FHN FINANCIAL

JANUARY 17, 2020

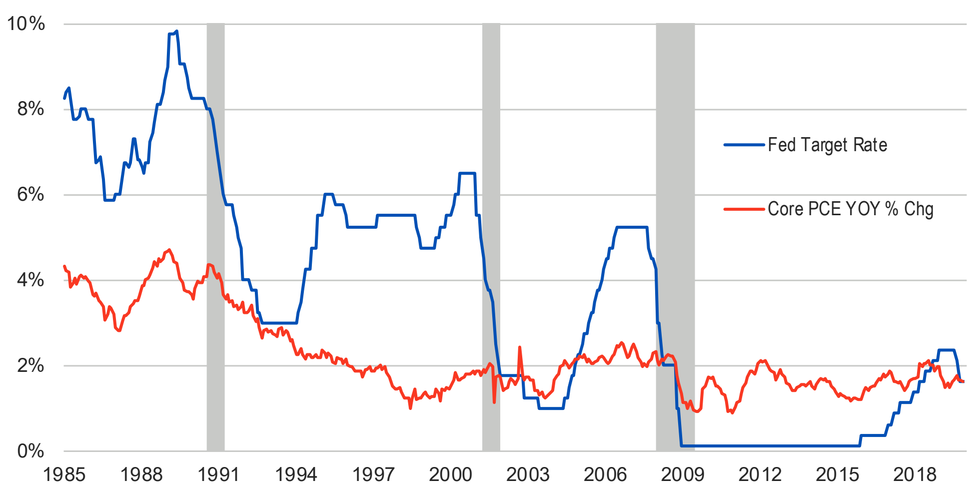
ECONOMIC WEEKLY

2020 is Key to Future Fed Relevance

According to *The Wall Street Journal*, the Fed is in trouble. The economic expansion is growing long in the tooth, but inflation and interest rates remain incredibly low. If there is a recession in the near future and interest rates remain this low, market interest rates could be slashed to modern lows. The Fed can hold the fed funds rate above zero, as it chose to do after the 2008 rate cuts, but it will almost certainly be pinned near zero for years after the recession is over. As a result, the Fed might not be able to stimulate growth enough to lift the economy out of recession even with an expanded tool kit and improved communications.

The Fed understands this risk very well, kicking off its extensive policy review in 2018. The review should wrap up in the middle of the year. We expect it will recommend changes in the Fed policy approach that might restore the Fed's relevance. We say "might" because inflation and rates are so low, the Fed could have waited too long. And, as the *Journal* highlighted, the fact that the neutral fed funds rate falls in recessions – the Fed must solve this problem before the next recession starts. How do we know that? Look at the successively lower level of fed funds needed to jump start the economy.

The neutral fed funds rate fell after each of the last three recessions



Source: Bureau of Economic Analysis, Federal Reserve Board, Haver Analytics

CONTENTS

ECONOMICS

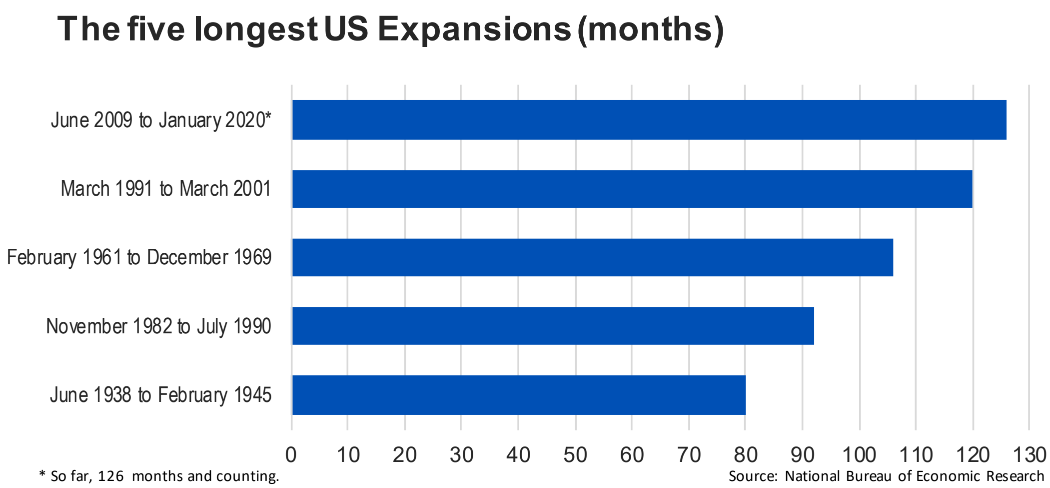
Chris Low
Chief Economist
212.418.7909
chris.low@fhnfinancial.com

