Outlook & Commentary

Making the Federal Reserve less relevant

Steven Malin | 19/12/2018

Summary

Fed Chairman Powell learned the hard way that his comments, even those made outside of official Fed communications channels, can move markets. The Fed is on a mission to make itself less important in the decision-making of savers, investors, consumers and governments.

Key takeaways

- The Fed is aiming to normalise its monetary policy and raise rates toward their neutral level – but the Fed also wants to make itself less relevant to market participants
- In 2019, multiple factors could determine the timing, pace and composition of the Fed's normalisation process, including the expansion of corporate debt, debt quality and unanticipated changes in the rate of inflation
- Watching these potential influences on Fed policy can help investors anticipate FOMC actions and make appropriate asset-allocation decisions

Monetary-policy makers in the US will continue to push interest rates toward their neutral level, though that level is uncertain. As they do so, however, they will be watching conditions in financial markets very carefully for signs that liquidity may be becoming too tight or that individual segments of the fixed-income space are starting to founder.

To understand what lies ahead for US monetary policy, investors must not forget that the members of the Federal Open Market Committee are not just monetary authorities – they also are central bankers. As a result, the overall policy mix in 2019 will reflect the Federal Reserve's overarching mission to return financial-market conditions to "normal" while also reestablishing the Fed's independence and making its decisions less relevant, even irrelevant, to investors.

Think of the Federal Reserve in 2019 much as you would think of a business determined to do what it perceives to be in the best interests of its shareholders. In the case of the Fed, those shareholders are the largest number of US individuals and institutions for the longest period of time.

Accordingly, the Fed can be expected to act in 2019 as if its vision, mission and strategies are as follows:

- Vision: to remain the world's pre-eminent central bank by formulating and implementing policies that set conditions conducive to the achievement, in the US, of maximum, sustainable real economic growth with stable prices and stable, well-functioning banking and financial systems.
- Mission: to fulfil the vision statement by normalising the balance sheet of the Federal Reserve System and the level and structure of interest rates in a manner that neither disrupts the flow of goods and services, money and credit, nor promotes the misallocation of resources in any market. Another aspect of this mission would be to make the Fed less relevant in the decision-making of participants in real and financial markets around the world.
- Strategies: adjust the level of bank reserves and short-term interest rates, wind down holdings of Treasury and mortgage-backed securities, and use official communications to provide forward guidance to market participants and set expectations.

In carrying out this business plan, the Fed will continue to implement monetary policy as it has since the end of the financial crisis. Research within the Fed suggests that its operating procedures are working very much as expected, keeping the federal funds rate within its target range. Meanwhile, neither the rate increases since 2015 nor the normalisation of the Fed's balance sheet since 2016 appear to have affected the economy and markets materially.

Comments by Fed Chairman Jerome Powell in August suggested that the FOMC might have to raise the target for its policy interest rates quite a bit further to get them to their neutral real level. However, after financial markets sold off sharply, Powell walked back his comments, telling an audience in New York that current money-market rates were indeed not much below neutral. A gleeful, but visceral, reaction shot through financial markets, if only for a day. The Fed Chairman learned again that his words count.

Here are factors to watch in 2019 that could determine the number of policy-rate increases and the timing, pace and composition of the Fed's balance-sheet normalisation:

- Communications from Jerome Powell – and, perhaps, Richard Clarida, Fed Vice Chairman – as well as official FOMC meeting minutes and press releases (but not from other individuals within the Federal Reserve System).
- Indications that the labour market has tightened enough to push labour compensation increases substantially above 3%. Read the so-called "beige book" to find out whether the Federal Reserve Bank presidents are hearing that the tariffs are raising their costs, wage pressure is rising and businesses are raising prices successfully.
- Indications that exogenous factors (like changes in oil prices) have become embedded in consumer prices and become endogenous. If so, inflation will go up – as will inflationary expectations – and the inflation premium embedded in long-term interest rates will increase.
- Productivity data and estimates of term premiums, both of which influence Federal Reserve estimates of the neutral real short-term interest rate.
- PMI and ISM readings, both for manufacturing and nonmanufacturing companies. These data provide an excellent indication of the strength of the national economy and pricing.
- Corporate earnings growth that may be slowing. It will be important to look at the quality of earnings – how much is from unit sales, how much is from price increases, how much is organic and how much came via acquisitions. Other factors to watch are the international economic, financial and currency-related conditions as non-US central banks begin removing monetary accommodation and face political and financial challenges.
- Are the financial markets operating in an orderly fashion or have they become disorderly, making price discovery impossible, counterparties impossible to find and trading too fast for human market participants to adjust positions when desired?
- Fixed-income and credit market conditions, including sovereign debt, corporate debt, and particularly high income and leveraged loans.
- Above all, liquidity conditions across the yield curve and in individual markets.

Focusing on these potential influences on Fed policy can help market-watchers anticipate FOMC actions before they occur, and help financial professionals make asset-allocation decisions that will be in their clients' best interest.

Learn more
For an in-depth exploration of this topic, read the December 2018 edition of *Under the Macroscope*.

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