

WEEKLY ECONOMIC COMMENTARY

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- **Fed Preview: Letting the Dust Settle**

Last December, the Federal Reserve raised interest rates for the ninth time in four years and suggested that further increases were likely. So much for forward guidance. This year, the Fed has cut rates three times, reduced its long-term rate expectations, and ceased its balance sheet runoff. The Fed’s decisions were blamed for contributing to a yield curve inversion and then credited for reversing it.

All this occurred despite a year of good economic growth, low unemployment and stable inflation. The Fed justified its retreat as a “midcycle adjustment” that aimed to address downside risks created by global trade tensions. That done, now is a good time to pause and take stock of where conditions stand. Here is our take on where things stand, and where things might go from here.

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Economic Growth	
Where We Stand	What Could Change
<p>The U.S. economic expansion reached a record length in July and has not stalled. Gross domestic product (GDP) growth has moderated to an annualized rate of about 2% in the last two quarters, sustained by strong consumer spending. Housing has had a positive year, reflecting good consumer fundamentals. The outlook calls for growth in 2020 at a rate close to the economy’s long-term potential; there is no recession on the immediate horizon.</p>	<p>The second and third quarter showed declines in business investment, as continued trade uncertainty weighs on business sentiment. A sustained contraction could spread to the service sector, denting confidence and employment.</p> <p>On the positive side, any reduction in trade tensions would improve sentiment and brighten the economic outlook.</p>

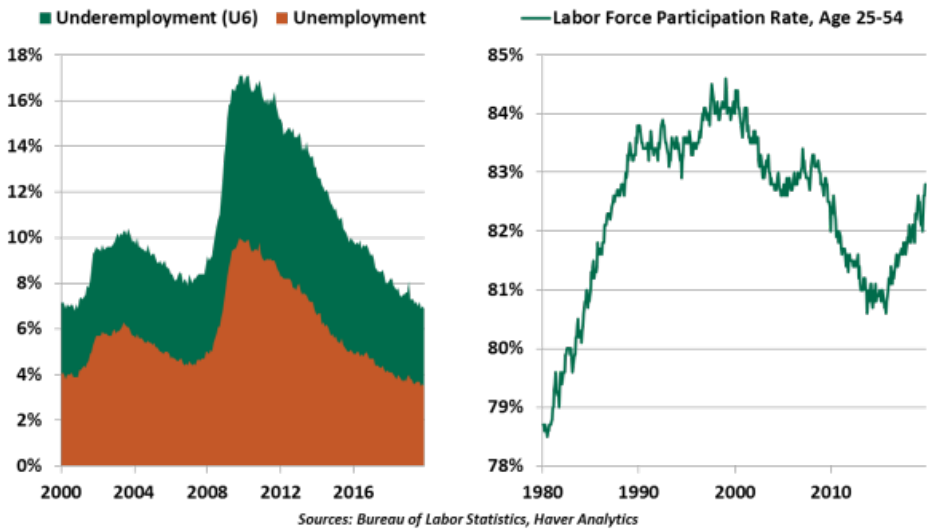
It bears noting that U.S. economic activity has been sustained in spite of fading support from the 2017 tax reform bill. That measure appears to have created some short-term stimulus, but little lasting impact on potential growth.

The greatest challenge for the Fed this year has been adapting to a new era of trade restrictions and retaliations, problems that monetary policy may not be well-suited to offset. Nonetheless, the Fed’s dual mandate requires it to make the attempt.

Throughout the year, the Fed’s press releases and commentary indicated it would “act as appropriate to sustain the expansion,” and the removal of that phrase from the October post-meeting statement was a signal that rate cuts would cease. We don’t expect a resumption anytime soon.

Employment	
Where We Stand	What Could Change
<p>The Fed has no explicit target for the employment rate, seeking only to “promote maximum employment.” And they are succeeding. The unemployment rate has held at or below 4% for nearly two years, less than most estimates of full employment. Sustained wage gains of 3% are well in excess of inflation, with even better compensation growth for production and nonsupervisory roles. The longer the expansion stretches, the more workers reenter the workforce; those already working receive better pay.</p>	<p>Job growth has had its ups and downs in 2019. Including November’s employment report, year-to-date, an average of 180,000 jobs have been created each month. We do not expect such a strong pace can be sustained this far into a growth cycle, and some slowing is likely to come. As fixed investment and sentiment surveys like the purchasing managers’ index (PMI) fall, an easy expense to defer will be additional hiring. A decline in productivity in the third quarter suggests some businesses are overstaffed for current levels of demand.</p>

Employment has been a continued source of upside surprises in this cycle. Jobs are still being created, unemployment is low and wages keep rising. The labor force participation rate for prime-aged (25-54) workers is holding at a cycle high of 82.8%, though this remains below the peaks seen in the past two expansions. Job openings have fallen from a record high level at the start of the year, but hiring rates remain elevated.