Rebecca Kooshak
Economic Analyst
212.418.7966
rebecca.kooshak@fhnfinancial.com

FHNFINANCIAL.COM
800.456.5460

Long expansion, low inflation

The Great Recession ended in July 2009, making the expansion ten-and-a-half years old, the longest in US history. There is no close second, assuming the expansion continues this year. Growth has been moderate throughout, a feature lauded by the Fed when it happened in the 1990s because sluggish growth meant low inflation. Of course, in those days, the Fed wanted inflation to move lower, not higher, as they do today. Sluggish growth today is a problem best summarized by the level of interest rates and inflation expectations despite the record-breaking length of the expansion.



We bring this up not to grouse about the Fed. They get plenty of that from the White House. Rather, we bring it up to highlight the potential for ruinously low rates after a recession; the threat of the Federal Reserve's future irrelevance, posited by Greg Ip in *The Wall Street Journal*; a recent Fed paper on lessons learned from Japan; and the Fed's ongoing policy review. They are all one thing.

Low inflation and low interest rates are related. Interest rates include an inflation component. That inflation component has shrunk over the past four decades as it has become increasingly clear central banks can and will prevent inflation from rising. The real component of yields has fallen, too, as has the term premium in longer-dated yields. The cause of these two declines is debatable, but the net result is the level of rates necessary to contain inflation has fallen.

We had misgivings about the 2018 rate hikes – and may have occasionally expressed them too vigorously – because we recognized the 2018 fiscal stimulus as a rare opportunity to allow inflation and interest rates to rise. The Fed recognized it, too, but as John Williams, the San Francisco Fed President at the time, explained, the Fed had not yet finished reviewing whether it was appropriate to allow inflation to exceed 2%. As a result, he said, the Fed had no choice except to raise the fed funds rate to what they estimated was long-run neutral. The combination of the four hikes in 2018 and the promise of three more to come, priced into market rates over the course of the fourth quarter of 2018, could have precipitated a recession and ultimately caused middle- to longer-term market interest rates to plunge 100 basis points.

The threat of negative rates in the next recession was heightened by the 2019 drop in market rates. Fed economist Michael Kiley recognized negative rate risk in a recent FEDS Note, a first for a Fed insider. The entire Fed recognizes negative rates as something best avoided.

Greg Ip's warning about an irrelevant Fed focuses on negative rate risk and the increasing irrelevance of the BOJ and ECB. Both cut rates so low they are endangering the survival of commercial banks. Both have pursued QE to the point of diminishing returns. Both would love to boost their economies, but have run out of ideas. Ip thinks it is too late for the Fed to avoid a similar fate.

Lessons learned from Japan, according to Federal Reserve economist Taisuke Nakata, are:

1. Announcing a higher inflation target does not guarantee the target can be achieved. If it is not achieved, the central bank loses credibility.
2. A central bank should achieve its old inflation target before announcing a new one or it will lose credibility.
3. Dissent weakens the credibility of a new inflation target. A central bank will have more success if all policy makers endorse it.

We would modify the lessons:

4. Notice each of Nakata's lessons are about lost credibility. He has an implicit assumption BOJ failure is a product of lost respect. What if that's not the problem? Perhaps the real lesson is liquidity traps are hard to escape and best avoided.
5. Also, opportunities to boost inflation from very low levels are rare. Japan squandered four opportunities in the past 15 years by raising rates or raising taxes before the public had a chance to acclimatize to higher inflation. Central bankers should be aware of the danger of prematurely declaring Mission Accomplished.

The Fed policy review is the most critical thing the Fed has worked on in a long time. The Fed hopes to avoid the negative-rate trap by changing the way it approaches inflation. As we learned from Japan, even a good plan requires an opportune time to execute it. Tax cuts in 2018 created a perfect opportunity, but the Fed wasn't ready yet. If there is no further opportunity in this expansion, Michael Kiley's negative rate prediction and Greg Ip's Fedless dystopia could become a reality.

Here's hoping for another opportunity.

Bottom line: This could be the Fed's last chance

The economy has changed since the financial crisis because economic behavior has changed. For the first time, in Kiley's big November paper, a prominent Fed insider recognized this new normal. Kiley and Ip make the case the Fed must change, too, or become irrelevant. It is more critical for the Fed to get policy right in this cycle than in any other. In the past, a monetary policy mistake meant premature recession, which is a shame but not the end of the world. This time, a premature recession with super-low interest rates forces the Fed to convince markets it is still capable of helping the economy climb out of the hole.

