Wake Me When December Ends

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Federal Reserve (Fed) Chair Janet Yellen has led her policy committee over an obstacle course in 2016. Having agreed to the general principle that policy renormalization should continue this year, she has found barriers that have kept the Federal Open Market Committee (FOMC) from acting at any of its seven regularly scheduled meetings. Reading through the minutes of those meetings, threats on the horizon included "global economic and financial developments," "the surprisingly weak May employment report," and "the British referendum on membership in the European Union."[1] Unmentioned in print but obviously shaping the September and November discussions was the U.S. election. With the finish line to 2016 in sight, we think it is almost certain that "...the case for an increase in the federal funds rate has continued to strengthen..." to the point that gets them to break the victory tape with a 25-basis-point firming of policy announced at the conclusion of its December 13-14 meeting.[2]

OUR FED CALL

Since the FOMC's November 1-2 meeting, the U.S. economy successfully navigated two risk events that could have stopped the process in its tracks one last time this year. The first, the big one, was the election of Donald Trump as president. As a nation, we selected an agent of change (or one of chaos, to quote Jeb Bush), but what that change means for the economy is shrouded in uncertainty. Our core thesis continues to be that, because governing poses different challenges than campaigning, the Trump administration will move toward the Republican establishment in legislative and regulatory practice even as it communicates policy direction unconventionally. The early cabinet-level picks and tweeting wars support that intuition and netted to a package that won the evident approval of investors. Major equity indices set new highs, the dollar appreciated on foreign exchange markets, and longer-term Treasury yields rose about ½ percentage point.

Federal Reserve officials were probably reassured that if financial markets could handily cope with an event having significant consequences for fiscal policy,

[1] Minutes of the FOMC meetings can be found at https://www.federalreserve.gov/monetarypolicy/fomccalendars.htm

[2] This quotation was in the November statement, among other places, and can be found at https://www.federalreserve.gov/monetarypolicy/fomccalendars.htm

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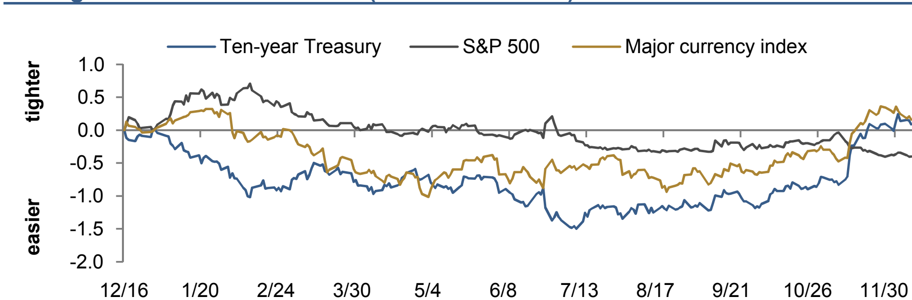
then they would also deal calmly with some scaling back of monetary accommodation. Moreover, markets have not done any of the work of the Fed in tightening financial conditions, on net, this year. The chart below plots the changes in the ten-year Treasury yield, the S&P 500 equity price index, and the weighted exchange value of the dollar since the last Fed action—about one year ago—scaled by simulation results of the Fed's domestic econometric model to have the same effect on aggregate demand after two years as a one-percentage-point increase in the fed funds rate.[3] As is evident, higher Treasury yields and an appreciated dollar tightened financial conditions, in sum, with especially sharp movements after the election, but this was offset by the easing associated with the gain in equity prices. As a result, while the Fed may have partly walked up the incline of its rate guidance this year, financial conditions are no different than when it started that path at the beginning of the year.

Change in financial conditions (since 12/16/2015)

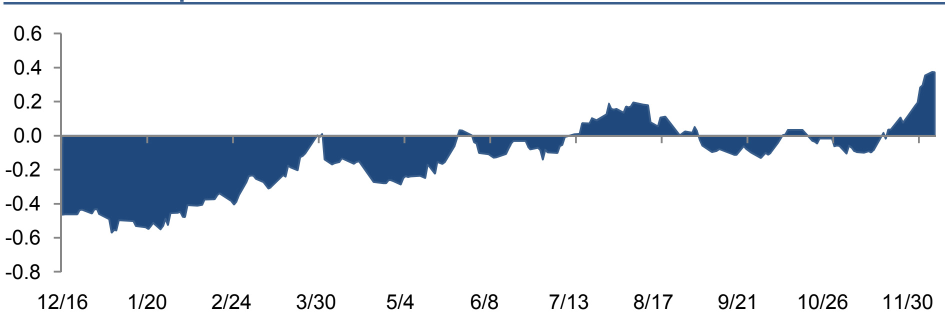


Note: Normalized to have the same effect on the output gap after two years in the FRB/US model.

