FHN FINANCIAL

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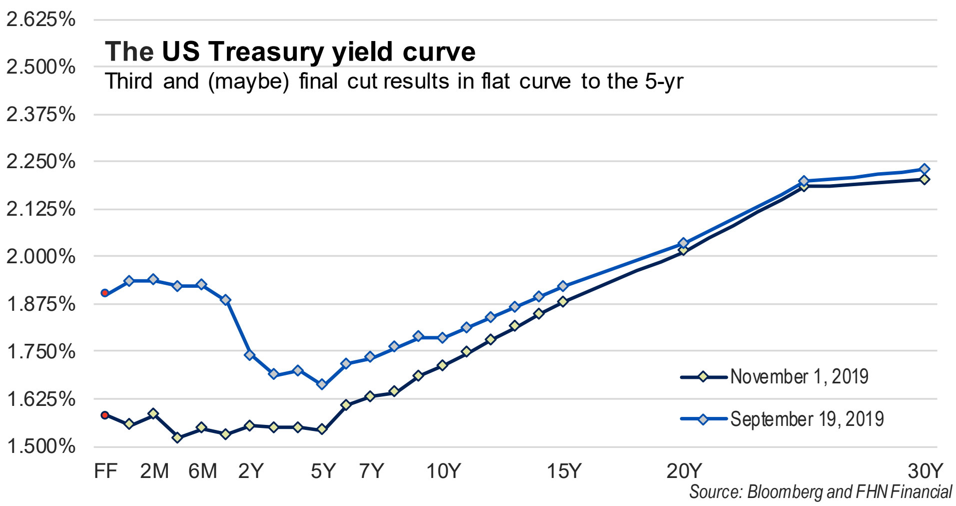
ECONOMIC WEEKLY

Monetary Policy on Hold

Federal Reserve Chair Jay Powell's press conference was packed with information. There was easily enough to write five weeklies. This week, we'll hit the highlights. As always, the transcript is worth reading. It offers insight into the logic driving Fed decisions, including the logical lapses. The official Fed transcript is up a week earlier than usual, here.

The Fed is on hold

The Fed cut rates for a third and final time — this year, at least — at its October meeting. Policy is now on hold. It is on hold because the Fed believes growth will continue at about 2% and inflation will settle into a symmetrical range around 2%. Chair Powell also noted risks to the outlook generally improved since the September meeting. The yield curve is now flat from fed funds to the 5-year.



Asked what might cause the Fed to cut rates again, Powell was definitive:

> "So, you ask what it would take — you know — to move, and as I mentioned, we're going to be watching all factors and if developments emerge that cause a material reassessment of our outlook, we would respond accordingly. **But that's what it would take. A material reassessment of our outlook."**

Powell was equally definitive when asked whether the Fed might raise rates next year:

> "So, that's really about inflation and we haven't yet — we just touched 2% core inflation to pick one measure, just touched it for a few months, and then we've fallen back. **So, I think we would need to see a really significant move up in inflation that's persistent before we would even consider raising rates to address inflation concerns."**

Disclaimer is on the last page of this report.

