The first week of February made for interesting on-the-job training for Federal Reserve (“Fed”) Chair Jay Powell.

On cracking open the crisis-management handbook, he will read that the first rule is that a significant asset price move reveals something about someone’s balance sheet. Unfortunately, what that is and whose balance sheet is unknown before the event. The second rule is to fade the initial impulse to react because financial markets can be volatile and mostly self-correcting. As a result, Fed rhetoric typically moves much more slowly than markets. The third rule is that a policy decision reveals an official opinion about the underlying economy. The same Fed enjoying good press last year that its hikes showed confidence in underlining economic strength most likely now frets that failing to deliver what had long been expected will be read as doubting the viability of expansion.

Combing these rules counsels patience and reacting to any potential adverse fallout from an asset price move using supervisory authorities, not the initial price move itself using monetary policy. The global economy has momentum, cost pressures are intensifying, and monetary policy is in motion. Central bankers mostly follow Newton’s first law that a body in motion stays in motion. We have thought for some time that the Fed will move four times this year, and we still think that. In this regard, the repricing of fed funds futures over the past few days seems overdone. Shaving more than 10% off the probability of a move at the next Federal Open Market Committee (FOMC) meeting (to 80%) should be read as the 20% probability of a significant extension of the drop in share prices. Because that seems too high, we would also put more chips than 17% that the FOMC moves at least four times in 2018.

CHART 1
PROBABILITY OF FOUR OR MORE FED MOVES IN 2018

Source: CME Group, accessed via Bloomberg, February 6, 2018. Charts are provided for illustrative purposes only and are not indicative of the past or future performance of any Dreyfus product.
But Jay Powell has screens on his desks, too, and the repetition of red raises risks. If the decline in equity prices is sustained, there are two questions relevant for the economic outlook. For one, how much have financial conditions, which drive the dynamics of spending, tightened? According to the Goldman Sachs financial conditions index (GSFCI, created way back when by the current vice chair of the FOMC, Bill Dudley), more accommodation remains in place than when the Fed embarked on this tightening cycle, even as resource use has stretched further. Notably, the easing in 2018 owed to the joint rise in share values, depreciation of the foreign exchange value of the dollar, and narrowing of credit spreads that more than offset the rise in the benchmark yield. Over the past few days, some of the hit to wealth from the fall in stock prices has been offset by a reduction in longer-term yields and depreciation of the dollar, with risk spreads mostly remaining compressed.

Source: Bloomberg, as of February 6, 2018.

The chart below provides a few rules of thumb in that regard, obtained by regressing the weekly change in the GSFCI against the changes in the ten-year Treasury yield and the Bloomberg Barclays’ aggregate credit spread and the percent changes in the S&P 500 equity price index and the foreign exchange value of the dollar vis-à-vis major currencies since 2010. The scatterplots show the movement of the prices of risk assets relative to the ten-year yield. The dashed lines translate the regression into the combinations of changes in each risk price (along the vertical axes) and the ten-year Treasury yield (along the horizontal axes) that keep financial conditions unchanged. For example, a 10% drop in equity prices matched by a 1% to 1.25% point decline in the ten-year yield holds the GSFCI steady (admittedly, such a market outcome would feel unsteady). Above the line for equity prices and below the line for the dollar and the corporate risk spread represents an easing of financial conditions. Given what has happened thus far, the combination of asset price movements probably seems less threatening to Fed officials than the headlines convey.

**CHART 4**
EXPLAINING THE GSFCI WITH SELECTED FINANCIAL QUOTES USING WEEKLY CHANGES, 1/8/2010 TO 2/6/18

<table>
<thead>
<tr>
<th>Change in:</th>
<th>Component</th>
<th>10-Year Treasury Yield</th>
</tr>
</thead>
<tbody>
<tr>
<td>S&amp;P 500</td>
<td>-10%</td>
<td>-1.27</td>
</tr>
<tr>
<td>MCI-FX</td>
<td>-10%</td>
<td>0.67</td>
</tr>
<tr>
<td>BB Credit Agg OAS</td>
<td>100bps</td>
<td>-1.30</td>
</tr>
</tbody>
</table>

The other relevant question: has market price volatility moved permanently higher? Over the past few years, implied equity volatility, the VIX, has generally been low and quickly reverted if shaken from those low levels, as seen, say, after the UK referendum or the U.S. presidential election. Those, however, were external shocks to financial markets that speedily recovered to business as usual. This recent downdraft in prices and surge in volatility seems much more a product of markets internally. Read this as an acknowledgement that the world is a risky place, which investors will probably find hard to forget once remembered. (They eventually forget, which is why crises recur.) Against that backdrop, when markets settle down, they likely will be less accommodating to risk.

But the plan at the Fed has been to coax investors to be more aware of risk by renormalizing policy over the course of this year and next. Some of this may be happening at an uncomfortably quick pace for the new Fed chair, but he has been around financial markets long enough to appreciate the path would be rocky at times. Look to read “a healthy appreciation of risk-taking” in the semiannual testimony on monetary policy as evidence that Chair Powell has worked his way through the crisis management briefing book.

Commodities contain heightened risk, including market, political, regulatory, and natural conditions, and may not be suitable for all investors. Equities are subject to market, market sector, market liquidity, issuer, and investment style risks, to varying degrees. Management risk is the risk that the investment techniques and risk analyses applied will not produce the desired results and that certain policies or developments may affect the investment techniques available to managing certain strategies.

The Standard & Poor's 500 (S&P 500) Composite Stock Price Index is a widely accepted, unmanaged index of U.S. stock market performance. The Bloomberg Barclays U.S. Aggregate Bond Index is a broad-based flagship benchmark that measures the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, mortgage backed security (MBS) (agency fixed-rate and hybrid ARM pass-throughs), asset backed security ABS and commercial mortgage backed security (CMBS)(agency and nonagency). Investors cannot invest directly in any index. Goldman Sachs Financial Conditions Index (GSFCI) provides a comprehensive weekly update on U.S. financial conditions in money markets, debt and equity markets and the traditional and “shadow” banking systems.

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