Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
Thomas Demas, Managing Director
Michael Warren, Energy Strategist

TRENDMACRO LIVE!

On the December FOMC: Good Job, Chair Yellen

Wednesday, December 13, 2017
Donald Luskin

So we were wrong about her: the super-dove who hiked five times and ended QE.

This might be Janet Yellen's last FOMC meeting, certainly her last with a press conference. So we will take this opportunity to appraise her tenure and project forward her policy legacy. After that, we'll get to the details of today's meeting.

We don't hesitate to say so when we get one right (this is a tough business, after all), so we have to admit we got this one wrong: *we thought Yellen would be a disaster as Fed chair* (see "Yellen and Screamin' at the Fed" December 5, 2013), *but overall she has done an outstanding job.* She leaves her successor Jerome Powell with a sensible policy framework that, as a non-economist, he will very much need and will likely follow by rote (see "On Powell for Fed Chair" November 2, 2017).

- To be sure, Yellen can be quite annoying. She's gone through a number of short-lived policy fads (such as "optimal control" – see "It's Yellen's World, and We're Just Living In It" June 18, 2014; and "running a 'high-pressure economy'" – see "On the November FOMC" November 2, 2016). And it drives us crazy that she has infected an entire generation of Americans with the habit of beginning declarative sentences with "so" (see "So Welcome to the Yellen Years" November 15, 2013).
- *But while we originally faulted her for being "hubristic, dogmatic, doctrinaire, rigid, bossy and angry," she proved, under fire, to be self-aware and adaptable.*
- Consider her personal odyssey as chair. When she took office she was known to be a super-dove, yet she presided over the termination of the Fed's Large-Scale Asset Purchases (see "On the October FOMC" October 29, 2014), the beginning of the normalization of the Fed's asset portfolio (see "On the September FOMC" September 20, 2017), and lift-off from six years of the funds rate at the zero-bound (see "On the December FOMC" December 16, 2015).
- *The timing of lift-off in December 2015 was Yellen's only big mistake.* She had been preparing the market for it for months, and her hubris and dogmatism got the better or her when she went ahead with it despite the economy visibly slowing, when too-low oil prices had sharply tightened financial conditions (see "Is This the Oil Shock Tipping Point?" August 20, 2015).

Update to strategic view

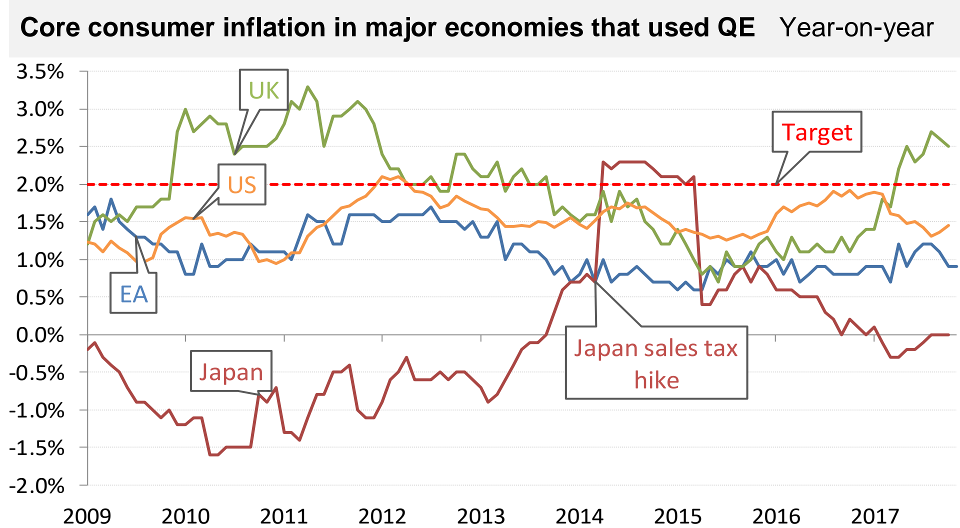
US FED, US MACRO: We were wrong about Yellen. She showed the flexibility to assume the Fed chair as a dove, but preside over the end of QE, lift-off from ZIRP and normalization of the balance sheet. Lift-off was terribly timed, but she quickly corrected her mistake and, with Fischer, turned the Fed away from the Phillips Curve and toward Wicksell's model of the natural rate of interest, for which r-star is a modelled proxy. It means rate hikes will be indexed to improvement in the real economy, and thus not tightenings. Today Yellen explicitly affirmed this policy framework in her last press conference, noting that the funds rate is now close to r-star, and predicating further hikes on r-star's expected ongoing recovery. The SEP both lowered expected unemployment rates and expected inflation. The Phillips Curve appears to be dead. This starts new chair Powell with the best possible policy inheritance.

