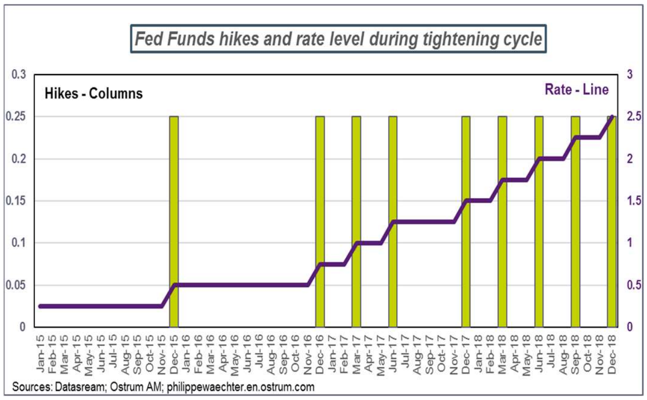
Monday February 4, 2019

The Federal Reserve puts an end to normalization
My weekly column

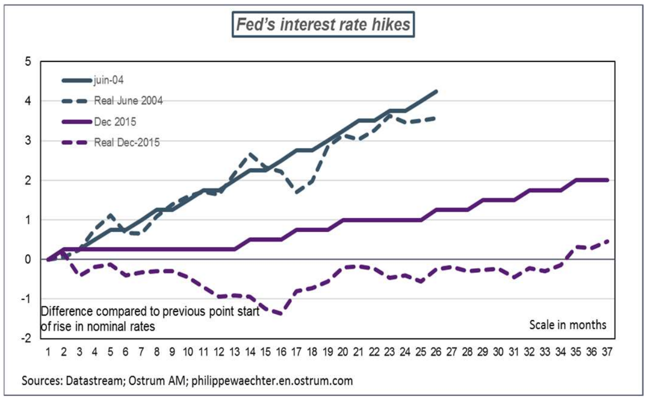
The US Federal Reserve decided to bring its monetary policy normalization to an end during its meetings on January 29 and 30, 2019.
The interest rate hike cycle had kicked off slowly in December 2015 and stepped up a pace a year later, as nine interest rate hikes pushed the Fed Funds rate up from 0.25% (upper end of range) to 2.5% in December 2018.

During last week's press conference, the Fed Chair indicated that Fed Funds are now in the range of neutral, in response to the first question from journalists: there is no longer an accommodative or a tightening slant. Powell's confidence in the strength of the US economy suggests that the end to normalization should not just be seen as hitting the pause button for a while.


Fed Funds hikes and rate level during tightening cycle

Sources: Datasream; Ostrum AM; philippewaechter.en.ostrum.com

The rate hike cycle has been long and slow-moving if we compare to the Fed's previous series of tightening moves from 2004 for example. A comparison with this period also reveals that real interest rates on Fed funds were much higher then than they are now. The figure is currently marginally above the level witnessed at the start of the normalization process in December 2015, unlike the situation after 2004, when the economy was much more restricted, while this is not the case in the current economic situation.

