



## The Fed Reaches for the Stars

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- This week, the team looks at what's ahead for the Fed

Federal Reserve Chairman Jerome Powell used a celestial metaphor to center his remarks at the recent Jackson Hole summit. The Fed's decisions, he noted, are often based on the distance of inflation, unemployment and growth from their long-run equilibria. In modeling shorthand, these long-run levels are known as "stars."

"Navigating by the stars can sound straightforward," said Powell. "Guiding policy by the stars in practice, however, has been quite challenging of late because our best assessments of the location of the stars have been changing significantly."

The stars certainly seem aligned in support of an interest rate increase next week, which is widely anticipated. But the market's telescopes will be looking for indicators of how much farther the Fed has to go before reaching its ultimate destination.

Here is our take on the likely content of next week's conversations.

Economic Growth	
Reasons to Be Hawkish	Reasons to Be Dovish
The U.S. economy grew at an annualized rate of 4.2% in the second quarter, and early reads on the third quarter are robust. Tailwinds from tax reform are still present. Strong job creation will aid consumption, and surveys of business sentiment reflect substantial optimism.	There is increasing concern that economic growth could hit a rough patch sometime next year. Fiscal stimulus will begin fading just as the impact of trade restrictions hits with full force. And the string of interest rate increases from the Fed will eventually affect economic activity.

The U.S. economy had good momentum entering 2018, and thanks to the Tax Cuts and Jobs Act of 2017, activity has accelerated. The second-quarter results are unlikely to be repeated (there was a surge in exports as firms tried to beat upcoming tariffs), but the economy is on pace for real growth of 3% for the full year. Our latest forecast can be found [here](#).

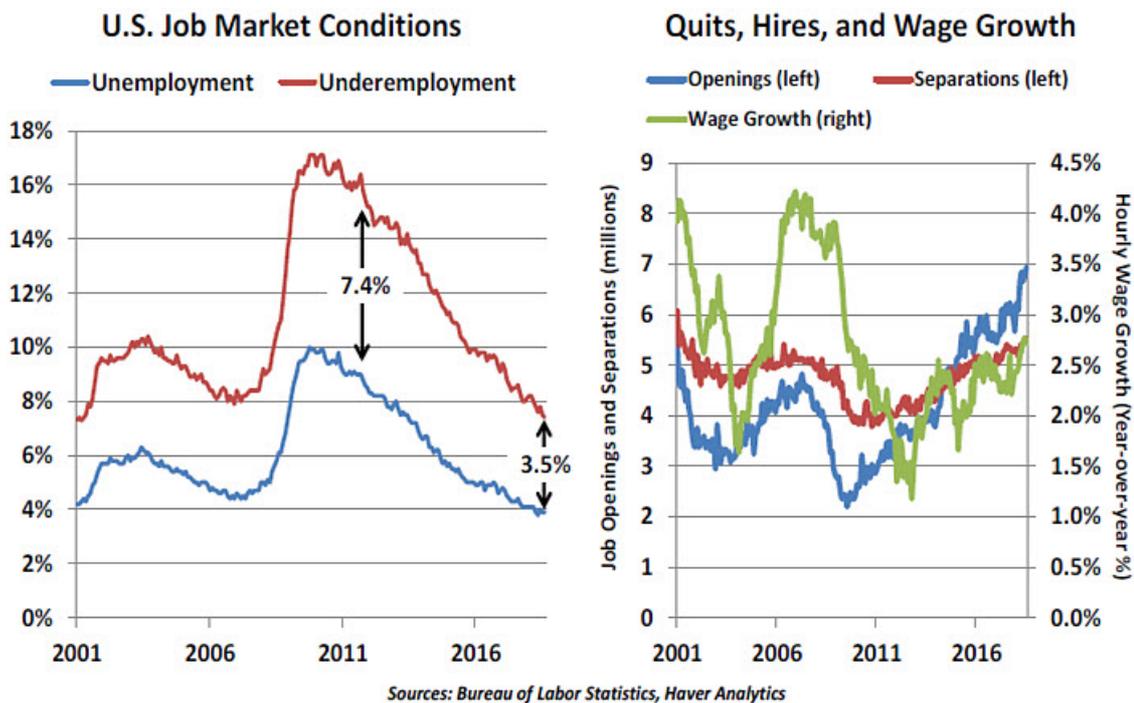
Growth in the coming quarters will be tempered as the cost of trade actions becomes apparent. Tensions have diminished with the EU and Mexico, but an extensive new round of tariffs on Chinese products was announced this week. Estimates suggest that trade restrictions could reduce real gross domestic product (GDP) growth by 0.5% next year, a sizeable amount.