CONTENTS

ECONOMICS

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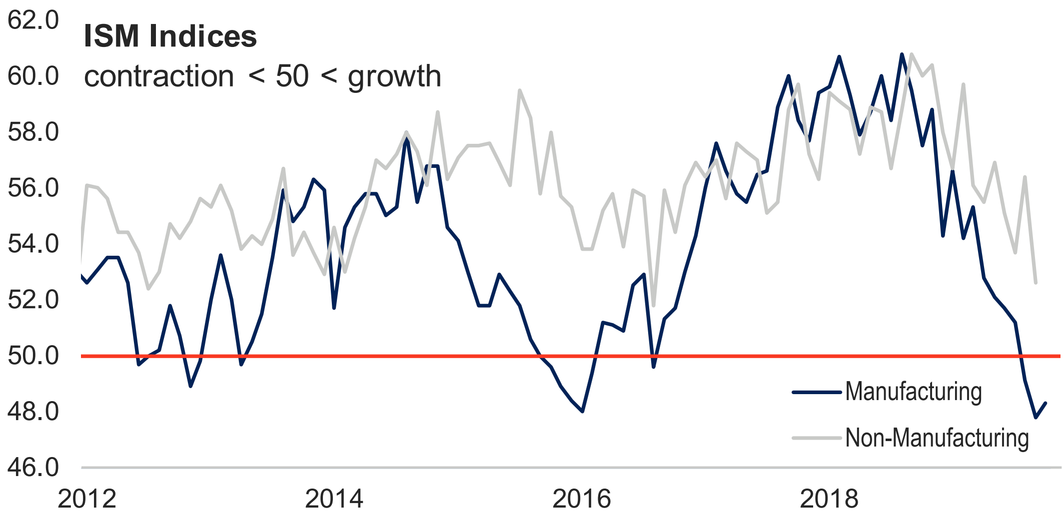
It is easy to be skeptical, because the Fed's forecasting ability is no better than any other economists, which is to say, it is lousy.[1] It's also easy to be skeptical when most of the month-to-month data economists and traders use to gauge the economy's health are moving in the opposite direction of the Fed's rosier assessment. Payroll employment growth, the purchasing management indices, and retail sales — to name the three most important — have deteriorated for months. In October, the employment report looked good, but the ISM manufacturing index was weaker than expected and still decisively below 50, indicating manufacturing trouble continues. As for retail sales, the latest report was September's, when sales declined. To assume one last rate cut will do the trick without confirmation from the data is premature.



Source: Institute for Supply Management

The Fed may not share a sense the economy is decelerating, however. Q3 GDP growth was 1.9%, which is virtually identical to the second quarter's 2.0% growth and the Fed's best-case, longer-run 2.0% economic growth forecast. The Fed watches monthly data —they watch everything, as Powell pointed out several times on Wednesday — but the quarterly data comprise the scorecard against which FOMC participants hold themselves accountable. From their perspective, traders and economists have made a whole lot of noise about a whole lot of risks in 2019, but it's October and those risks have not materialized.

And yet, there's more than a little denial in Powell's responses, too. When asked if he worries this is some kind of "one-legged recovery," over-reliant on households and under-supported by business spending, Powell was dismissive. "That's the economy we've had this year." Powell is convinced weakness in manufacturing, investment, and trade is not a monetary policy problem. Instead, he implied it is primarily the result of the President's trade policy. He also claimed there is nothing the Fed can do to offset it.

The Fed has a blind spot when it comes to inflation expectations, too. We address that below.

[1] Ben Bernanke, who was Fed Chair at the time, said that shortly after the financial crisis.

Implications for FHN's forecast: First and foremost, the December rate cut in our last forecast is not going to happen. Yet, the next move is more likely a cut than a hike. The longer the Fed takes to reach that conclusion, the more it will have to cut. For now, it's likely the Fed will cut once more, early next year. Another cut will be necessary if the yield curve, which flattened already in reaction to Powell's optimism, flattens further.

Inflation confusion

The risk of sustained sub-2% inflation was a primary reason for cutting rates this year, and Powell said a material increase in inflation — or inflation risk — is required to justify a rate hike. The Fed expects neither in its outlook. Monetary policy is consistent, he said, with inflation expectations necessary to anchor inflation at about 2%. And yet, that's not what the data show.

Source: Federal Reserve, Bloomberg, and FHN Financial

next five years, and the 5-year forward 5-year breakeven index, which is the expected rate of inflation in the five years after that.