Ip suggests the US economy could be "one recession away" from following Europe and Japan down the rabbit hole of negative interest rates. He cites Ray Dalio, but he could have cited Kiley, who said pretty much the same thing. The risk of negative market interest rates is a widely accepted possibility in the trading community and is finally an accepted possibility within the Fed. **Recognizing a risk is the necessary first step in avoiding a risk.**

Judging from the number of people asking us about it, Ip's piece generated a lot of attention, which is a good thing. The public should know about the downside risks from low inflation and low inflation expectations, and they should know what a recession can be like without fiscal or monetary stimulus to shorten it. What they should also know is that the Fed is aware of the risks and is in the midst of rethinking its policy approach. We should all get behind the effort.

– Chris Low, Chief Economist

The Week Ahead

This Week's Numbers

		CONSENSUS				
		PRIOR	HIGH	LOW	MEDIAN	FHN
Wednesday, January 22	FHFA House Price Index MoM - Nov	0.2%	0.6%	0.1%	0.3%	**0.2%**
	Existing Home Sales MoM - Dec	-1.7%	3.2%	0.4%	1.5%	**1.0%**
	Existing Home Sales - Dec	5.35m	5.52m	5.37m	5.43m	**5.40m**
Thursday, January 23	Leading Index - Dec	0.0%	0.2%	-0.3%	-0.2%	**-0.3%**

Review

This week, the Beige Book, retail sales, consumer sentiment, and China's Q4 GDP release took a backseat to the signing of the Phase One US-China trade deal.

- **President Trump and Vice Premier Liu He signed phase one** of the US Economic and Trade Agreement at the White House Wednesday. Inside, there are six chapters, covering intellectual property, technology transfers, food and agricultural products, financial services, foreign exchange rate transparency, and opening-up China's market to foreign goods and services.

  The Office of US Trade and China's Ministry of Agriculture released the agreement Thursday. Both sides made concessions, but the rhetoric coming out of China's press appears slanted toward a China unwilling to yield to US demands.

  The specifics of trade expansion, particularly of US exports to China fall under Chapter 6. The text reads, "China shall ensure that purchases and imports into China from the US of the manufactured goods, energy products, and services… exceed the corresponding 2017's baseline amount by no less than $200 billion." Over the next two years, the additional $200b of exports to China would be allocated as follows:

  - **Manufactured goods** should increase by at least **$77.7b.** (By $32.9b in 2020 and $44.8b in 2021.) The category includes purchases of aircraft, vehicles, medical instruments, pharmaceutical products, and iron and steel products.
  - **Agricultural products** should increase by at least **$32.0b**, and a footnote reads, "At the request of the United States, China will strive to purchase and import $5b per year…in addition to the minimum amounts set forth herein." (In 2020, $12.5b more should be exported and $19.5b in 2021.)
  - **Energy products** should increase by **$52.4b.** (By $18.5b in 2020 and by $33.9b in 2021.) The category includes liquefied natural gas, crude oil, refined products, and coal.
  - **Services** should increase by **$37.9b.** (By $12.8b in 2020 and $25.1b in 2021.) The category includes charges for intellectual property use, business travel and tourism, as well as cloud related services.

Whether the US can produce and China can import $200b of goods and services in two years, thus adding net contributions to US GDP, remains to be seen. The deal promotes structural changes within China, particularly as Chinese consumers increase demand for "high-quality, competitively priced goods and services," which the US has positioned itself to supply.

