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The great Fed pivot

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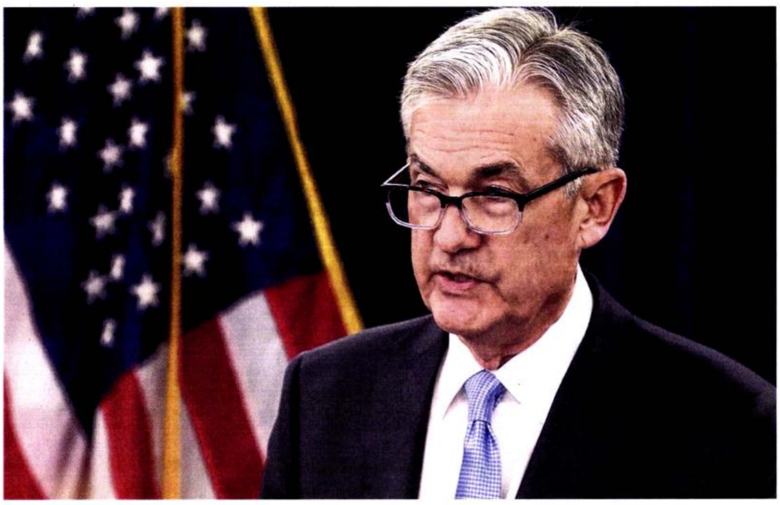

Fed chief Jerome Powell addressing the media on a change in direction on March 20. The current level of the funds rate is far below the average amount of conventional policy space needed to cushion the subsequent downturn. PHOTO: AFP

The great Fed pivot

Switching from 'further gradual increases' to an overly patient policy stance might potentially be elevating the risk of a more negative shock. BY THOMAS LAM AND DAVID FERNANDEZ

SINCE the end of last year, the outlook for monetary policy globally, especially in the US, has changed dramatically. Before the December 2018 Federal Open Market Committee (FOMC) meeting, we noted that a "flatter Fed rate path is probably more prudent than a progressively steeper inclination". Since then, the median federal funds rate projection among Fed participants has fallen from three hikes to zilch for 2019, with (barely) one increase in 2020.

The great Fed pivot has had a similarly significant impact on financial markets broadly. Clearly, the abrupt shift in the policy stance from expecting "further gradual increases" in December to currently being "patient as it determines what future adjustments…may be appropriate" has led to more confusion. In this piece, we attempt to provide some clarity to the ongoing debate and highlight the likely risks to this great Fed pivot.

Essentially, despite a "favourable" or "solid" modal US outlook for 2019, increasing evidence of domestic and global "risks" likely inclined the FOMC toward a "risk management" approach, resulting in a "patient" policy stance currently.

In particular, the downside "crosscurrents" include slower global growth, unresolved policy issues (Brexit and trade-related), mixed US data releases along with the government shutdown distortion and less supportive financial conditions. Also, the apparent diminution of upside risks, emanating from the perception of less future inflation (symmetrically speaking) and perhaps lesser financial imbalances initially, has provided additional leeway for the Fed to lean back.

POLICY LEEWAY

The present magnitude of rate increases – totalling 225 basis points (bps) through 2018 – is somewhat less than previous tightening cycles (of around 275bps since 1980s), but with the balance sheet normalisation, the extent of policy firming is probably comparable to previous episodes. In this sense, a Fed pause might not seem unusual. Still, the current level of the funds rate is far below the average amount of conventional policy space needed to cushion the subsequent downturn. We estimate that, assuming the FOMC prolongs the pause, the balance sheet can conceivably expand beyond 25 per cent of GDP during the next recession, surpassing the prior peak level.

Indeed, issues pertaining to the lower bound and policy leeway are key reasons for commencing a review on the Fed's "strategies, tools and communication practices". This is also linked to the desire of further enhancing the Fed's commitment to its symmetric inflation objective, though without lifting the existing longer-run inflation goal of 2 per cent.

Our recent discussion with the folks from the New York Fed at the Sim Kee Boon Institute suggests a general slant toward gradual changes, possibly adopting some version of average inflation targeting or selective price level targeting. Although inflation "makeup" strategies can lower the risk of hitting the effective lower bound in theory, the challenges and hurdles surrounding expectations management can lead to different outcomes in practice.

Given the slew of considerations, there ought to be questions on the reaction function – that is, how the Fed calibrates conventional monetary policy in response to economic conditions. One simple way to assess whether the Fed's implied reaction function has evolved lately is to determine if changes to the funds rate projections are roughly consistent with an assumed rule-based policy that incorporates revisions from participants' economic and longer-run projections.

Our analysis suggests that the great Fed pivot of 75bps – from June or September 2018 to March 2019 – seems broadly in line with the estimates from a standard policy rule (as per the 1993 Taylor rule). Similarly, we find that this policy rule accounts for roughly 30bps out of the 50bps pivot in the median dot-plot from December 2018 to March 2019 (however, assigning more weight to stabilising unemployment produces an estimate of 45bps).

Hence, the 2019 Fed pivot appears to be more or less in line with participants' updates to the US outlook (relative to June or September), perhaps with a hint of risk management consideration (relative to December). The overall takeaway from this exercise, however, seems broadly consistent with our dialogue with the New York Fed, suggesting no material changes to the Fed reaction function.

Still, given the ramp-up of references to various "risks", it is unclear why the FOMC omitted the balance of risks statement since the January 2019 meeting. One conjecture pertains to the sketchiness of incoming data releases, partially resulting from the US government shutdown. Another might be linked to the lack of consensus on how to frame the risk statement, without skewing expectations unduly toward a preferred policy action. This implies that probably not all voting members are on the same page on the future policy path.

Similarly, the evolution of the latest funds rate projections or dot-plot from all 17 Fed participants has also contributed to a hazier future rate trajectory. While we are cognisant that the median projection does not represent the consensus judgment of the FOMC (10 voting members), only six participants expected a rate hike in 2019 at the March meeting, down sharply from 15 participants in December.

STRUCTURAL DEVELOPMENTS

Unsurprisingly, the great Fed pivot – at the January and March 2019 meetings – elicited significant financial market reactions. The sporadic and apparent inversion along some segments of the yield curve implies that expected future short-term rates might be lower than current levels. But Fed policy could be more accommodative for varied reasons (recession prospects, desire to defend a symmetric inflation objective, etc), producing different spillover effects.

Also, structural developments – from domestic and global influences – and uncertain risk-neutral estimates can either dilute or distort the signal from the yield curve. Despite an unsettled policy environment, lop-sided market positioning could potentially harden the current "wait-and-see" policy stance, possibly raising the risk of unintended or self-fulfilling eventualities.

We wonder whether the desire to "sustain the economic expansion" will ultimately raise financial stability risks or amplify the next downturn. If efforts to prolong the economic cycle lead to greater financial imbalances over time – prospectively worsening the next downturn – then the potential costs of this action should be evaluated more carefully.

The great Fed pivot has been monumental, both in jolting expectations and swinging markets. Back in December, we wrote that the general call was too hawkish in expecting three to four rate hikes. Today, our sense is that while the FOMC has not pushed the prospect of additional policy firming completely off the table, financial markets might be too dovish in expecting looser monetary policy in the offing. Besides, the seemingly one-sided policy expectation currently reinforces the notion that future Fed policy appears to be on a preset course. Hence, unless incoming data nudges the Fed toward resetting the policy direction, an overly patient policy stance might potentially be elevating the risk of a more negative shock in the future.

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