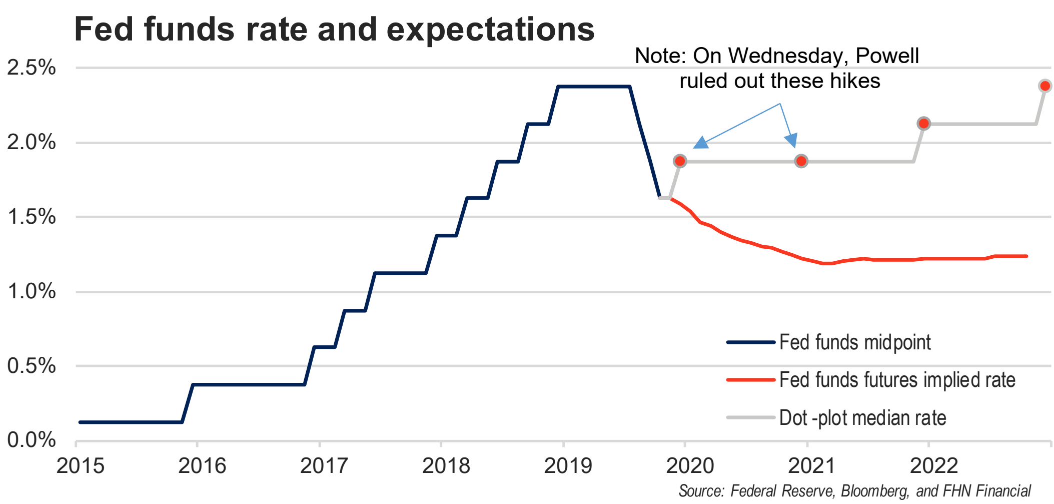
Both medium- and long-run inflation expectations rose between the indication the Fed would cut rates in June and the first rate cut in July. That makes sense. Dovish policy results in inflation. Both fell after the July cut, however. Since early August, long-run inflation expectations have been range bound between 1.65% and 1.80%. On Wednesday and Thursday, they broke through the bottom of this range. Again, it makes sense. A less dovish Fed will result in less inflation.

Medium-term expectations rose before the July, September, and October rate cuts, but fell after each one. This was likely a communication problem. The failure to clearly signal further cuts in July and September, and the decision to clearly signal no more cuts in October, disappointed traders. There's no questioning the Fed's commitment to fight inflation, but the commitment to fight disinflation is lacking. **Persistent weakness in 5-year breakevens — featuring lower highs and lower lows even as the Fed cut rates the first two times — demonstrates growing skepticism among traders of the Fed's commitment to hit its inflation target anytime in the next five years. The break above that trend coming into the October meeting was encouraging, but the definitive no-more-cuts-message ended the recovery in medium-term expectations.**

Powell himself is conflicted. He told Bloomberg Television's Mike McKee the current policy stance is consistent with 2% growth and 2% inflation, and he told Nick Timiraos, from *The Wall Street Journal*, policy resulting in inflation expectations consistent with 2% inflation is the key to achieving 2% inflation. He also told Timiraos the Fed's current policy is consistent with achieving 2% inflation expectations. And yet, he also told Timiraos the Fed's ongoing policy reassessment is designed to be even more consistent with achieving inflation expectations consistent with hitting the inflation target. There's a clear undercurrent of unease that the Fed's current policy approach to inflation is lacking.

Note, too, that Powell answered Timiraos' question about falling breakevens by implying they are not falling.

The Fed's quarterly economic forecasts illustrate the Fed's anti-inflation bias. Over time, as long as the economy is growing and the unemployment rate is falling, FOMC participants believe they should be raising rates to prevent inflation rising — and staying — above 2%. There are always rate hikes in the dot plot. **The September dot plot, the most recent, is no exception.**



As for the risk of lower inflation, a reporter from Tokyo's Nikkei Shimbim asked Powell whether the US is in danger of Japanification. Powell insisted participants are watching Japan and Europe. He also said, twice, they know the US is not immune to what is happening there. Yet, the FOMC continues to behave as if the only real inflation risk is to the upside. In other words, they know the US is not immune to Japanification, but they act as if it is.

