decline. **A caveat of course is that the April data preceded the recent intensification of trade tensions. If those tensions are weighing heavily on business confidence, we would expect more substantial declines in the months ahead.**

A classic indicator, housing, has bounced back from declines at the end of last year with the March number being revised up to a new cycle high. Typically, substantial, sustained downturns in housing activity precede recessions. This historical pattern suggests that we should take comfort in the housing numbers. That said,



the 2001 recession did not have a large housing component; housing even rebounded in the year ahead of the recession. Hence, we should be open to the possibility of a non-housing related recession. On the other hand, the data also matches the 1994-95 pattern. If we are experiencing a repeat of that episode, we should be looking for housing to be modestly supportive of growth this year (although this may just cancel out the modest weakness anticipated from the auto sector).

The Atlanta Federal Reserve's GDP Now measure currently estimates Q2 growth at a paltry 1.3%. Inventories, however, are a substantial drag on the headline growth numbers. **In contrast, final sales to private domestic purchasers are estimated to rise 2.7% compared with a 1.3% gain in the first quarter. The Fed will be watching this number; if underlying domestic demand rebounds substantially relative to the first quarter, Fed policymakers will discount weakness in the headline number.**

Federal Reserve Minutes

The minutes of the April/May FOMC meeting revealed that participants were generally comfortable maintaining the "patient" policy stance initiated in January. Policymakers recognized that special factors boosted the first quarter growth numbers:

For this year as a whole, a number of participants mentioned that they had marked up their projections for real GDP growth, reflecting, in part, the strong first-quarter reading. Participants cited continuing strength in labor market conditions, improvements in consumer confidence and in financial conditions, or diminished downside risks both domestically and abroad, as factors likely to support solid growth over the remainder of the year.

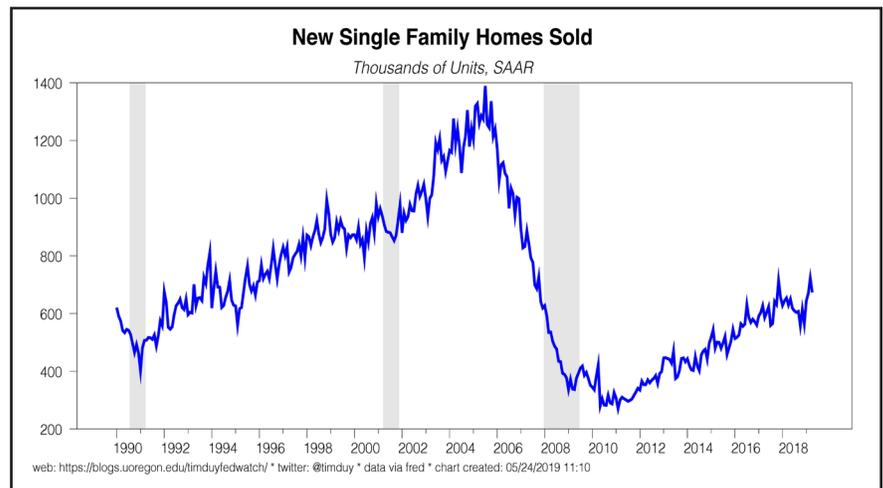
Looking forward:

Some participants observed that, in part because of the waning impetus from fiscal policy and past removal of monetary policy accommodation, they expected real GDP growth to slow over the medium term, moving back toward their estimates of trend output growth.

It's interesting that only "some" participants believed growth would slow toward trend. Presumably, a larger group anticipated a more moderate slowing of activity (and there isn't a group anticipating excessive slowing). Still, at that time the Fed was somewhat optimistic about risks to the forecast:

A number of participants observed that some of the risks and uncertainties that had surrounded their outlooks earlier in the year had moderated, including those related to the global economic outlook, Brexit, and trade negotiations. That said, these and other sources of uncertainty remained.

As noted above, rising trade tensions have since clouded the outlook, so the Fed will likely not be quite so optimistic at the June meeting. As far as inflation was concerned, policymakers generally supported the conclu-



sion that recent declines were transitory:

Consistent with the view that recent lower inflation readings could be temporary, a number of participants mentioned the trimmed mean measure of PCE price inflation, produced by the Federal Reserve Bank of Dallas, which removes the influence of unusually large changes in the prices of individual items in either direction; these participants observed that the trimmed mean measure had been stable at or close to 2 percent over recent months.

