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FED SHADOW

It’s So Time to Cut Rates

Monday, June 3, 2019

Donald Luskin

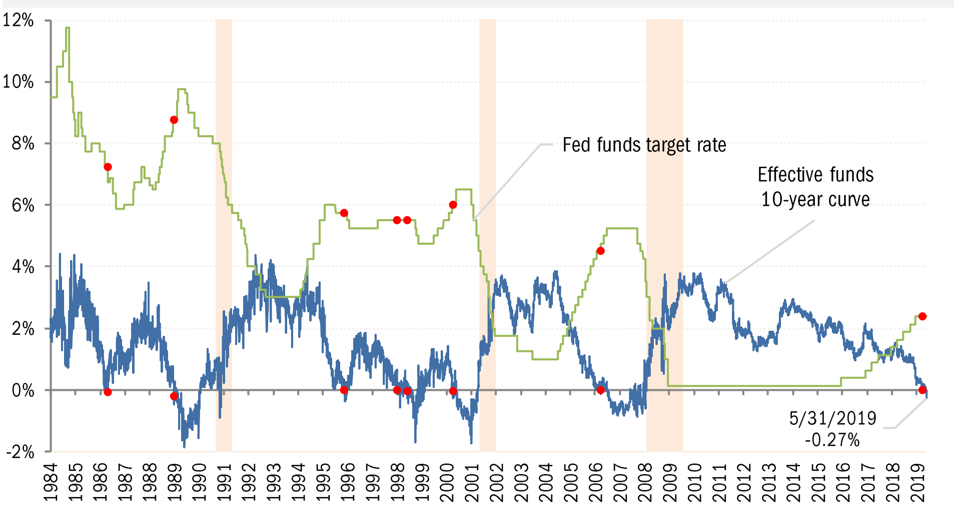
It would take two cuts to un-invert funds-10. Powell: “your policy’s tighter than you think.”

Our outlook just six weeks ago for a continued back-up in long-term yields has been roundly whacked (see “So About That Recession” April 15, 2019). But even with the 10-year Treasury yield at 2.11% as of this writing the 2-10 curve isn’t inverted – in fact, it’s slightly wider now at 23 bp than it was at 11 bp in December and 12 bp in late March (see “The Curve Inverts, and a ‘Growth Hawk’ for the Fed” March 25, 2019).

The curve that counts is the effective fed funds rate-10 curve, and at negative 28 bp this morning, it would now take two rate cuts to un-invert it (please see the chart below). So it’s preposterous that the futures markets give the probability of a rate cut at the June FOMC a mere 20%. *We think consensus clamoring for a cut is about to begin with a vengeance, and by the time the FOMC meeting rolls around on June 19, the demand effect will be irresistible. This is really simple: it’s time for a rate cut.*

- Working against it is the annoying reality that President Donald Trump got there first, way ahead of the bond market. He’s been calling for a cut all year, most recently with two tweets sent right in the middle of the May FOMC meeting. All the while, Chair Jerome Powell has been writhing in humiliation, under Trump’s thumb,

Funds-10 curve versus funds rate • Onset of inversion Recession

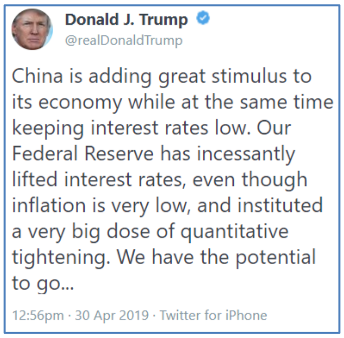


Source: FRB, NBER, Bloomberg, TrendMacro calculations

Update to strategic view

US FED, US BONDS: The funds rate-10 year Treasury curve is so deeply inverted, it would now take two cuts to un-invert it – even though the canonical 2-10 curve isn’t inverted at all. Powell stated last year that the 10-year represents the neutral rate of interest, so this inversion means “your policy’s tighter than you think.” With his stated distrust of abstract quant models, and with inflation low, he has every reason and opportunity to cut. Powell is telling GOP insiders that he is in step with Trump’s pro-growth policy outlook, and is fighting the “deep state” in the Fed. Yet surely he finds it distasteful to be seen as caving to Trump’s wishes for rate cuts. A consensus for a cut as soon as June is forming. The probability implied in the futures markets is absurdly too low. That consensus will build rapidly, and Powell can hide behind it to preserve the Fed’s independence. It may take just one, because when the cut comes, the funds-10 curve will smartly un-invert as the 10-year yield backs up andconfidence and risk-appetite are restored.