Implications for FHN's forecast: We expected the Fed would cut rates enough to fully normalize the yield curve and restore economic growth. At the very least, we expected the Fed would cut rates until there was definitive proof rate cuts had stemmed the decline in key indicators. We were wrong. The Fed is back on guard against rising inflation. Result: Inflation will be lower than we expected. Core PCE inflation may never reach 2%, despite recent tariff increases, and is even more likely to drop below 1.5% at some point next year as a result.

The balance sheet

Three questions touched on the Fed's balance sheet. The first was from Politico's Victoria Guida, who asked if the Fed would establish a permanent repo facility. Marketplace's Nancy Marshall-Genzer asked whether the Fed would relax bank capital and liquidity rules to ease the repo crisis. And Brian Cheung, from Yahoo Finance, wondered whether Powell has any more to say about the longer-run disposition of its balance sheet.

FOMC participants plan to discuss the repo facility at their January meeting, which is why Powell insisted no decision will be made until then. The Fed will use ad hoc policy until then.

To Marshall-Genzer, Powell explained the Fed sees no need to change regulation, nor does it plan to do so. The Fed can end repo-market disruption by growing excess reserves to $1.45-1.5 trillion, Powell insisted, where they were before the first repo market disruption in September. To Cheung, Powell said the disposition of the balance sheet is important, but the Fed will not make any decisions about it for a while.

We do not entirely agree with Chair Powell that the Fed can grow its balance sheet without stimulating the economy. Bill purchases are not the same as the longer-term purchases the Fed made in three round of quantitative easing. Nor are they entirely different, however. We could not help noticing Wednesday's Treasury announcement of another quarter of record debt issuance, featuring a big increase in the share of T-bills. The Fed's T-bill appetite is limiting the supply of coupons. Still, this is not likely to have much economic effect in the grand scheme of things.

It is a little troubling to hear the Fed Chair insist he still does not know why the repo markets broke down. Repo participants have explained at length why they did not extend more cash despite attractive rates. It seems the Fed is not listening to them.

Implications for FHN's forecast: There are no direct big forecast implications here as long as repo functions adequately, but there are important insights into the Fed. For one thing, they have too many balls in the air. The fact they abandoned discussion of long-run balance sheet disposition is a tell. They were obsessed with it at meetings early this year. For another, the Fed does not fully understand the repo crisis because they are trying to do too many other things at once. Fed Listens events, meetings with community activists, exhaustive policy discussions, open market operations. They are stretched too thin. One result was the decision to declare the end of easing when a significant portion of economic data point to trouble ahead. It's as if participants decided they are too busy to worry about the economy anymore, so they declared it fixed and moved on to the rest of the agenda. We can only hope they are right, but one implication of short-order decision-making is a heightened risk of error.

Bottom line: Fed policy encourages lower rates

The combination of sluggish growth and low inflation in 2020 and 2021 suggests market interest rates will be lower than we expected. The Fed is committed to keeping the expansion going, but they balance that desire against a persistent fear of cyclical inflation. As a result, the Fed continues to implement policy likely to keep inflation under 2%, despite insisting it has a symmetrical 2% target. It's puzzling, but after five years of similar behavior, it is no longer surprising.