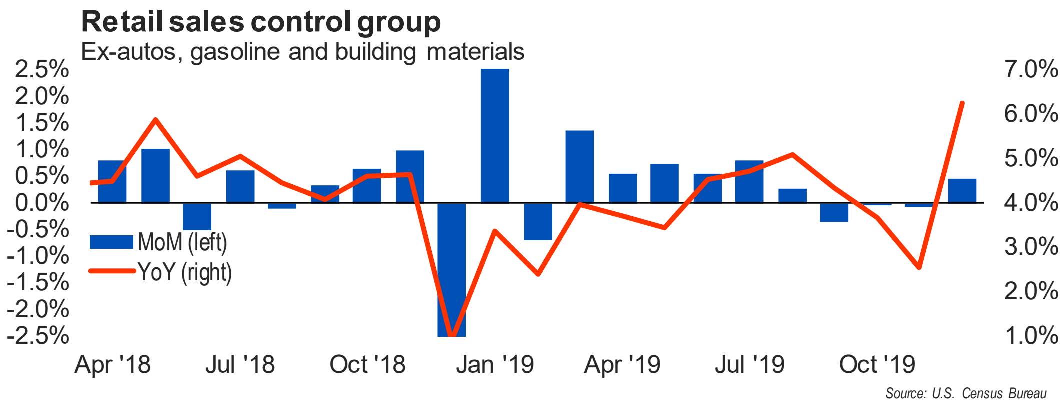
Trade terms, particularly around agriculture remain vague, as vice agricultural minister Han Ju has said Beijing will not increase import quotas to appeal to any one country. Agriculture, according to the deal, is "a strong pillar of the bilateral relationship." In addition, China recently suspended the expected national rollout of its ethanol mandate requiring gas blends containing 10% ethanol. There is cautionary language underscoring China's reluctance to commit to US agricultural imports on page 6-2:

"**The Parties acknowledge** that **purchases will be made at market prices based on commercial considerations and that market conditions**, particularly in the case of agricultural goods, **may dictate the timing of purchases within any given year**."

Aside from the particulars, the Phase 1 deal achieves three strategic goals.

1. It resets the playing field. The old normal had few US impediments to Chinese access to the US, but tariffs, quotas, outright bans and subsidies blocking US sales in China. Phase One resets the status quo to include big US tariffs, which establishes a kind of equivalence.
2. The biggest barrier to trade negotiation up to now was Chinese fear of losing face by making unilateral concessions. Phases 2 and 3 should be easier to negotiate as both sides now have trade barriers to take down.
3. It restores predictability to international trade. Companies have a better understanding of the environment and can plan and invest with confidence they are not likely to be hit with an unexpected tariff in the next year. Global growth should benefit from the trade détente, assuming the President can resist opening the European front in the trade war.

- **December's retail sales rose 0.3%** m/m, in line with consensus, but October and November were revised lower, resulting in weaker-than-expected fourth quarter results. The retail sales control group posted a 0.5% rise over the month, beating expectations, but November was lowered from 0.1% to -0.1% m/m and Oct was revised down 0.3% to -0.02% m/m. The revisions brought Atlanta's GDPNow forecast down from 2.3% to 1.6% for Q4.



- December's small business NFIB confidence survey fell 2 points from November's 104.7 to 102.7, missing 104.6 consensus. Seven out of 10 indicators fell and two rose. (Firms expect an improvement in the economy and an increase in real sales.)
  - Plans to increase employment fell 2 points from 21 to 19
  - Plans to make capital outlays fell 2 points from 30 to 28
  - Plans to increase inventories remains flat at 3
  - Current inventory levels fell 5 points from 1 to -4
  - Now a good time to expand fell 4 points from 29 to 25
- **Tuesday, the US, EU, and Japan issued a three-page joint statement tweaking WTO rules** intended to limit China from providing government subsidies to government sponsored entities. China reportedly exploits WTO rules as part of its state-sponsored capitalism. Additionally, the joint statement also called for the end of forced technology transfers to Chinese companies.
- China trade in December beat estimates, but according to Capital Economics reflects base and price effects rather than strength. Exports rose 9.0% y/y (CNY basis) or 7.6% y/y (USD basis) and imports rose 17.7% y/y (CNY basis) or 16.3% y/y (USD basis). Bilateral trade between the US and China improved late last year, as China imports from the US rebounded in November and December. China's vice-minister of customs administration, Zou Zhiwu said China doubled its imports of US agricultural products and increased vehicle imports by 50% at the end of last year.

The Atlanta Fed's Q4 GDPNow forecast fell from 2.3% last week to 1.8% driven by the downward revisions in retail sales. The NY Fed revised its Nowcast up from 1.1% to 1.2% due to data revisions in the CPI.

Davos begins next week, with a focus on climate change and taxing the digital economy. Also next week, the ECB and BOJ set policy, which are expected to remain unchanged, but both are expected to signal changes in upcoming policy reviews.