[Strategy dashboard]

Copyright 2017 Trend Macrolytics LLC. All rights reserved. This document is not to be forwarded to individuals or organizations not authorized by Trend Macrolytics LLC to receive it. For information purposes only; not to be deemed to be recommendations for buying or selling specific securities or to constitute personalized investment advice. Derived from sources deemed to be reliable, but no warranty is made as to accuracy.

- *But to her great credit, Yellen quickly recognized her mistake and corrected it.* While the economy continued to weaken and Vice-chair Stanley Fischer was blabbing about four rate hikes being "in the ballpark" for 2016, Yellen delivered a self-deprecating speech confessing her failure to have embraced "uncertainty" (see "Yellen Adds 'Uncertainty'" March 30, 2016). There wasn't another hike until December (see "On the December FOMC" December 14 2016), when the economy had unambiguously come of what we think of as an "undocumented recession" (see "The Recession Caused by Low Oil Prices" January 8, 2016).
- *Yellen and Fischer together deserve great credit for coming to terms with the central conundrum of their tenure: why, after so many years of various combinations of zero interest rate policy, negative interest rate policy and quantitative easing by central banks around the world, only the UK, and only recently, has managed to get core inflation above the 2% target they all share* (please see the chart below).

Core consumer inflation in major economies that used QE Year-on-year



Source: Bloomberg, TrendMacro calculations

- This has been as perplexing to monetarists (who believe that the massive creation of bank reserves should have accelerated inflation) as it has been to adherents to the Phillips Curve, like Yellen (who believed that low unemployment should have done so). Yellen and Fischer found a *third* framework, by going back almost 120 years to the work of Swedish economist Knut Wicksell, who argued for the existence of an unobservable, but still very real, "natural rate of interest." *Wicksell argued that when inflation was too low, the policy rate must be higher than the rate of interest that would occur naturally in the real economy, if there were no central banks. That implies that in the aftermath of the Great Recession, the natural rate must have been below zero, which in turn means that the world's central banks were too tight, even when ZIRP, NIRP and QE made them seem easy.*
- Yellen was first to exhume this framework in her March 2016 "uncertainty" speech. Fischer took it further two months later in a

Contact TrendMacro

On the web at
trendmacro.com

Follow us on Twitter at
twitter.com/TweetMacro

Donald Luskin
Chicago IL
312 273 6766
don@trendmacro.com

Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

Michael Warren
Houston TX
713 893 1377
mike@trendmacro.energy

[About us]

Recommended Reading

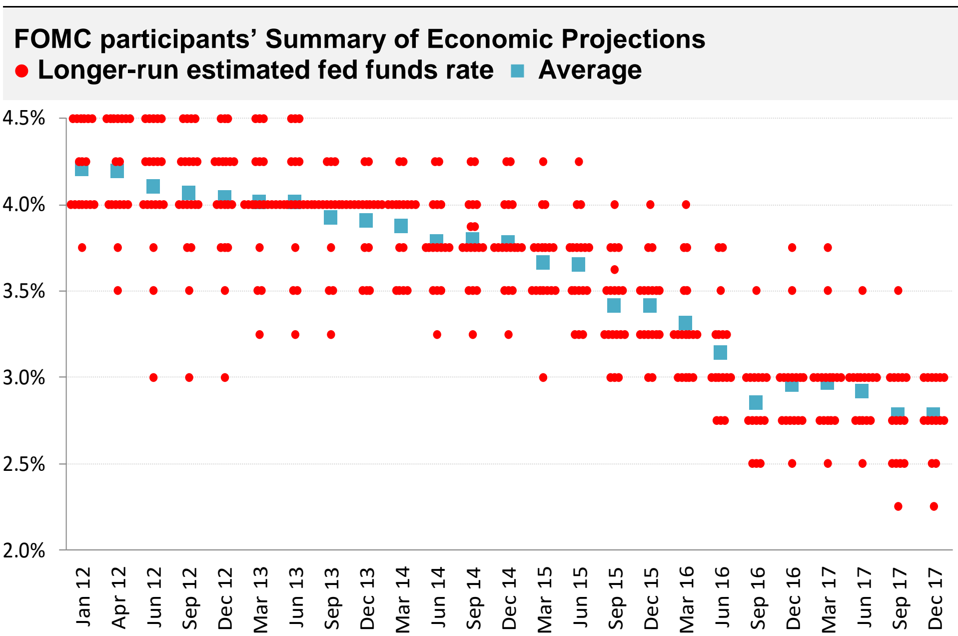
Macron's Polling Revival
Wall Street Journal
December 12, 2017

The Incredible Shrinking Workforce
Edward Lazear
Wall Street Journal
December 8, 2017

[Reading home]

speech, in which he quoted *verbatim* almost 1,000 words from Wicksell (see "Is the Fed Stuck on Stupid?" May 20, 2016).