– Chris Low, Chief Economist

The Week Ahead

This Week's Numbers

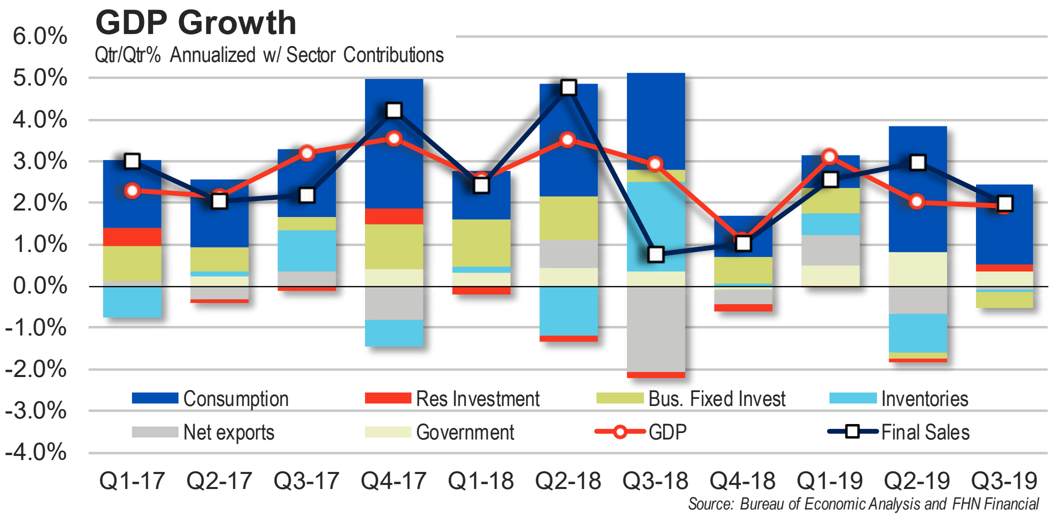
		CONSENSUS				
		PRIOR	HIGH	LOW	MEDIAN	**FHN**
Monday, November 4	Factory Orders - Sep	-0.1%	-0.1%	-0.7%	-0.5%	**-0.4%**
	Trade Balance - Sep	-$54.9b	-$51.8b	-$55.7b	-$53.0b	**-$55.0**
	ISM Non-Manufacturing Index - Oct	52.6	54.9	52.5	53.5	**52.0**
Tuesday, November 5	Nonfarm Productivity - 3Q P	2.3%	1.6%	0.2%	1.0%	**1.0%**
	Unit Labor Costs - 3Q P	2.6%	3.0%	0.5%	2.2%	**2.2%**
Wednesday, November 6	Consumer Credit - Sep	$17.901b	$17.000b	$13.300b	$15.600b	**$15.000b**
Friday, November 8	U. of Mich. Sentiment - Nov P	95.5	97.5	94.0	96.0	**96.5**

Review

US Q3 GDP beat expectations and the Fed delivered its third, and possibly last, rate cut of the year. The ISM Manufacturing Index continues to contract, though at a slower rate, while job growth beat expectations in October while September and August revised higher.

Internationally, China's Caixin manufacturing PMI rose back to expansion, but the official — and broader — PMI slipped deeper into contractionary territory; EU Q3 GDP rose 0.2%, beating expectations, Hong Kong's economy (unsurprisingly) fell into recession. Finally, the Bank of Japan kept rates unchanged but tweaked its forward guidance to indicate potential for deeper cuts at a future meeting and QE will continue for "as long as it takes."

- **Q3 GDP rose 1.9% qtr/qtr** on an annualized basis, three-tenths higher than consensus. Personal consumption led the increase, rising 2.9% over the quarter, beating the 2.6% consensus, and contributing 1.93% to GDP growth.
    - **Residential fixed investment** rose 5.1% and added two-tenths to growth. It was the first positive reading for residential investment since Q4 2017.
    - **Government expenditures** rose 2.0% and added 0.4% to GDP. (Federal government spending rose 3.4%, with national defense rising 2.1% and nondefense rising 5.2%. State and local government rose 1.1%.)
    - **Business fixed investment** was the weak economic link. Fed officials and business surveys have been indicating firms planning to reduce capital expenditures. It fell 3.0% in Q2 and clipped 0.4% from growth.
    - **Net exports** subtracted nearly a tenth from GDP. Imports rose by $10.3b led by services (+$6b) and exports rose by $4.7b led by goods (+7b). September's trade data, not yet released, will be incorporated into the second estimate of GDP on November 27.