Concerns about falling inflation expectations remain contained to a minority. That said, that contingent will grow if inflation doesn't pick back up soon:

Several participants commented that if inflation did not show signs of moving up over coming quarters, there was a risk that inflation expectations could become anchored at levels below those consistent with the Committee's symmetric 2 percent objective—a development that could make it more difficult to achieve the 2 percent inflation objective on a sustainable basis over the longer run.

In the end, the FOMC concluded they would be best served by continuing along the current path:

Members observed that a patient approach to determining future adjustments to the target range for the federal funds rate would likely remain appropriate for some time, especially in an environment of moderate economic growth and muted inflation pressures, even if global economic and financial conditions continued to improve.

That last line implies that even if conditions improve relative to their current expectations, they will not easily raise their rate forecasts. In other words, the bar to a hawkish shift is fairly high.

Fed Speak

As a general rule, Fed officials are sticking with the story that the economy is in a "good place" and that rate hikes and cuts are equally likely. San Francisco Federal Reserve President John Williams **said**:

I don't see any strong argument today, based on what we have seen in the data or other information, to move interest rates one way or the other...

Although trade tensions simmer in the background, Boston Federal Reserve President Eric Rosengren **believes the outlook has brightened in recent weeks**:

Setting aside recent trade-related concerns, the broader U.S. economy seems to be displaying a sounder footing than it was at the beginning of this year.

He does of course recognize the risk that the U.S. – China dispute may drag on for longer than he anticipates and adversely impact the outlook. Ultimately, he sees no "no clarion call to alter current policy in the near term."

Atlanta Federal Reserve President Raphael Bostic **doesn't see the case** for a rate cut over a rate hike. Instead, he believes: "the policy course we have done has been exactly on point." In contrast, St. Louis Federal Reserve President thinks **policy might be a notch too tight**:

I am concerned we may have slightly overdone it with our December rate hike but I was pleased that the committee pivoted.

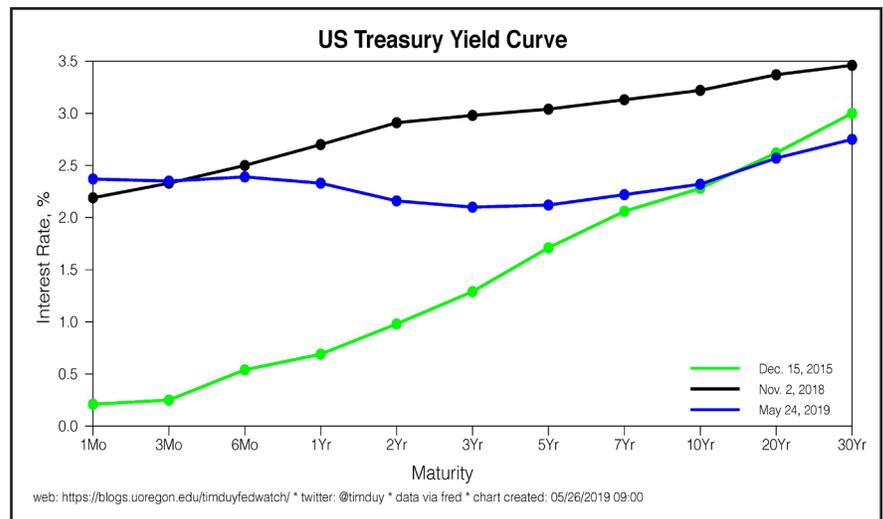
He doesn't think, however, the situation justifies an immediate rate hike. He also argues that the tariff battle would need to continue for six months before it impacted monetary policy.

Cleveland Federal Reserve President Loretta Mester **also dismissed calls for rate cuts**, arguing that boosting inflation back to target requires only a continued patient policy stance. Kansas City Federal Reserve President Esther George **opposes rate cuts** on the grounds that lower rates might induce a fresh round of asset bubbles.

In short, no one is clamoring for a policy change right now.