Household debt has moderated in the last decade, and corporations are awash with cash released by tax reform. So interest rate increases from the Fed may not be having the same dampening effect that they have in the past. Overall, financial conditions have actually gotten easier since the Fed began raising rates in 2015.

## Labor Markets

Reasons to Be Hawkish	Reasons to Be Dovish
<p>The jobless rate has recovered remarkably and currently stands more than a half-percent below the Fed's median estimate of full employment. Wage gains have been slow to manifest, but have been rising steadily over the past year. Reports of worker shortages and anecdotes of rising pay are legion.</p>	<p>The past year has illustrated the limitations of traditional unemployment measures. Additional capacity has been found among the underemployed and those who had been drawing disability benefits. More importantly, firms have proven especially resourceful in keeping wage growth modest.</p>

The data make a fairly compelling case that we are at, or past, full employment. Even broad measures of joblessness are stronger now than they were in 2008. The number of job openings exceeds the number of people looking for work, and the number of people voluntarily quitting their jobs for better ones is at a record level. As these metrics have risen, so has wage growth.



With labor demand strong, it seems inevitable that wage gains will accelerate. This does not necessarily mean higher inflation, but it will almost certainly not mean lower inflation.

Inflation	
Reasons to Be Hawkish	Reasons to Be Dovish
<p>The Fed's favored measure shows inflation of 2% over the past year, and it has been rising steadily for the past 12 months. Apart from the wage pressures noted above, trade restrictions will raise the cost of a range of products. Shipping costs are also rising, as trucking capacity has failed to keep pace with consumption. Energy prices have quietly risen through the summer.</p>	<p>Few expect inflation to rage out of control; the Fed's own forecasts show a peak of 2.3%. Process automation and global sourcing are powerful forces holding down operational costs. E-commerce has severely limited pricing power for products that are sold (or researched) online. The strong dollar has curtailed import costs. Inflation expectations remain very well-anchored.</p>

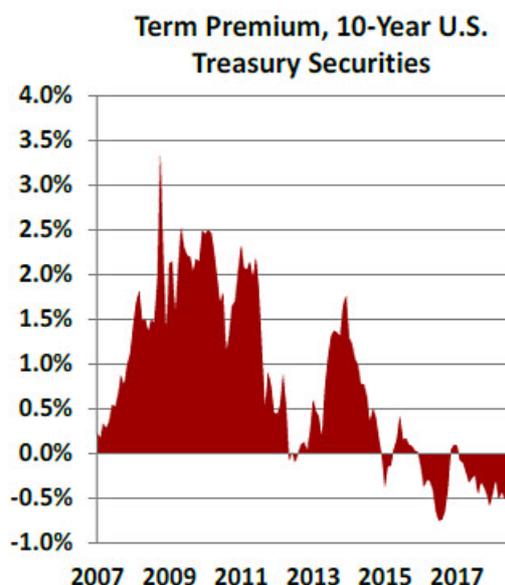
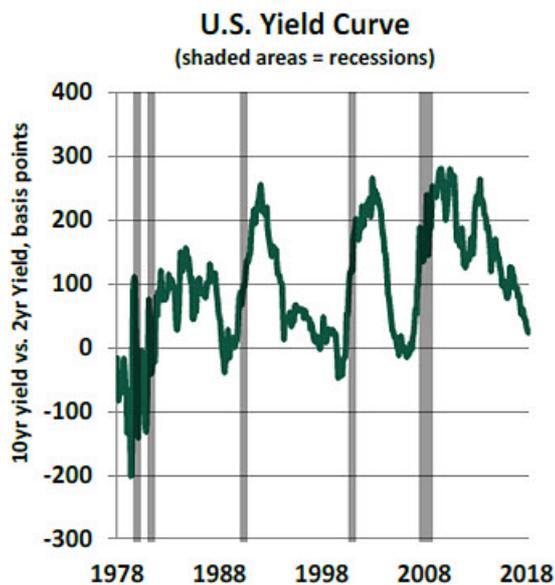
At the outset, we should note that the links between unemployment and wages and between wages and prices are weaker than they have been in the past. We acknowledge that the series of secular changes noted above are powerful, and likely to spread to the service sector over the next decade. We are not calling for inflation to rage as it did 30 years ago.

However, the retreat from globalization (which is not just confined to the U.S.) is a secular development that will not be helpful to containing the price level. The precise effect on inflation will depend on what fraction of cost pressures can be passed on. Past episodes suggest that consumers will end up paying steeper prices.

And while the "speed limit" of the economy (long-run potential GDP growth) is one of the stars of uncertain position mentioned earlier, the current economic pace is almost certainly well above it. Reduced capacity usually means higher inflation.