- **ISM Manufacturing Index** contracted for the third straight month. Despite a 0.5 point bump from 47.8 to 48.3 in October and a 9.4 point rise that lifted new export orders into expansion at 50.4, the report is weak. Five of 18 industries reported growth, up from three last month. All indicators (save new exports) are contracting:
  - New orders rose 1.8 points to 49.1 (contracting slower)
  - Production dropped 1.1 points to 46.2 (contracting faster)
  - Orders backlog fell 1 point to 44.1 (contracting faster)
  - Employment rose 1.4 points to 47.7 (contracting slower)
  - Inventories rose 2 points to 48.9 (contracting slower)
  - Supplier deliveries fell 1.6 points to 49.5 (indicating faster delivery speeds)
  - Imports (a separate index) fell 2.8 points to 45.3 (contracting faster)
  - Prices fell 4.2 points to 45.5 (contracting faster)

- **The FOMC cut rates** 25bp to the 1.50-1.75% range, as expected, undoing part of last year's policy mistake of forcing short-term rates higher into slowing growth. Two dissents on the committee – Eric Rosengren and Esther George – both reiterated September's dissent over concerns that weakening manufacturing and business fixed investment was not a compelling reason to cut rates. Powell's press conference remarks indicated a definitive pause in rate cuts unless something materially changes its 2.0% growth outlook.

- **China's Caixin manufacturing PMI improved,** from September's 51.4 to 51.7. New orders rose at the fastest pace in almost 7 years, driven primarily by domestic demand, and to a lesser extent, overseas orders. The separate new export orders sub-index rose to expansionary levels of February 2018 after the Commerce Department granted tariff exemptions on more than 400 Chinese products. Employment levels were cut at the quickest pace since December 2016 on cost reduction measures, and factory gate manufacturing prices fell as firms re-priced products for competition.

On the flip-side, China's state-surveyed manufacturing PMI reported deteriorating conditions. The PMI fell from September's 49.8 to 49.3. Three of five components are in contraction — new orders (47.4), employment (47.3), and raw inventories (47.4) — and two fell just above the 50-level threshold – production (-1.5 to 50.8) and supplier deliveries (-0.4 to 50.1). Non-manufacturing also fell, from 53.7 to 52.8, with employment continuing to contract.

- The **Bank of Japan** kept its overnight rate at -0.1% and 10-year yield target at "around 0.0%." But, indicated it expects "short- and long-term interest rates" to remain at "present or **lower levels**." The Bank underscored its need to pay "close attention" to its loss of momentum of achieving its elusive price stability target of a sustained 2.0% CPI, ex-fresh food. Governor Kuroda reiterated Japan has more room to cut rates than Europe. He also said they need to watch the impact of October's consumption tax increase, and indicated they will only cut rates further if the economy deteriorates substantially. Note that the BOJ's assets have been larger than its nominal GDP since November 2018. Further, institutional investors are moving investments further into foreign assets and the BOJ is being forced out of the domestic market as yields fall further.

The Atlanta Fed's GDP Nowcast is tracking 1.1% Q4 growth. The New York Fed's is tracking 0.8%, down from last week's 0.92%, due to the ISM manufacturing report.

Preview

Note: ★ = High Impact Event
All times Eastern

Monday, November 4

- 3:45am – Italy: Markit Manufacturing PMI – Oct (Last: 47.8)
- ★ 3:50am – France: Markit Manufacturing PMI – Oct F (Oct P: 50.5)
- ★ 3:55am – Germany: Markit/BME Manufacturing PMI – Oct F (Oct P: 41.9)
- 4:00am – EU: Markit Manufacturing PMI – Oct F (Oct P: 45.7)
- 4:30am – EU: Sentix Investor Confidence – Nov (Last: -16.8)
- 4:30am – UK: Markit/CIPS Construction PMI – Oct (Last: 43.3)
- 5:00am – EU:
  - PPI – Sep (Last: -0.5% m/m)
  - PPI – Sep (Last: -0.8% y/y)
- 8:00am – Singapore:
  - Purchasing Managers Index – Oct (Last: 49.5)
  - Electronics Sector Index – Oct (Last: 49.1)
- ★ 10:00am – US:
  - Durables Goods Orders – Sep F (Sep P: -1.1% m/m)
  - Durables Ex Transportation – Sep F (Sep P: -0.3% m/m)
  - Factory Orders – Sep (Last: -0.1% m/m; Con: -0.5% m/m)
  - Factory Orders Ex Trans – Sep (Last: 0.0% m/m)

