Clues from the Fed II - A Review of Jerome Powell's Speech 11/28/2018

The following speech by Jerome Powell, Chairman of the Federal Reserve, was given on November 28, 2018. Highlighted below are quotes which we believe are important in helping to determine current Fed posture and inclination. Intertwined within his speech you will find our comments and explanations. Please also see our summary thoughts following the speech below. If you have not read our review of Vice-Chairman Richard Clarida's speech from yesterday you can find it HERE.

The Federal Reserve's Framework for Monitoring Financial Stability Chairman Jerome H. Powell At The Economic Club of New York, New York It is a pleasure to be back at the Economic Club of New York. I will begin by briefly reviewing the outlook for the economy, and then turn to a discussion of financial stability. My main subject today will be the profound transformation since the Global Financial Crisis in the Federal Reserve's approach to monitoring and addressing financial stability. Today marks the publication of the Board of Governors' first *Financial Stability Report*. Earlier this month, we published our first *Supervision and Regulation Report*. Together, these reports contain a wealth of information on our approach to financial stability and to financial regulation more broadly. By clearly and transparently explaining our policies, we aim to strengthen the foundation of democratic legitimacy that enables the Fed to serve the needs of the American public. **Outlook and Monetary Policy** Congress assigned the Federal Reserve the job of promoting maximum employment and price stability. I am pleased to say that our economy is now close to both of those objectives. The unemployment rate is 3.7 percent, a 49-year low, and many other measures of labor market strength are at or near historic bests. Inflation is near our 2 percent target. The economy is growing at an annual rate of about 3 percent, well above most estimates of its longer-run trend. For seven years during the crisis and its painful aftermath, the Federal Open Market Committee (FOMC) kept our policy interest rate unprecedentedly low--in fact, near zero--to support the economy as it struggled to recover. The health of the economy gradually but steadily improved, and about three years ago the FOMC judged that the interests of households and businesses, of savers and borrowers, were no longer best served by such extraordinarily low rates. We therefore began to raise our policy rate gradually toward levels that are more normal in a healthy economy. Interest rates are still low by historical standards, and they remain just below the broad range of estimates of the level that would be neutral for the economy??that is, neither speeding up nor slowing down growth. My FOMC colleagues and I, as well as many private-sector economists, are forecasting continued solid growth, low unemployment, and inflation near 2 percent.

RIA Pro comment- *In these first two paragraphs Jerome Powell points out that the economy is running above its longer-term trend in large part due to the support of ?near zero? interest rates (Fed monetary policy). Given recent above-trend economic growth and a sustained recovery from the financial crisis, the Fed raised rates to get to a less simulative level. He states that ?interest rates are still low by historical standards? and ?remain just below? what they would consider neutral for the economy.* ***The phrasing ?remain just below? is the key line from the speech as it was only a month ago, on October 3rd, when he said they were a ?long way? from neutral. In no***

uncertain terms, this abrupt change in posture is a clear signal to the market that the Fed may be close to ending their hiking cycle.

There are two other important points regarding the neutral rate worth discussing. First, the Federal Reserve does not know with any real precision what the ?neutral? rate of interest for the economy is or should be. This is best left to un-manipulated markets and the independent buyers and sellers that drive them. Second, if indeed Powell and the Fed did know with certainty where the neutral rate should be, it likely would not be at a real rate near zero, with economic growth running above 3% and the unemployment rate at 50 year lows as is currently the case.

There is a great deal to like about this outlook. But we know that things often turn out to be quite different from even the most careful forecasts. For this reason, sound policymaking is as much about managing risks as it is about responding to the baseline forecast. Our gradual pace of raising interest rates has been an exercise in balancing risks. We know that moving too fast would risk shortening the expansion. We also know that moving too slowly--keeping interest rates too low for too long--could risk other distortions in the form of higher inflation or destabilizing financial imbalances. Our path of gradual increases has been designed to balance these two risks, both of which we must take seriously. We also know that the economic effects of our gradual rate increases are uncertain, and may take a year or more to be fully realized. While FOMC participants' projections are based on our best assessments of the outlook, there is no preset policy path. We will be paying very close attention to what incoming economic and financial data are telling us. As always, our decisions on monetary policy will be designed to keep the economy on track in light of the changing outlook for jobs and inflation.

RIA Pro comment- *Powell is parroting the substance of Clarida?s speech yesterday essentially saying that the Fed is no longer on rate-hiking auto-pilot. They will raise rates or abstain from raising rates based on what economic and financial data tell them (data dependency). As we mentioned yesterday, the increased emphasis on data dependency by definition reduces their reliance on forward guidance which will introduce more volatility to the markets. Prior reliance on forward guidance helped suppress volatility, so it follows that less reliance on it will make them less predictable and naturally raises the level of uncertainty for investors.*

Under the dual mandate, jobs and inflation are the Fed's meat and potatoes. In the rest of my comments, I will focus on financial stability--a topic that has always been on the menu, but that, since the crisis, has become a more integral part of the meal. We omitted the rest of the speech as its focus is a historical perspective of financial stability and less relevant to current monetary policy. The entire speech can be found HERE

RIA Pro Summary

It is clear from this speech, as well as recent trial balloons put out by the Fed, that they are taking a more dovish stance. This does not mean they will halt their rate hikes, but in our opinion it is clear that once we move beyond the scheduled hike in December, all bets are off the table. Barring signs of wage growth, stronger inflation or sustained economic growth above 3%, they are unlikely to raise rates further. The stock market rocketed higher on what is perceived as a dovish speech with the strong possibility that Fed hikes will be halted come 2019. Time will tell if the gains are sustainable and if the market is interpreting his speech correctly. It is worth mentioning however that a recession followed the last three times that the Fed Funds rate hit a cycle high.&#2013266080;