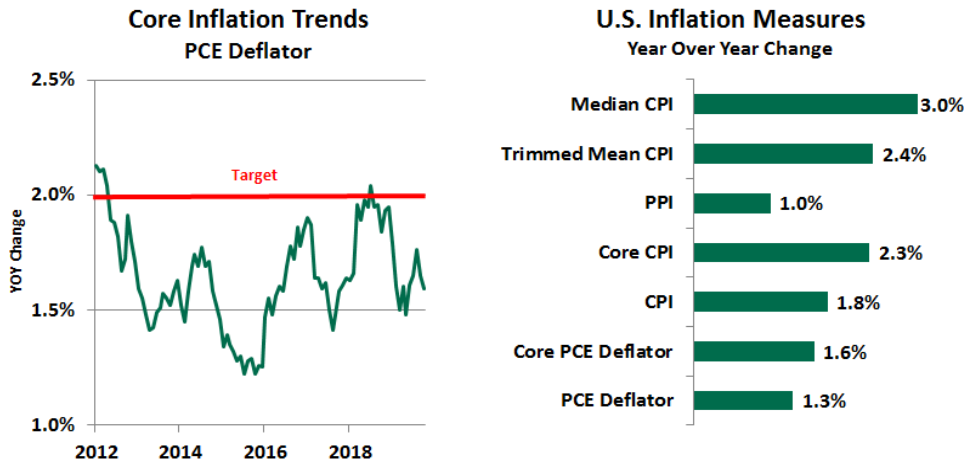


In several speeches, Fed officials have pointed to increased employment among lower wage earners as a sign the expansion still has room to run. Recent experience is giving us a window into what “full employment” truly means. The difference between working and not working is a dramatic lifestyle shift for workers on the margin of employment.

The workforce has continued to grow for a variety of reasons: older workers deferring retirement, workers coming off disability rolls, increased willingness of employers to invest in training their new hires, and more “gig” opportunities to work independently. Together, these marginal developments have helped align labor supply and demand to the benefit of both workers and employers.

Inflation	
Where We Stand	What Could Change
<p>Inflation measures have been mixed this year. The Fed's favored measure, the core personal consumption expenditure (PCE) deflator, is up only 1.6% for the most recent twelve months; the core consumer price index (CPI) has risen 2.3% over the same interval. While below-target inflation should not be ignored, it does not yet cry out for prompt corrective action. Secular forces like e-commerce are holding prices back, but trade frictions and low unemployment will maintain upward pressure. The march to, and past, full employment may eventually provoke a bigger wage reaction.</p>	<p>Inflation could break lower or higher in 2020. Any slippage of economic growth could push inflation to lower levels, which would force further rate cuts. If interest rates return to the zero lower bound, permanent losses of output could result.</p> <p>On the other hand, persistent fiscal deficits and low unemployment could stress resources and rekindle inflation. And tariffs on high-value consumer products are set to go into place on December 15, which would be inflationary in the near term.</p>

The Fed has been conducting a series of sessions aimed at revisiting and refining its inflation target. One possible strategy got some attention this week: if inflation falls persistently below the desired level, the target will be raised so that below-target intervals are offset with overages. If this paradigm were in operation today, eight years since inflation has been above its target, it would certainly force the Fed into an easing bias.