  - Capital Goods Orders Nondefense Ex Air – Sep F (Last: -0.5% m/m)
  - Capital Goods Shipments Nondefense Ex Air – Sep F (Last: -0.7% m/m)
- ★ 1:30pm – EU: ECB President Lagarde speaks in Berlin.
- 5:00pm – US: San Francisco President Mary Daly speaks in New York. (FOMC voter in 2020)
- ★ 7:30pm – Hong Kong: Markit PMI – Oct (Last: 41.5)
- 8:00pm – Singapore: Markit PMI – Oct (Last: 48.3)
- ★ 8:45pm – China:
  - Caixin Services PMI – Oct (Last: 51.3; Con: 51.7)
  - Caixin Composite PMI – Oct (Last: 51.9)

Tuesday, November 5

- ★ 4:30am – UK:
  - Markit/CIPS Services PMI - Oct (Last: 49.5)
  - Markit/CIPS Composite PMI – Oct (Last: 49.3)
- 5:00am – Italy: Istat releases the Monthly Economic Note
- ★ 8:30am – US: Trade Balance – Sep (Last: -$54.9b; Con: -$54.0b; Con: -$54.0b)
- ★ 9:45am – US:
  - Markit Services PMI – Oct F (Oct P: 51.0)
  - Markit Composite PMI – Oct F (Oct P: 51.2)
- ★ 10:00am US:
  - ISM Non-Manufacturing Index – Oct (Last: 52.6; Con: 53.7)
  - JOLTS Job Openings – Sep (Last: 7051)
- 12:40pm – US: Dallas Fed President Robert Kaplan speaks. (FOMC voter in 2020)
- 6:00pm – US: Minneapolis Fed President Neel Kashkari speaks. (FOMC voter in 2020)
- ★ 6:50pm – Japan: Bank of Japan's policy minutes from September meeting.
- ★ 7:30pm – Japan:
  - Jibun Bank Services PMI – Oct F (Oct P: 50.3)
  - Jibun Bank Composite PMI – Oct F (Oct P: 49.8)

Wednesday, November 6

- ★ 2:00am – Germany:
  - Factory Orders – Sep (Last: -0.6% m/m)
  - Factory Orders – Sep (Last: -6.7% y/y)
- 3:45am – Italy:
  - Markit Services PMI – Oct (Last: 51.4)
  - Markit Composite PMI – Oct (Last: 50.6)
- ★ 3:50am – France:
  - Markit Services PMI – Oct F (Oct P: 52.9)
  - Markit Composite PMI – Oct F (Oct P: 52.6)
- ★ 3:55am – Germany:
  - Markit Services – Oct F (Oct P: 51.2)
  - Markit/BME Composite PMI Oct F (Last: 48.6)

- 4:00am – EU:
  - Markit Services PMI – Oct F (Oct P: 51.8)
  - Markit Composite PMI – Oct F (Oct P: 50.2)
- 5:00am – EU:
  - Retail Sales – Sep (Last: 0.3% m/m)
  - Retail Sales – Sep (Last: 2.1% y/y)
- ★ 8:00am – US: Chicago Fed President Charles Evans speaks in New York. (FOMC voter)
- 8:30am – US:
  - Nonfarm Productivity – Q3 P (Last: 2.3% q/q; Con: 0.6% q/q)
  - Unit Labor Costs – Q3 P (Last: 2.6% q/q; Con: 2.6% q/q)
- 9:30am – US: New York Fed President John Williams takes part in moderated Q&A on workforce development organized by *The WSJ*. (FOMC voter)
- 3:15pm – US: Philadelphia Fed President Patrick Harker speaks on future of work. (FOMC voter in 2020)
- ★ 6:30pm – US: New York Fed President John Williams gives welcoming remarks at Global Risk Forum. (FOMC voter)