The Yield Curve	
Reasons to Be Hawkish	Reasons to Be Dovish
<p>Many things affect the position of the yield curve; the economic outlook is only one of them. The influx of international capital to the long end of the U.S. bond market over the last 20 years has had a pronounced effect on the "term premium" that rewards investors for taking long-term interest rate risk. This might diminish the yield curve's value as a recession indicator.</p>	<p>Prior to the last five recessions, the yield on the two-year Treasury note has exceeded the yield on the 10-year Treasury note. The correspondence is not perfect, but strong enough to give pause. While the American economy is chugging along nicely for now, forecasting surveys reflect increasing odds of recession sometime in the next two years; the market may be sensing this. The Fed proceeds at its own peril.</p>

Federal Open Market Committee (FOMC) members have expressed a range of thoughts on the topic of the yield curve. Work from the Federal Reserve Bank of San Francisco offered a different lens on the yield curve, with much less threatening conclusions.



Sources: Haver Analytics, Bloomberg

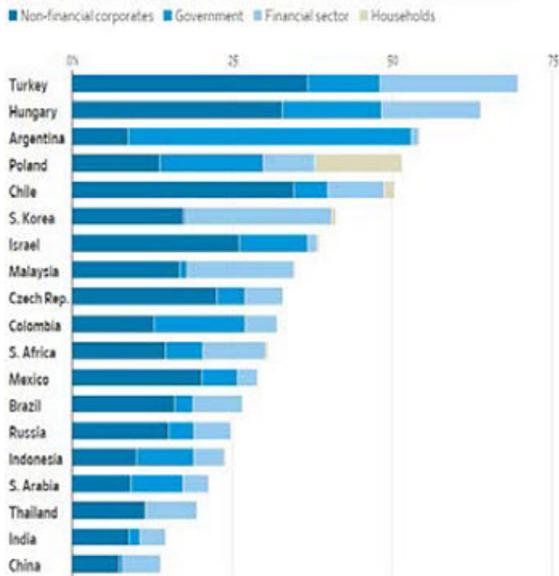
The two-year yield likely reflects an expectation for at least two more hikes from the Fed, which could (in theory) be undertaken without inverting the longer end of the curve. Thereafter, caution would be advised in any event; the Fed would very much like to do what it feels is needed without creating a yield curve inversion.

International Factors	
Reasons to Be Hawkish	Reasons to Be Dovish
Global economic momentum remains firm, and that accrues to the benefit of smaller markets. The recent emerging market (EM) sell-off has garnered headlines, but is confined to economies that are modest in size and that have made poor policy choices. The Fed cannot, and should not seek to save every EM.	Many EMs are deeply indebted, with a good portion of that debt in dollars. Even those who have used leverage more carefully have been affected by the strength of the dollar, which raises costs for imports like oil. With India now under pressure, the breadth of difficulty is spreading.

The U.S. is the world's largest economy, and the dollar is the world's reserve currency. Any action by the Federal Reserve to influence the money supply has consequences for the global financial markets. Through this channel, a negative feedback loop back to U.S. growth could be established.

The low interest rate environment and abundant liquidity from developed markets over the last few years has led to higher debt accumulation in many EMs, much of it denominated in foreign currencies. With interest rates now increasing, concern is rising over the ability of companies within these countries to repay dollar-denominated debt.

Foreign-currency denominated emerging markets debt as a share of gross domestic product



Source: Deutsche Bank via Institute of International Finance

## YTD Currency Performance vs. U.S. Dollar



Source: Bloomberg

Even though many EMs today are less vulnerable, they remain sensitive to swings in investment sentiment. The Fed has been watching developments very closely, but has acknowledged that their consequences are hard to gauge. So far, the markets most acutely affected are not major contributors to global GDP. Unless and until something more significant threatens, the Fed will likely remain focused on domestic fundamentals.

### Our View

A 25 basis point increase in interest rates is a virtual certainty next week. The market odds on a similar move in December have risen to almost 70%. From there, things get a little fuzzier; there are many variables to consider when thinking more than a few months ahead. A lot can happen between now and next spring.

We are anticipating four more increases from the Fed, at the end of each of the next four quarters. Our forecast is rooted in two foundations:

There is no further need for accommodative monetary policy.

1. After a nine-year expansion and a coincident bull market, the U.S. economy no longer needs easy monetary policy. While there is ongoing debate over what the “neutral” funds rate is, there is almost certainly some distance to travel before it is reached. We would concur with recent Fed estimates that the long-run overnight rate is somewhere between 2.75% and 3%.
1. Leaving interest rates too low for too long is not without its risks. Fed Governor Lael Brainard reminded us of this in a recent speech, noting that financial excesses can build up on the back of easy credit. There are some signs of such excess in the lending market, and there is a lot of capital chasing available deals. Observers found Brainard’s comments interesting, as she has offered more dovish comments on monetary policy in the past.