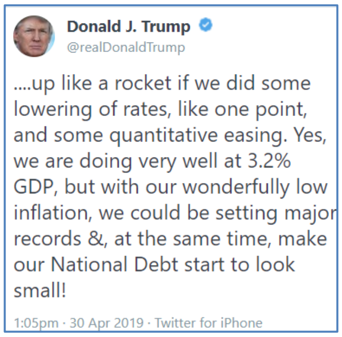
[Strategy dashboard]



Donald J. Trump
@realDonaldTrump

China is adding great stimulus to its economy while at the same time keeping interest rates low. Our Federal Reserve has incessantly lifted interest rates, even though inflation is very low, and instituted a very big dose of quantitative tightening. We have the potential to go...

12:56pm · 30 Apr 2019 · Twitter for iPhone



Donald J. Trump
@realDonaldTrump

....up like a rocket if we did some lowering of rates, like one point, and some quantitative easing. Yes, we are doing very well at 3.2% GDP, but with our wonderfully low inflation, we could be setting major records &, at the same time, make our National Debt start to look small!

1:05pm · 30 Apr 2019 · Twitter for iPhone

having cut a deal with him Christmas week in order to keep his job (see "Did Powell Just Cut a Deal?" December 23, 2018).

- *No one likes to admit Trump was right, Powell least of all.*
- *And yet the funds-10 curve is giving Powell all the intellectual ammunition he needs to claim – with complete truthfulness – that he, Powell, has been there all along, all by himself. It was his idea. No compromise to Fed independence.*
- *Based on Powell's own policy statements, this inversion means the Fed is too tight.*
- Last July, in the Q-and-A following his first semi-annual testimony to Congress, he told Senator Patrick Toomey (R-PA):

> *"…longer run rates…tell us something…about what the longer run neutral rate is. That's really, I think, why the slope of the yield curve matters… if you raised short term rates higher than long term rates, then maybe your policy's tighter than you think…"*

- We've been unapologetic critics of Powell, to be sure. But we have to give him credit for *that* statement. It is a simple, elegant monetary policy rule, integrating the idea of the Wicksellian natural rate of interest with the use of market-derived signals.
- It sits beautifully next to his skepticism of academic models expressed the following month at Jackson Hole:

> *"…u* (pronounced 'u star') is the natural rate of unemployment, r* ('r star') is the neutral real rate of interest, and Π* ('pi star') is the inflation objective. According to the conventional thinking, policymakers should navigate by these stars. In that sense, they are very much akin to celestial stars… 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."*

- *So there you have it.* Throw out the stars and the discredited models like the Phillips Curve, which has Fed officials like Vice Chair Richard Clarida – sophisticated economists who should know better, except that they're too sophisticated for their own good – still yacking as recently as Thursday about "the dynamic relationship between inflation and employment."
- *Instead, act on loud-and-clear market signals like the inversion of the funds-10 curve.* No one dares talk seriously about the gold standard anymore, though a version of it worked very well during Alan Greenspan's best years as Fed chair (see "Video: What you're not hearing about Cain, Moore and the gold standard" April 8, 2019). But can't we have some objective standard, some market signal to follow? *The bond market – specifically, the funds-10*

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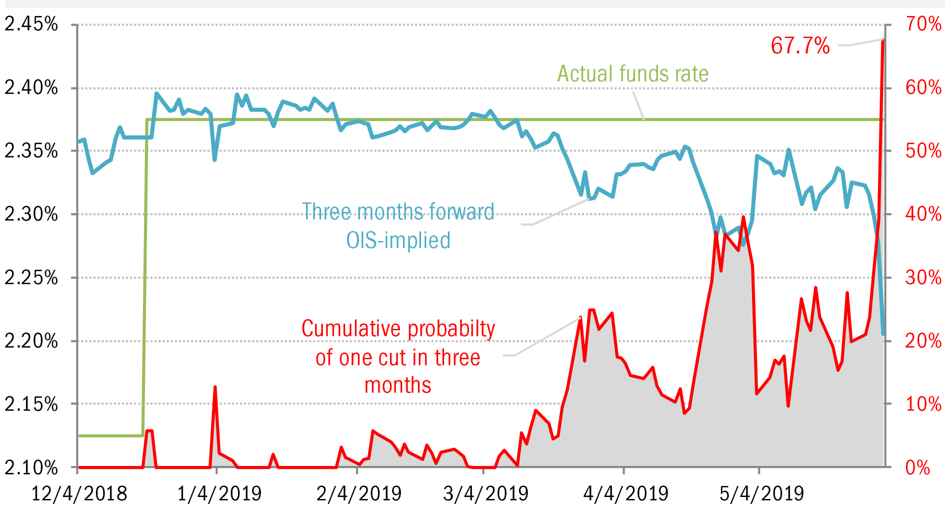
[About us]

