Cumberland Advisors Market Commentary – The Fed – What Next?

With the no-change decision by the FOMC, rendered as the impeachment finale was playing out, and with the next FOMC meeting about a month away, the most important upcoming event for the Fed is Chairman Powell's semiannual testimony before Congress this week. The Board's report is already out, and it provides a fairly clear indication of where policy is likely to be the next few meetings. See https://www.federalreserve.gov/monetarypolicy/2020-02-mpr-summary.htm.
Here is what is in the report and what we can glean from its contents.

The report is divided into several sections, beginning with a statement on "Longer-Run Goals and Monetary Policy Strategy," which in broad terms reaffirms the FOMC's goal of a symmetric inflation target and it argues is consistent with its statutory mandate to foster stable prices, moderate long-term interest rates, and maximum employment. The statement goes on to note that employment is largely determined by nonmonetary factors which vary over time, such that it is not appropriate to specify a fixed target. The goal statement concludes by stating that the Board seeks to minimize deviations of inflation from its target and in doing so that policy is consistent with and complementary to its other statutory objectives. However, when it is not, the Committee will pursue a balanced approach to its policy decisions.

With both this goals and strategy statement and the obligatory report summary out of the way, the report is divided into three main parts: a discussion of both domestic economic and financial developments and international issues relevant to policy, a discussion of current monetary policy, and an explanation of the Committee's Summary of Economic Projections (SEPs). What follows is brief summary of some of the key points in each of these three sections, intended for those who have neither the time nor, perhaps, the inclination to read the report or watch the testimony.

The economic developments section notes that while the labor market continues to be strong and job creation remains solid, the pace is somewhat behind that of 2018. Nevertheless, the number of jobs created in 2019 was greater than the number of new entrants to the market. As a result, the unemployment rate moved down to 3.5%, and the participation rate for key ethnic cohorts increased. However, despite the solid job market, wage gains were at best moderate. The inflation story was short and sweet. Although the headline PCE (personal consumption expenditures) was close to the 2% target in 2018, 2019 saw the rate fall to 1.6% y/y by the end of the year. Economic growth in the first half of 2019 was a bit below that in the first half of 2018, but growth was seen as moderate in the second half of 2019. (However, the Q4 number has not yet been published.) Consumer spending was moderate, while business fixed investment declined, in part, no doubt, because of trade uncertainties. However, downside risks to growth were somewhat lower, as some of the uncertainties began to be resolved toward the end of the year. The new risk to growth going forward is seen as the still-unknown fallout from the coronavirus in China and elsewhere. And this risk will clearly be raised during the testimony.

In financial markets, rates declined while equity prices surged due to the policy accommodation that the Board implemented in the latter half of the year. Spreads over Treasuries declined, and mortgage rates were low, while credit conditions remained accommodative. The financial system was characterized as being resilient compared to where it was prior to the financial crisis – leverage was low and household debt grew at a slower pace than in the past 10 years. In contrast, the corporate sector continued to leverage itself, and this was especially the case for the riskier firms. Thus, valuations became elevated in the second half of the year. Finally, on the international side, growth slowed in both developed and developing countries as a result of a decline in manufacturing, trade uncertainties, and political and social unrest in some countries. Central banks responded with more accommodation, which resulted in a slight upward movement in equity prices, a narrowing of sovereign risk spreads, and a decline in long-term interest rates. We note that the Board's report came out before the most recent market reactions to the coronavirus outbreak and the epidemic's emerging hit to global financial markets. This topic will likely get attention in the hearings.

The monetary policy section of the report is short. It simply notes that the FOMC lowered its target federal funds range by 75 basis points in a series of moves in three meetings beginning in July. Also, at its July meeting the Committee stopped the reduction in the size of its balance sheet, And in October the Fed supplied funds in response to what appeared to be a liquidity shortage and an increase in volatility in short-term markets, especially the repo market. This section ends with a discussion of three special topics: business cycles in manufacturing, the role and usefulness of monetary policy rules, and the review of the Committee's policy framework with regard to the Fed Listens initiative.

The last section, on the Summary of Economic Projections, simply reproduces and summarizes the Committee's economic projections, with an emphasis on the material compiled in conjunction with the December 2019 FOMC meeting. (New projections will be provided at the March 2020 meeting.) Near-term median expectations for GDP remained at 2.2% for 2019 and only slightly lower for 2020, at 2%; unemployment was expected to decline and remain in the 3.5–3.7% range through 2022; and inflation was expected to edge up to 1.9% in 2020 and hit 2% in 2022. These results were expected to materialize with an essentially unchanged federal funds rate target through 2020. With the majority of Committee members expecting only one rate hike in 2021, it appears this year may be an uneventful one as far as FOMC policy is concerned; and the best guess now is that policy is on hold unless and until some shock hits the economy or financial markets more broadly. Can this happen? Surely, and the report concludes with a discussion of the risks and uncertainties that accompany the SEP projections, but with the clear understanding that the FOMC will respond to events as they unfold.

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