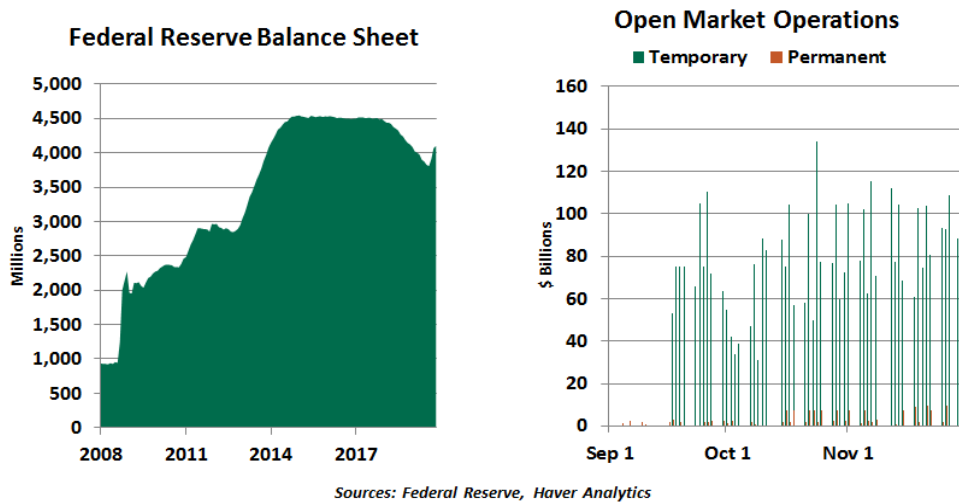


Source: Haver Analytics

But a critical question remains: if the Fed is struggling to hit a 2% target, what gives it confidence that it could reach 2.5%? And if the rate cuts needed to produce that outcome encourage investors to reach for yield, financial stability might come under threat. For these (and other) reasons, we continue to think significant alterations to the Fed's approach are not imminent.

Balance Sheet	
Where We Stand	What Could Change
<p>The Fed stopped reducing its balance sheet last summer, after it became apparent that the financial system was short on reserves. To fill gaps in the short term, the Fed has been undertaking a series of daily transactions that inject additional supply into the system. At some point, the Fed should seek a more permanent solution.</p>	<p>Over the long term, a central bank’s balance sheet should grow in concert with the underlying economy. The exact pace depends on market texture and regulation. The Fed is expected to announce updated targets for its balance sheet sometime next year; it should make every effort to ensure that the path is well-calculated and well-understood.</p>

The challenge of balance sheet management has been one of the more prominent stories surrounding the Fed this year. The Fed has had persistent difficulty gauging the amount of reserves to provide financial markets. New capital and liquidity rules, along with market changes as a result of the 2010 Volcker Rule, have limited the willingness of banks to sell short-term funding. As a result, overnight interest rates have spiked on several occasions in 2019. Year-end is often a volatile interval for money markets, and some participants are concerned that this one will be especially stressful.



Geopolitics	
Where We Stand	What Could Change
<p>Geopolitical risks, from the trade war to Brexit, appear to have moderated a bit. The U.S. and China are still working to complete “phase one” of a trade deal, which would pause tariff escalation and potentially roll back some of the recently applied tariffs. Brexit is now a step closer to resolution but subject to the outcome of the December 12 elections.</p>	<p>Though some external threats are closer to resolution, they remain unresolved. The potential “phase one” trade deal will likely amount to a mere ceasefire without addressing core issues. The recent tariff escalations by the U.S. against Argentina, Brazil and France diminish confidence that Washington is seeking to ease tensions.</p>

Financial markets have performed remarkably well this year, in spite of a long series of potential threats. Equities have set records, credit spreads remain narrow, and volatility has receded. But there is no shortage of issues that could try investor patience next year. Difficult situations in a number of places (Iran, Hong Kong, South America) could break badly next year. And the 2020 U.S. Presidential election is already generating considerable anxiety.

Summary

The October 30 Fed meeting concluded with refreshingly clear guidance that the Fed will stop its rate adjustments. We expect the committee to be conservative in any future actions. The Fed has said it is following the playbook of past adjustments to sustain expansions, as we saw in 1995 and 1998, with three rate cuts followed by a pause. October was the third cut of this cycle.

Further movements are possible from here but unlikely to be needed in the year ahead. Broad economic underperformance could necessitate rate reductions, and renewed risks could prompt more pre-emptive easing. But this is not our base case. Rate hikes are possible if inflation is sustained above its 2% target, an unlikely circumstance. We expect the Fed's updated forecasts and dot chart to suggest it will be much less active next year.

The greatest risk to the U.S. economy is sluggish business investment caused by trade uncertainty. The Fed will watch any developments in this area closely. Any progress toward a resolution will support a prolonged pause.

The Fed's focus will now turn to financial system stability as it strives to return to a stable overnight funding market with infrequent needs for liquidity injections. We do not expect liquidity actions to have any bearing on the Fed's interest rate decisions.

We'll be offering immediate reflections on the Federal Open Market Committee meeting via social media. And if past is prologue, we will undoubtedly have much more on the Fed in this space in the year ahead.

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