Preview

Note: ★ = High Impact Event
All times Eastern

Saturday, January 19

- 11:30pm – Japan:
  - Industrial Production – Nov F (Nov P: -0.9% m/m)
  - Industrial Production Nov F (Nov P: -8.1% y/y)
  - Capacity Utilization – Nov F (Nov P: -4.5% m/m)

Monday, January 20

- ★ US: Public Holiday
- 3:30am – Hong Kong: Unemployment Rate – Dec (Last: 3.2%)
- ★ 8:00am – US: IMF World Economic Outlook Update

Tuesday, January 21

- ★ Japan: Bank of Japan monetary policy decision and economic outlook.
- 4:30am – UK:
  - ILO Unemployment Rate – Nov (Last: 3.8%)
  - Average Weekly Earnings + Bonus – Nov (Last: 3.2% 3m/y/y)
  - Average Weekly Earnings ex Bonus – Nov (Last: 3.5% 3m/y/y)
- ★ 5:00am – Germany:
  - ZEW Survey Current Situation – Jan (Last: -19.9)
  - ZEW Survey Expectations – Jan (Last: 10.7)

Wednesday, January 22

- 2:45am – France:
  - Manufacturing Confidence – Jan (Last: 102)
  - Business Confidence – Jan (Last: 106)
- 4:00am – Italy:
  - Industrial Orders – Nov (Last: 0.6% m/m)
  - Industrial Sales – Nov (Last: 0.6% m/m)
- 4:30am – UK: Public Finances
- 8:30am – US: Chicago Fed National Activity Index – Dec (Last: 0.56)
- 9:00am – US: FHFA House Price Index – Nov (Last: 0.2% m/m; Con: 0.3% m/m)
- ★ 10:00am – US:
  - Existing Home Sales – Dec (Last: -1.7% m/m; Con: 1.3% m/m)
  - Existing Home Sales – Dec (Last: 5.35m; Con: 5.42m)
- ★ 10:00am – Canada: Bank of Canada interest rate decision.
- ★ 11:15am – Canada: Bank of Canada Governor Poloz post-meeting press conference.

- 6:50pm – Japan:
  - Trade Balance – Dec
  - Exports – Dec (Last: -7.9% y/y)
  - Imports – Dec (Last: -15.7% y/y)
- 11:30pm – Japan: All Industry Activity Index – Nov (Last: -4.3% m/m)

Thursday, January 23

- 1:00am – Japan: Machine Tool Orders – Dec F
- ★ 7:45am – EU: ECB monetary policy meeting.
- ★ 8:30am – EU: ECB President Christine Lagarde holds press conference. Rates are expected to remain unchanged but President Lagarde is expected to offer insight into some details of the upcoming strategy review.
- 10:00am – US: Leading Index – Dec (Last: 0.0% m/m; Con: -0.2% m/m)
- 11:00am – US: Kansas City Fed Manufacturing Activity – Jan (Last: -8)
- 6:30pm – Japan: CPI Dec (Last: 0.5% y/y)

Friday, January 24

- ★ 3:15am – France:
  - Markit Manufacturing PMI – Jan P (Last: 50.4)
  - Markit Services PMI – Jan P (Last: 52.4)
  - Markit Composite PMI – Jan P (Last: 52.0)
- ★ 3:30am – Germany:
  - Markit/BME Manufacturing PMI – Jan P (Last: 43.7)
  - Markit Services PMI – Jan P (Last: 52.9)
  - Markit/BME Composite PMI – Jan P (Last: 50.2)
- ★ 4:00am – EU:
  - Markit Manufacturing PMI – Jan P (Last: 46.3)
  - Markit Services PMI – Jan P (Last: 52.8)
  - Markit Composite PMI – Jan P (Last: 50.9)
- ★ 4:30am – UK:
  - Markit Manufacturing PMI – Jan P (Last: 47.5)
  - Markit/CIPS Services PMI – Jan P (Last: 50.0)
  - Markit/CIPS Composite PMI – Jan P (Last: 49.3)
  - Bank of England MPC member Jonathan Haskel speaks at panel in Davos. Last week, Haskel said the Bank should cut interest rates as December UK data indicate prices and economic activity are slowing.
- 9:45am – US:
  - Markit Manufacturing PMI – Jan P (Last: 52.4)
  - Markit Services PMI – Jan P (Last: 52.7)
  - Markit Composite PMI – Jan P (Last: 52.8)

- 8:30pm – Canada:
  - Retail Sales – Nov (Last: -1.2% m/m)
  - Retail Sales Ex Autos – Nov (Last: -0.5% m/m)
- 7:30pm – Japan:
  - Jibun Bank Manufacturing PMI – Jan P (Last: 48.4)
  - Jibun Bank Services PMI – Jan P (Last: 49.4)
  - Jibun Bank Composite PMI – Jan P (Last: 48.6)

– Rebecca Kooshak, Economic Analyst