Source: Standish calculations, data accessed via Bloomberg as of December 7, 2016

The second contributor to the Fed's smooth passage through the straits of firming has been the data since the November meeting. Statistical releases have met or exceeded expectations, at least as measured by the economic surprise index compiled by Bloomberg. Indeed, as the chart below suggests, the past month marks the largest surface area in positive territory in 2016.

Economic surprise index



Source: Bloomberg, accessed as of December 7, 2016

[3]The simulations of the latest vintage of the Fed model can be found here: https://www.federalreserve.gov/econresdata/notes/feds-notes/2014/november-2014-update-of-the-frbus-model-20141121.html

At the top of the leader board of releases sits the nonfarm payroll report. The employment situation in November gives the earliest read on economic momentum (well maintained, with a net employment gain of 178,000), resource slack (tight, with the unemployment rate touching 4.6%), and labor costs (subdued, with average hourly earnings declining that month to pull the 12-month change to 2.5%). Taken together, there was not much support for Chair Yellen's view that a hot labor market pulls in entrants looking for work—the participation rate notched lower. But neither was there reason to fret about cost pressure. Policymakers will likely take the entire package as supporting the removal of some policy accommodation soon, but also to project that subsequent action will be gradual and limited.

Highlights of the employment situation

	Sep-16	Oct-16	Nov-16
Nonfarm payrolls (thousands)	208	142	178
Private (thousands)	205	135	156
Manufacturing (thousands)	-6	-5	-4
Unemployment rate (%)	5.0	4.9	4.6
Participation rate (%)	62.9	62.8	62.7
Average hourly earnings (m/m, %)	0.3	0.4	-0.1
Average hourly earnings (12m, %)	2.7	2.8	2.5

Source: Bureau of Labor Statistics, via Bloomberg, accessed as of December 2, 2016

That is our Fed call. A quarter-point funds rate firming will be unwrapped on December 14 and forward guidance will point to two more such actions next year.

POLICY NEXT YEAR

Signals about what Fed officials will do beyond 2017 are irrelevant as several of those actors will be recast in short order by the incoming Trump administration. There are two open Fed slots already and two more will presumably open up in 2018, when the terms of the chair and vice chair end.[4] Appointing a new governor as the vice chair for supervision and regulation would presumably lead the governor performing that job without the title, Daniel Tarullo, to quit. Our current hypothesis is that the While House will move relatively quickly on the "Sup and Reg" job because that is central to the high-priority goal of restructuring the regulatory edifice associated with the Dodd-Frank legislation. Putting a stamp on monetary policy will take longer, closer to the expiry of Yellen's term, implying that the group dynamics of the FOMC of the past few years extends into 2017. That is, Chair Yellen corrals her committee to keep the funds rate lower for longer so that she leaves office with the nominal funds rate ¾ percentage point higher than today.

[4]In the Federal Reserve Act, the president appoints, and the Senate confirms, two of the seven governors of the Board (who have terms of 14 years each) as chair and vice chair for four-year terms. In principle, the incumbents in those positions, Janet Yellen and Stanley Fischer, respectively, could choose to remain as Board members after those designations expire for the rump of their governor terms (until 2024 and 2020, respectively). The long-held tradition at the Fed, not always honored, is to resign if not reappointed as chair or vice chair. Expect Yellen and Fisher to respect precedent and leave in 2018.

The upside risk is that President Trump expeditiously chooses a senior establishment figure for the other open Fed Board slot, leading everyone to assume that this person slides over to the chair's position in 2018. Such a presence on the FOMC would likely embolden the more hawkish Federal Reserve Bank presidents to challenge the lame duck strategy of lower for longer.

The December FOMC meeting is the occasion for a full Fed data dump, with the statement, the Summary of Economic Projections, and the chair's press conference. As Fed officials and staff prepare for the meeting, they are facing a problem confronting every forecaster: What will Donald Trump do? Financial markets have taken the election with an attitude somewhere between equanimity and enthusiasm, as seen in the low level of the forward-looking volatility of equity prices (the VIX chart plotted below). But underlying uncertainty about economic policymaking remains high, at least as measured in the widely followed index from the trio of researchers, Baker, Bloom, and Davis. Fed officials understandably must share this considerable uncertainty about the future of fiscal, regulatory, and trade policies, which will incline them to keep as low a profile as humanly possible. At most, they will tune their year-by-year forecasts and put off signaling a major change in views.