<u>curve, is the one Powell himself said he would observe. So now's the time to observe it.</u>

<u>History is clear that Powell is right about the funds-10 curve. It is a signal to be respected and observed – or to be disrespected and ignored at our peril. When funds-10 inverts, and the Fed cuts rates swiftly, recession can be deferred by many years</u> (please again see the chart on the first page, and "Video: What Jay Powell should be telling you about the inverted yield curve" April 1, 2019). *<u>When it inverts and the Fed hikes rates, recession follows.</u>*

- When the funds-10 curve inverted in April 1986, it was in the midst of an easing regime under chair Paul Volcker. He kept cutting rates, and the expansion went on for many years. At the next inversion in that expansion in December 1988, Greenspan hiked rates, and a recession followed.
- In the next expansion, when the funds-10 curve inverted in November 1995, Greenspan cut rates; when it inverted again in January and May 1998, Greenspan held rates steady at first, then cut – and in both cases the expansion continued. When funds-10 inverted again in March 2000, he hiked, and recession followed.
- In the next expansion, when the funds-10 curve inverted in March 2006, new chair Ben Bernanke hiked rates three times, and didn't finally cut until October 2007, when it was very much too late to head off the Great Recession that followed.
- *<u>In the present expansion, the funds-10 curve inverted in late March. So far, at least Powell has not made the mistake of hiking rates. But he hasn't cut them. We think he should, and we think he will.</u>*
- This isn't *entirely* an out of consensus view. The OIS forward curve stopped expecting rate hikes, three months ahead, right after the December FOMC (see "On the December FOMC" December 19, 2018). It sets the three-month probability of a cut now at 68% (please see the chart below).

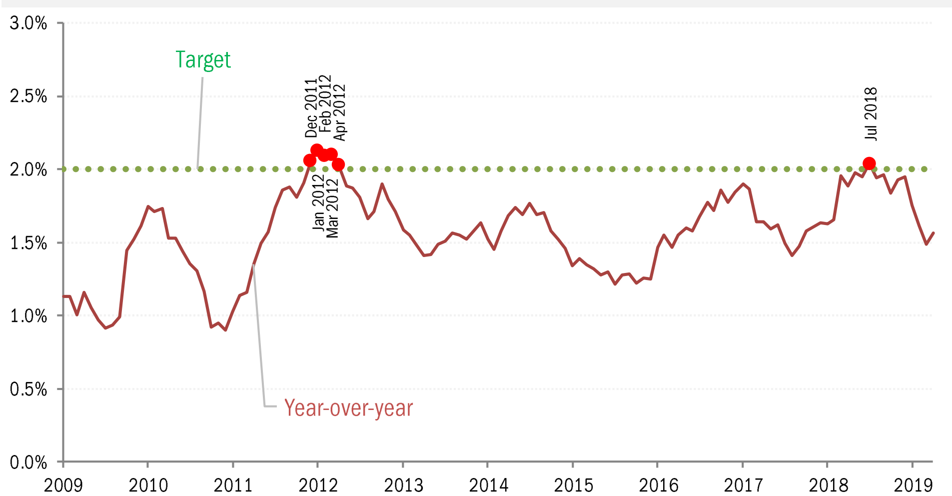
Funds rate, actual and forward, and probability of a cut



Source: FRB, Bloomberg, TrendMacro calculations

- *It's going to take a stronger consensus than that to get Powell to act.*
- We are hearing through our friends in the vast right-wing conspiracy – third-hand, but still sourced – that *Powell is telling GOP insiders he considers himself completely aligned with Trump's vision*. We are told Powell claims he embraces the idea of an expansive Fed oriented toward running the economy at full speed for the sake of boosting working-class wages, so long as too-high inflation is not a binding constraint. We are hearing Powell claims this shared vision has been thwarted by the Fed bureaucracy, which he likens to the "deep state" that Trump complains about. We are hearing that he says he refuses to look at any research generated internally by Fed staff.
- We're willing to assume that Powell has indeed said those things. But then it's not obvious why, other than the two statements we have cited, Powell has made no action that would indicate that he is not himself a creature of the Fed's "deep state." He sings along with the Fed choir, insisting that low inflation is only "transitory." And he babbles all the same stuff as Clarida and all the others about the enduring meaning of the Phillips Curvewhile admitting it has become "flat." If he wanted to stand against the Fed's "deep state," he certainly could.
- His compliant positions are most unfortunate if, indeed, he actually does adhere to Trump's vision that the Fed can let the economy "run hot" unless inflation is a binding constraint – *because inflation very much isn't a binding constraint.* In one sense, Trump's tweet was right – inflation is "wonderfully low." In another sense, former chair Ben Bernanke's deflation-fighting sense, inflation is "dangerously low." Either way, it's low.
- For the last decade-plus, inflation has only met or exceeded the Fed's target of 2% on core personal consumption expenditures in six months out of 124 (please see the chart below). *It's not low inflation that is "transitory." It's at-target inflation that is "transitory."*