- Versions of it have been in the Fed *zeitgeist* for years. It is reflected in the steady march lower of the "dots" for the "longer-run" funds rate in the FOMC participants' Summary of Economic Projections (please see the chart below). And it is evoked every time a Fed spokesman talks about the "neutral rate of interest" or "r-star."



Source: FOMC, TrendMacro calculations

- Indeed, in his most recent speech on economic matters, chair nominee Powell reliably recites the new narrative, exactly as we have just constructed it:

> *[The] decline in the long-run neutral rate…imply that even the very low rates of recent years may be providing less support to the economy than may appear.*

- In some sense it's an argument of convenience for central bankers. It lets them off the hook for not being able stimulate the global economy after the Great Recession, despite all the heavy-lifting with various "unconventional policy tools."
- But going forward, it has real virtue.
- It amounts to a predictable "policy rule" (see "Yellen Gives Conservatives Something to Cheer" February 17, 2017). It dictates that *the Fed will only gradually hike the funds rate as it is assured, meeting by meeting, that the natural rate of interest is commensurably rising. Such hikes would only be indexation of the policy rate to the rising natural rate – they would not be policy tightenings.*
- How will the Fed know that the natural rate is rising? Thankfully, it will no longer look to the unemployment rate alone as a sufficient statistic. If any single simple statistic has to rule the decision, it will be inflation. *If inflation remains below target, then there's no such*

thing as an unemployment rate so low that the Fed would, simply in virtue of that, need to actually tighten. Remember, it has been the persistence of low inflation in the face of apparent easy policy and low unemployment that gave rise to Yellen's embrace of the natural rate concept in the first place.

- The Fed uses various models to estimate the neutral rate, or r-star – it's quant proxy for the natural rate of interest. These are an excellent starting point for grasping the center of the Fed's thinking now. Adjusting them for core inflation, they yield a funds rate in the range of 1.25% to 1.65% (see "Data Insights: Federal Reserve" December 13, 2017) – the mid-point of which is where the funds rate was set today. *When these estimates move, the Fed will move.*
- *But just three more hikes will take the funds rate to the lowest of the FOMC's longer-run "dots"* (again, please see the chart on the previous page). *Those three more hikes are all the money-market curve is expecting for the coming three years. We think the economy will evolve more favorably than the consensus believes, so for us that's a conservative estimate – but we emphasize that in the face of a quickening economy, a couple more rates hikes than expected would only be policy indexation, not tightening.*
- *This is the policy framework that Jerome Powell inherits*, and he likely has neither the time, the training, nor the inclination to change it.

Now let's turn to today's FOMC statement, Summary of Economic Projections, and press conference. *Much of what we have just discussed was clearly in evidence.*

- In her prepared remarks at the press conference, Yellen acknowledged that, as we have pointed out, the funds rate is now very close to r-star, which she calls the "neutral" funds rate. She goes on to say,

  But because we also expect the neutral level of the federal funds rate to rise somewhat over time, additional gradual rate hikes are likely to be appropriate over the next few years...

- Again, such hikes, would not be tightenings. And despite her expectations, for now, the average "dots" for the expected funds rate fell slightly for both 2018 and 2019 (again, see "Data Insights: Federal Reserve"). This implies two-and-a-half hikes next year, which is about what the money market curve is expecting. Clearly, the FOMC is in wait-and-see mode.
- The FOMC's cautious stance, despite what would have historically been seen as an unemployment rate so low as to command an automatic rate hike to avoid risking runaway inflation, there were two dissents *against* today's hike – from Chicago's Charles Evans and Minneapolis' Neel Kashkari – after three meetings in a row with no dissents.
- Indeed, in today's statement, the labor market was upgraded from an expectation in November for "some further strengthening" to a

presumably ongoing "strong." And today's SEP lowered the expected unemployment rate at all tenors. Yet at the same time, the "central tendency" for inflation next year was also lowered for 2018 and 2019. *The Phillips Curve would appear to not be just flat, but dead.*

Bottom line

We were wrong about Yellen. She showed the flexibility to assume the Fed chair as a dove, but preside over the end of QE, lift-off from ZIRP and normalization of the balance sheet. Lift-off was terribly timed, but she quickly corrected her mistake and, with Fischer, turned the Fed away from the Phillips Curve and toward Wicksell's model of the natural rate of interest, for which r-star is a modelled proxy. It means rate hikes will be indexed to improvement in the real economy, and thus not tightenings. Today Yellen explicitly affirmed this policy framework in her last press conference, noting that the funds rate is now close to r-star, and predicating further hikes on r-star's expected ongoing recovery. The SEP both lowered expected unemployment rates and expected inflation. The Phillips Curve appears to be dead. This starts new chair Powell with the best possible policy inheritance.