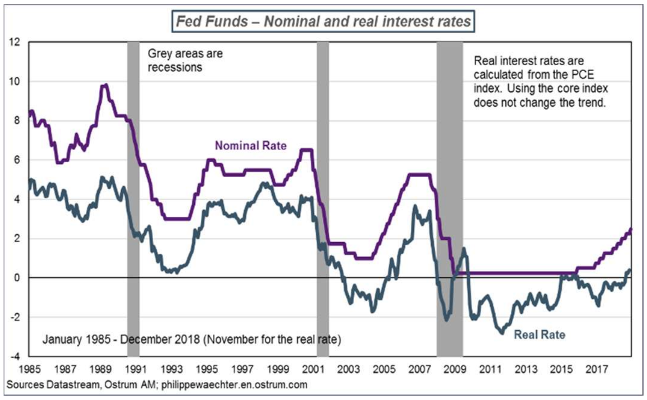

Fed's interest rate hikes

Sources: Datastream; Ostrum AM; philippewaechter.en.ostrum.com

A comparison of current real interest rates with previous phases of monetary tightening shows that today's situation is completely different to these episodes.
Real interest rates in November 2018 stood at around 0.4% (inflation figures for December are not yet available on the PCE index), which is much lower than figures in 2006, 1999 or 1990. Does this mean that the US economy is too weak to be able to deal with a real rate above 1%? This would be extremely worrying and would undermine Jerome Powell's comments that the US economy is in a good place.
It is difficult to understand why US normalization is coming to an end when we look at the economy, as unemployment is near its low, so the central bank should be tightening the reins. The Fed's projections for 2019 and 2020 are for figures above the country's potential growth rate and this also fits with the economists' consensus, at least for 2019. Against this backdrop, monetary policy needs to be tighter to ensure that growth does not create imbalances that then have to be addressed, and this was the message from Powell in 2018, when he suggested that fiscal policy (too aggressive for an economy running on full employment) would need to be offset by tighter monetary policy to rebalance the policy mix. During the press conference on Wednesday January 30, he did not raise this question: the issue was side-stepped, but yet the analysis still remains the same. There are only two possible economic explanations for the halt to normalization: either there are expectations of a severe downgrade to projections when they are updated in March, but this would not be consistent with Powell's comments; or the Fed is doing whatever it takes to extend the economic cycle at any

cost, with the end to the rate hike cycle aimed at cutting back mortgage rates and taking the pressure off the real estate market. However, with the overall economy remaining robust, the risk of this type of move is that it could lead to imbalances that would be difficult to eliminate. This is the opposite approach to the Fed's strategy right throughout 2018, so it would be a strange tactic.

The economic basis for the end to normalization is unclear as any number of interpretations are possible: the Fed is leaving investors in the dark. Perhaps this move marks the start of a less predictable policy doctrine to leave some scope to surprise investors: this type of approach was very frequently discussed in theoretical documents on monetary policy in the very distant past. It would mean that forward guidance no longer has the same significance that it had until very recently. In other words, monetary policy logic has changed, moving from a very clear policy that minimized risk to an approach where investors' interpretation of the Fed's moves will be key. This question still remains to be seen, but it looks like a radical change in strategy.


Fed Funds – Nominal and real interest rates

Grey areas are recessions

Real interest rates are calculated from the PCE index. Using the core index does not change the trend.

January 1985 - December 2018 (November for the real rate)

Sources Datastream, Ostrum AM; philippewaechter.en.ostrum.com

On the third chart, we can see a fairly clear relationship between tougher monetary policy and the chances of a recession. The three recessions identified on the chart are all preceded by tighter monetary policy. Is this still the case today? This question harks back to the previous point on the relationship between Fed Fund rates, monetary policy and economic activity. This is not what the Fed expects.

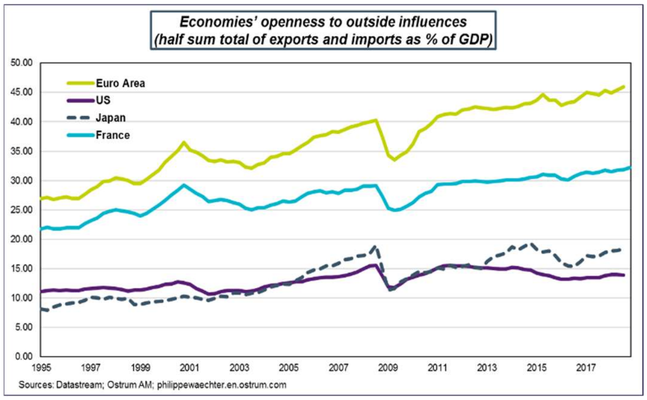
We can draw parallels between the current situation and the period of monetary policy normalization in 1994. At that time, the Fed had started to tighten policy (also on February 4!) to tackle a potential return to inflation, regain some leeway and make monetary policy more compatible with the economic cycle. However, we can see that this readjustment was completely unlike the current situation as real interest rates stood at around 4%.

So our hunt for an economic basis for the Fed's decision leaves us empty-handed. The Fed remains optimistic on the US cycle but has eased its tone. This is a new context in the US and the rationale behind it is still unclear, unless we believe that the Fed has information that the public is unaware of, or that it is seeking to extend the cycle at any cost.

Meanwhile, ISM and job data for January do not point to the need to bring monetary policy normalization to a swift halt.

However, if we read the statement and listen to the press conference, we do come across one new aspect. The Fed does not attribute the end to normalization to domestic factors because the international environment is worrying, thereby creating risks that could affect the US economy. This argument has never been used so far.

It is worth remembering that in 2016, Janet Yellen had delayed a rate hike due to tension and doubts over China, but it was merely a postponement. The decision announced on January 30, 2019 marks the end to normalization, which is a much more radical move and a very strange argument, as the US economy is fairly closed.