Inflation: PCE price index, excluding food and energy ● At or above target



Source: BEA, TrendMacro calculations

- *Hey, at this point, we'd think that all it has to be is "not high," and that would be sufficient for Powell to act* upon his own stated policy rule – that when the funds-10 curve is inverted, "maybe your policy's tighter than you think."
- *He wouldn't be giving in to Trump. He could defend himself easily against charges that he has compromised the Fed's independence. He can say he's just following his own policy rule, because that's just what he'd be doing. He could even get in a dig at Trump, saying he's doing it, in part, to offset the contractionary effect of the president's reckless tariffs.*
- Realistically, given Powell's revealed inability to lead – which he alibis by griping that he has somehow been thwarted by the "deep state" – following his own rule is going to require first that a consensus be formed. When that consensus forms, then Powell can get out in front and act like he's leading it. Or he can act like he's following the consensus, which for him is better than being seen as following Trump.
- *A consensus is forming. It's been clear to us all last week from talking to clients.*

Our view has been that we are approximately repeating the almost-recession episode of late 2015 and early 2016. That episode, like the present, saw the economy shocked by risk of a hard landing in China, a collapse in oil prices, a breakout in credit spreads and a too-tight Fed that didn't seem to be aware of any of it (see "So About That Recession" April 15, 2019). We thought we'd seen enough turbulence, and that we were about to leave all that recession-risk behind, using it as a "mid-cycle refresh" or "pit stop" that would power-up the next leg of the expansion.

- Maybe we were plain wrong. Or maybe we just got ahead of ourselves. After all, in the 2015-2016 episode, the turbulence didn't end until the mid-year crisis associated with the Brexit referendum, which drove risk aversion to a crisis-point at which the US 10-year yield traded at 1.32%, the lowest in the history of our nation. Perhaps we are heading into such a crisis-point now.
- At the crisis-point in 2016, the Fed had only hiked rates once – Chair Janet Yellen's poorly-timed "lift-off" in December 2015. So a rate cut wouldn't have meant anything, because from a target range of 0.25%-to-0.50% there was practically no room to cut anyway. And even with the 10-year yield at an historically low 1.32%, the funds-10 curve was a long way from inverted.
- This time the environment is different in both respects. Now, nine rate hikes later, there's plenty of room to cut. And the funds-10 curve is inverted.
- *It is so time for a rate cut. Unless the crisis-point comes first and clears itself and we definitively move beyond it – as happened swiftly from the bottom in 2016 – the cut is coming in June, and if not, surely in July.*
- *When it comes, the funds-10 curve will un-invert smartly – all else equal in the economic backdrop – both because the funds rate will have been lowered by fiat, and because the 10-year yield will back up in response as confidence and risk-appetite are restored.*

- *The combination of a cut and a back-up in the 10-year yield might mean that a single cut will be all that's needed. Even if it takes two, this wouldn't have to be the onset of a whole new "easing cycle." This could be Powell's chance to play "maestro," tweaking rates up and down as need dictates, just like Greenspan did in the long expansion of the 1990s.*

Bottom line

The funds rate-10 year Treasury curve is so deeply inverted, it would now take two cuts to un-invert it – even though the canonical 2-10 curve isn't inverted at all. Powell stated last year that the 10-year represents the neutral rate of interest, so this inversion means "your policy's tighter than you think." With his stated distrust of abstract quant models, and with inflation low, he has every reason and opportunity to cut. Powell is telling GOP insiders that he is in step with Trump's pro-growth policy outlook, and is fighting the "deep state" in the Fed. Yet surely he finds it distasteful to be seen as caving to Trump's wishes for rate cuts. A consensus for a cut as soon as June is forming. The probability implied in the futures markets is absurdly too low. That consensus will build rapidly, and Powell can hide behind it to preserve the Fed's independence. It may just take one, because when the cut comes, the funds-10 curve will smartly un-invert as the 10-year yield backs up and confidence and risk-appetite are restored.