The Restoration of Monetary Policy Equilibrium

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Rick Rieder, Russ Brownback and Trevor Slaven contend that much of the recent criticism brought to bear against Fed policy makers is misguided, and in fact the central bank has done an admirable job of pivoting toward a pragmatic equilibrium in recent months.

We have talked in the past about how global digital distribution capabilities are re-shaping the rules of economics, where supply can expand nearly instantaneously to fill a void. Nowhere is supply in over-abundance today more than in the critical comments appended to every policy headline, or action. In this world of seemingly perpetual disapproval, and unfounded criticism without consequence, we would like to acknowledge and commend the leadership and staff of the Federal Reserve for what they have recently accomplished. Many observers will suggest that last week's quarter-point policy rate move was a muddled "hawkish cut," or an insignificant step in a waffling "mid-cycle adjustment." But we see the cumulative 2019 rate cuts, combined very importantly with much needed new liquidity provisions, as an historic restoration of policy neutrality. That is a very big deal, and the Fed's actions are worthy of recognition.

The path back to policy neutrality

From our perspective, "neutral" Fed policy going forward is a Funds Rate that hovers around 2% (perhaps in a range of 1.5% to 2.5%) alongside healthy liquidity provisioning. As monetary policy strives to achieve its dual mandate in the years ahead, some combination of debt, deficits, and demographics will present a significant challenge. We believe this policy mix will help equilibrate savings and investment in the household and corporate sectors by setting a reasonable level of real risk-free returns, without incentivizing unproductive leverage. And as deficits and debt almost certainly expand as we approach Social Security and Medicare spending booms, improved liquidity growth, even if limited to the "natural" rate of nominal GDP growth, will free up tremendous amounts of private sector capital for more productive uses that can sustain and improve the economic outlook for future generations.

From this neutral stance, the Fed enjoys tremendous flexibility to respond to future shocks, both positive and negative, but the bar should be sufficiently high to move meaningfully away from policy neutrality going forward. It's fair to ask, if 1.5% to 2.5% represents a neutral policy rate, why was the move to 2.5% so difficult in 2018? In our view, it was a mix of decelerating global growth and liquidity contraction via the experimental Fed balance sheet run-off that were primary culprits. Starting in the second quarter of 2018, overt U.S. dollar strength and aggressive yield curve flattening signaled that the policy cocktail of raising rates and reducing liquidity was too onerous for the prevailing economic backdrop. That burdensome policy continued into 2019 with rolling bouts of stress in USD funding markets and continued deceleration in emerging market (EM) growth. However, since July of this year, the Fed has proactively maneuvered back toward policy equilibrium, which can and should be very effective in arresting the global growth slowdown, and in restoring the smooth functioning of the financial economy.

The vital importance of Fed balance sheet policy, liquidity and the USD

With regard to the balance sheet as a crucial policy tool, not only does enhanced liquidity help to facilitate productive capital deployment in the private sector, it ensures a sufficient stock of systemic reserves and a smooth functioning of USD funding markets that the global real economy is highly dependent upon. In a world where EM economies contribute the majority of global growth, improved liquidity helps grease the gears of cross-border investment by pushing back against dollar strength. Indeed, liquidity's influence on the dollar, and hence on global growth, is hard to overstate, as more than 80% of global trade finance is USD denominated. In short, the liquidity lever gives the Fed significant policy flexibility, without imposing the absurdity of negative interest rates on household savers, banking centers, insurance companies and pensions.

Vitally important to our thinking is the notion that future Fed policy will not follow its global counterparts into the unproductive arena of zero or negative rates. In the modern economy, a neutral Funds rate hovers in a relatively stable band around 2%. The rate can be tweaked against cyclical forces, but the range is narrow, reflecting a world of aging demographics where potential growth and inflation are much lower than in decades past, and where the volatility of growth and inflation is at all-time lows.

Hence a reliance on zero or negative rates would be counterproductive as it would catalyze a collapse in sentiment and a concomitant rise in household savings rates. In the corporate sector, negative rates incentivize superfluous leverage and financial engineering, and keep zombie companies alive and their unproductive capacity in an already well-supplied system. While many decry the leverage on corporate balance sheets today, we would highlight that the bulk of that debt was added from 2013-2016 when rates were held at the zero-lower-bound in the face of accelerating economic activity.

Policy equilibrium in the context of evolving demographic and technological change

“Neutral” policy today must be persistently more accommodative than historical precedent due to the secular influences of aging and declining populations, an enduring shift in consumption away from goods and towards services, onerous systemic indebtedness and technology-induced disinflation, all of which are headwinds to nominal economic growth. These same secular influences are creating an immense demand for income-producing assets to fulfill pension, insurance and individuals’ implied or direct liability streams. The absence of ***some*** nominal (and real) rate benefit here leads to an underappreciated stress on the financial system by diminishing the range of appropriate investable assets, especially when it drives a dramatic increase in high risk investing to achieve insurmountable, and unrealistic, return requirements, particularly as people de-risk into retirement.

Thus, as we have written about extensively: the world doesn’t need negative (or zero) rate levels; it needs liquidity and a more contained U.S. dollar. That is what frees up animal spirits in a global economy that is much softer than the U.S., and is running the risk of falling in to a dangerous deflationary cycle.

With the Fed now absorbing massive amounts of front-end Treasury issuance, the U.S. yield curve can steepen, allowing banks and others to lend with healthier net interest margins, promoting systemic credit creation and economic velocity. The provision of $200 billion into the financial system and an incremental $60 billion a month of liquidity injections, at least through the second quarter of 2020, takes pressure off of funding markets, reduces the stubborn and pernicious bid for the USD, and allows the global economy (much of which is explicitly or implicitly pegged to the dollar) to enact policy prescriptions more appropriate to their own economic conditions, such as the much needed easing of monetary policy in emerging economies.

For the near term, we think the Fed has rightly concluded that while uncertainties surrounding trade friction, Brexit, etc. have weighed on sentiment, some important segments of the economy are still quite robust (consumption, housing, many parts of the service sector, etc.). Solid fundamental underpinnings that are supported by a benign monetary policy mix, combined with a positive pivot in systemic sentiment, can unleash pent-up research and development spending and capital investment projects that are crucial to driving future growth. Thus, a truly neutral Fed that is now wholly data dependent regarding incremental policy initiatives is precisely the right philosophy for today’s conditions.

The policy path ahead

For the long term, the secular dulling of real-economy volatility, combined with commensurate modern policy pragmatism, can go a long way towards mitigating or even eliminating traditional whole-economy business cycles, reinforcing stability in economic outcomes, and thus in policy reaction functions as well, in a reinforcing cycle. Of course, there will always be political and fiscal policy risks that hold the potential to unsettle economic growth and market progress, so those developments will bear close watching.

We applaud the Fed as it observes and adapts to the important organic signals from both the real and financial economies, thereby eschewing obsolete models and philosophies that heretofore risked imposing policy disequilibrium and invited unnecessary left-tail risks. Indeed, market positioning has already begun to reflect this profound reclamation of policy neutrality and a reflexive and needed boost to real economy sentiment is almost certain to follow.

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