Economies' openness to outside influences
(half sum total of exports and imports as % of GDP)

Sources: Datastream; Ostrum AM; philippewaechter.en.ostrum.com

The chart opposite shows the extent to which some economies are open to outside influences.

The US economy is a large and closed economy, and it is not much more open to influence from outside factors today than it was 20 years ago. So using changes in the rest of the world as a justification for a shift in monetary policy is most definitely over the top. The Fed has always focused on domestic issues to develop its strategy, and based on the economy's continued fairly closed profile, there is no reason to change its methods.

We can also see on the chart that the question is very different in the euro area, which is very open to outside influences, particularly due to the German economy's features. The area is much more exposed to influence from events in the rest of the world.
So the argument of uncertainties outside US borders is not entirely convincing. These concerns are admittedly real for all of us, whether American or not, and no-one can deny the potential impact of Brexit, the slowdown in China and US-China trade tension. However, the macroeconomic impact for the US is small given its relatively closed economy.

The Fed is putting the brakes on monetary policy normalization for reasons that look unwarranted when compared with the way it usually reacts. Its optimism on the economic situation contrasts with the end to rate hikes at a time when real rates are still well below 1% (real rates are set to rise as inflation falls, but not to an extent that would put them on a par with previous episodes). Justifications are not domestic but rather external, which is strange for a large and closed economy.

The motivations behind the Fed's moves are often negative events on the financial markets, primarily the stock-markets. In the past, this explanation worked as it took action after a crisis moment in vital moves to swiftly reassure investors. This was the case during various events, first and foremost October 1987, and the Fed will do so again in the future.
But in this case, would the Fed really have watched the markets collapse in December and then make its move when the US market posted its best January performance in 30 years? This looks like an excessive explanation, even if Powell appeared increasingly dovish over recent weeks.

Let's hope that the Fed does not need to hike key rates on economic justifications for any reason other than inflation. Powell has clearly mentioned the impact of falling oil prices on inflation and the leeway that created for monetary authorities. He also indicated that the central bank would only hike rates if inflation picked up, particularly as a result of oil prices, which looks unlikely this year.
So a rate hike would have a crippling impact on the Fed's credibility, and it can only cut its leading rate if it wants to remain credible. The only way to hike rates and safeguard credibility at the same time would be if oil prices were to surge.
This prospect would mean a dollar that no longer has any upside, which would be good news for emergings, especially those with dollar-denominated debt.
This would also mean a future drop in long-term interest rates. According to the Fed, fears of a negative shock in the future would give an even greater advantage to low-risk assets, such as sovereign bonds. 10-year yields in the US, Germany, Japan and also France would continue to be pushed down, further exacerbated by the Fed's balance sheet management policy, which will no longer be on autopilot, but rather would be used as a monetary policy instrument.

Legal information

Ostrum Asset Management

Asset management company regulated by AMF under n° GP-18000014 – Limited company with a share capital of 27,772,359 euros – Trade register n°525 192 753 Paris – VAT: FR 93 525 192 753 – Registered Office: 43, avenue Pierre Mendès-France, 75013 Paris – www.ostrum.com

This document is intended for professional clients in accordance with MIFID. It may not be used for any purpose other than that for which it was conceived and may not be copied, distributed or communicated to third parties, in part or in whole, without the prior written authorization of Ostrum Asset Management.

None of the information contained in this document should be interpreted as having any contractual value. This document is produced purely for the purposes of providing indicative information. This document consists of a presentation created and prepared by Ostrum Asset Management based on sources it considers to be reliable.

Ostrum Asset Management reserves the right to modify the information presented in this document at any time without notice, and in particular anything relating to the description of the investment process, which under no circumstances constitutes a commitment from Ostrum Asset Management.

Ostrum Asset Management will not be held responsible for any decision taken or not taken on the basis of the information contained in this document, nor in the use that a third party might make of the information. Figures mentioned refer to previous years. Past performance does not guarantee future results. Any reference to a ranking, a rating or an award provides no guarantee for future performance and is not constant over time. Reference to a ranking and/or an award does not indicate the future performance of the UCITS/AIF or the fund manager.

Under Ostrum Asset Management's social responsibility policy, and in accordance with the treaties signed by the French government, the funds directly managed by Ostrum Asset Management do not invest in any company that manufactures, sells or stocks anti-personnel mines and cluster bombs.