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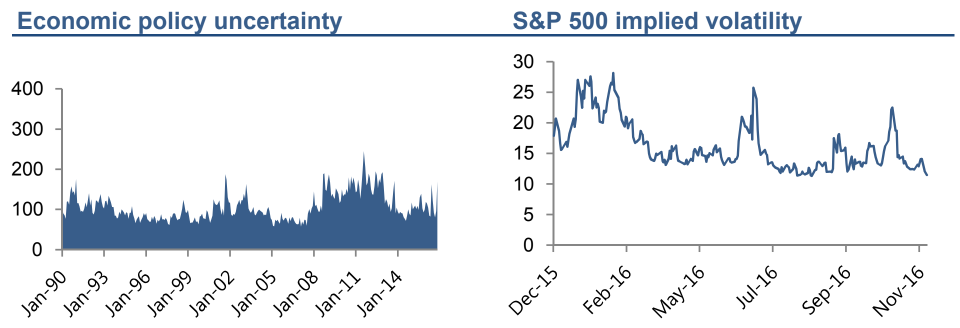

Sources: Baker, Bloom, and Davis and CBOT, via Bloomberg, accessed as of December 7, 2016

THE OUTLOOK BRIEFLY NOTED

We have to publish a forecast, too, so it seems opportune to nod toward the upside risks in the near term introduced by the election results. As for the domestic economic policies of the new team, infrastructure spending and corporate tax changes are likely to be legislated early on, with the former offering some encouragement to public-private partnerships and the latter paired in the package so as to limit the rise in the federal deficit—at least as scored by budget officials. Judging by some of the early personnel picks, the incoming administration is also likely to move quickly to lessen regulatory strictures on the exploration, extraction, and shipment of energy. Those activities are capital intensive and, over time, should help to distribute energy

more efficiently through the middle part of the nation to the comparative cost benefit of manufacturing. While global oil prices surely shape incentives, the deregulatory push should encourage a more significant pickup in business investment than previously expected. Other reforms will take time to maneuver through the legislative and regulatory thicket, but expect a shift in financial regulation as the heads of agencies change. The personal income tax code and the Affordable Care Act are among the toughest nuts to crack, with changes probably deferred to allow specific legislative proposals to come from Capitol Hill.

Trade relationships are more problematic as there is a yawning gap between the positions of the new president and his party's establishment. The White House could use executive authority to abandon ongoing global trade negotiations and backpedal on some existing agreements. Entrenched interests will lead large firms to push back forcefully on radical changes, suggesting relatively modest net movement associated with somewhat lower trade flows. There will likely be limited, at best, benefit to domestic employment, modest additional pressure on costs, and an asymmetric effect on our trading partners whereby the drag on their activity will be greater than the boost to ours.

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On net as of now, we take all this as a modest positive for the growth of U.S. aggregate demand and an upside risk to our point forecast for real growth. Quarterly arithmetic, though, makes annual changes a bit more dramatic looking than that. U.S. economic expansion has been decidedly uneven this year, with GDP growth below 1% in the first half and around 3% in the second half. The anemic first-half performance pulls down average growth for 2016 while the later pickup sets a higher plateau that boosts the average 2017 pace. As shown in the table below, we see the Q4/Q4 growth of real GDP as slowing in 2017 and 2018, but less so than in the prior forecast and still above the growth of potential output. Annual growth rates, however, move up more notably given the back-loaded nature of the quarterly outcomes in 2016.

U.S. economic outlook

percent

		2016	**2017**	**2018**
Real GDP growth, Q4/Q4				
	current	1.9	2.0	1.9
	prior	*1.9*	*1.9*	*1.7*
Real GDP growth, annual				
	current	1.6	2.2	1.8
	prior	*1.7*	*2.0*	*1.7*
Consumer price inflation, annual				
	current	1.3	2.4	2.5
	prior	*1.3*	*2.3*	*2.5*

Source: Standish calculations

With resource slack shrinking and the earlier decline in commodity prices receding in the rearview mirror, U.S. consumer price inflation should pick up to around 2% by the turn of the year and above thereafter. In the Standish view, the Fed moves too slowly to prevent inflation from breaching its 2% goal. This inflation overshoot will be compounded by a further rise in the inflation risk premium as investors recoil from both higher volatility and the sticker shock of rapid consumer price changes. As already noted, the Fed is expected to raise its policy rate one-quarter percentage point once in 2016 and twice in 2017, assuming that the White House only moves slowly to put its stamp on central bank policy.

RISKS

All investments contain risk and may lose value.

S&P 500 is one of the most commonly used benchmarks for the overall U.S. stock market, and is an index that tracks the performance of the largest 500 U.S. companies. VIX is a trademarked ticker symbol for the CBOE Volatility Index, a popular measure of the implied volatility of S&P 500 index options; the VIX is calculated by the Chicago Board Options Exchange (CBOE). It is not possible to invest directly in an unmanaged index.

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