Thursday, November 7

- ★ China: Foreign Reserves – Oct (Last: $3092.43b)
- ★ 2:00am – Germany:
  - Industrial Production – Sep (Last: 0.3% m/m)
  - Industrial Production – Sep (Last: -4.0% y/y)
- 3:30am – Germany: Markit Construction PMI – Oct (Last: 50.1)
- 4:00am – EU: ECB Publishes Economic Bulletin
- 4:00am – Italy:
  - Retail Sales – Sep (Last: -0.6% m/m)
  - Retail Sales – Sep (Last: 0.7% y/y)
- ★ 7:00am – UK: Bank of England monetary policy meeting and inflation report. The Bank is expected to keep policy unchanged until Brexit, then adjust monetary policy to the planned outcome.
- ★ 7:30am – UK: BOE's Governor Mark Carney speaks at post-meeting press conference.
- 1:05pm – US: Dallas Fed President Robert Kaplans speaks. (FOMC voter in 2020)
- 3:00pm – US: Consumer Credit – Sep (Last: $17.901b; Con: $15.000b)
- 6:30pm – Japan: Household Spending – Sep (Last: 1.0% y/y)
- 6:50pm – Japan: Japan Buying Foreign Bonds & Stocks
- 7:10pm – US: Atlanta Fed President Raphael Bostic speaks at New York. (FOMC voter in 2020)

Friday, November 8

- ★ China:
  - BoP Current Account Balance – Q3 P (Last: $46.2b)
  - Trade Balance – Oct (Last: $39.65b)
  - Trade Balance – Oct (Last: 275.15b CNY)
  - Exports – Oct (Last: -3.2% y/y USD)

    - Exports – Oct (Last: -0.7% y/y CNY)
    - Imports – Oct (Last: -8.5% y/y USD)
    - Imports – Oct (Last: -6.2% y/y CNY)
- 2:00am – Germany:
    - Trade Balance – Sep (Last: €16.2b)
    - Current Account Balance – Sep (Last: €16.9b)
    - Exports – Sep (Last: -1.8% m/m)
    - Imports – Sep (Last: 0.5% m/m)
- 2:45am – France:
    - Trade Balance – Sep (Last: -€5019m)
    - Current Account Balance – Sep (Last: -€2.5b)
    - Wages – Q3 P (Last: 0.5% q/q)
    - Industrial Production – Sep (Last: -0.9% m/m)
    - Industrial Production – Sep (Last: -1.4% y/y)
    - Manufacturing Production – Sep (Last: -0.8% m/m)
    - Manufacturing Production – Sep (Last: -1.6% y/y)
- 8:15am – Canada: Housing Starts – Oct (Last: 221.2k)
- 8:30am – Canada:
    - Building Permits – Sep (Last: 6.1% m/m)
    - Labor Survey
- ★ 10:00am – US:
    - UMich Consumer Sentiment – Nov P (Last: 95.5; Con; 95.0)
    - UMich Current Conditions – Nov P (Last: 113.2)
    - UMich Expectations – Nov P (Last: 84.2)
    - UMich 1Y Inflation – Nov P (Last: 2.5%)
    - UMich 5-10Y – Nov P (Last: 2.3%)
    - Wholesale Inventories – Sep F (Sep P: -0.3% m/m)
    - Wholesale Trade Sales – Sep (Last: 0.0% m/m)
- 11:45am – US: San Francisco Fed President Mary Daly speaks on climate change. (FOMC voter in 2020)
- ★ 8:30pm – China:
    - CPI – Oct (Last: 3.0% y/y)
    - PPI – Oct (Last: -1.2% y/y)

– Rebecca Kooshak, Economic Analyst