Upcoming Data

Although a holiday-shortened week, there is still plenty of data to chew on. Tuesday, the Case-Shiller home price measures will be released, providing insight into



the strength of the housing market. Thursday brings us an additional read on that sector with the pending home sales index. Also Thursday is initial jobless claims, a revision of the first quarter GDP numbers, and the monthly international trade report. Fridays ramps up further with the personal income and outlays report for April. Included in the report is the PCE price index, which will be intensely examined as to the mix of transitory versus persistent factors pushing the inflation numbers. We also get readings on consumer sentiment and the Chicago PMI; with the latter, we gain some insight into the next week's ISM manufacturing report.

Discussion

Bond markets continue to signal that the Fed's next move is a rate cut while the Fed continues to push back on that idea. The story here is relatively straightforward. The Fed anticipates the economy will slow throughout 2019 to something more consistent with what they view as a sustainable pace. At this point, they are not particularly apocalyptic regarding the outlook. Quite the opposite – they are relieved that the late-2018 fears of imminent recession failed to materialize. Recall from above that FOMC participants have generally upgraded their growth assessments compared to their March meeting. **Moreover, those growth forecasts need to be taken in the context of an economy with a 3.6% unemployment rate, well below what most central bankers believe is consistent with price stability over time. They hesitate to consider a rate cut under such circumstances.**

Arguably, the fact they signal a continued "patient" policy stance is something of a small miracle. Remember, they see the downward pressure on inflation as only transitory. In the context of their models, when those transitory factors dissipate and inflation reverts to target, they will face upward pressure on inflation (remember, low unemployment relative to estimates of the natural rate). Typically, they would retain a tightening bias under such

circumstances. From their view, signal policy stability and a willingness to accept inflation overshooting is already a fairly substantial concession to the bearish concerns percolating throughout the financial markets.

Trade tensions rattle financial market participants more than they concern the Fed. To be sure, the Fed remains wary of downside risks, but when they plug tariffs into their models, they do not see big impacts. In the words of [John Williams via Bloomberg](#):

It probably will boost inflation by a few tenths over the next year. It affects demand a bit and growth in the short run. But also its negative effects on the value chains and how our economic system works.

A little inflation, a little slower growth, a reorganization of supply chains, but nothing that in their mind justifies the need for a rate cut. **Overall, from the Fed's perspective growth is solid, unemployment low, inflation likely to revert to trend, and threats to the outlook manage-**

able. This leaves Fed officials hawkish relative to market expectations.

Bottom Line: Market expectations of a rate cut are well founded. Despite the Fed's resistance, I still think the odds favor a rate cut over a hike. I think the situation is less equally weighted than the Fed believes. This is a fairly challenging time in the cycle. The yield curve suggests that the path of activity will require a rate cut sooner than later, but the yield curve is a long leading indicator. It's typically well ahead of the data. At the current time, the data itself has yet to give the Fed much room to shift to a more dovish stance. For now, the Fed requires greater evidence of slowing activity, particularly in the employment data, to cut rates. Remember, the Fed's typical pattern ahead of a rate cut is to resist, resist, resist, and then move quickly. And note that we don't need to see a recession in the data to justify a rate cut; given the lack of inflation, the Fed only needs to see a substantial risk that growth will fall below estimate of the longer-run sustainable rate.

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Professor Duy received his B.A. in Economics in 1991 from the University of Puget Sound, and his M.S. and Ph.D. in Economics in 1998 from the University of Oregon. Following graduate school, Tim worked in Washington, D.C. for the United States Department of Treasury as an economist in the International Affairs division and later with the G7 Group, a political and economic consultancy for clients in the financial industry. In the latter position, he was responsible for monitoring the activities of the Federal Reserve and currency markets. Tim returned to the University of Oregon in 2002. He is the Senior Director of the Oregon Economic Forum and the author of the University of Oregon Statewide Economic Indicators, Regional Economic Indicators, and the Central Oregon Business Index.

Tim has published in the *Journal of Economics and Business* and is currently a member of the Oregon Governor's Council of Economic Advisors and the State Debt Policy Advisory Commission. Tim is a prominent commentator on the Federal Reserve. MarketWatch describes his blog as "influential." The Huffington Post identified him as one of the top 26 economists to follow on Twitter, and he is listed on StreetEye as one of the top 100 people to follow to discover finance news on Twitter. Major national and international news outlets frequently quote him, including the *New York Times*, the *Washington Post*, the *Financial Times*, the *Wall Street Journal*, and *Bloomberg*. He also writes a regular column for *Bloomberg Prophets*.

Notice: This newsletter is commentary, not investment advice.

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