Will The Fed "Do It Again"?

Ahead of Chair Yellen's speech on the economic outlook at 1pmET that will further inform expectations for the March 15th meeting and beyond, this note shares personal opinions on the strong cautions against being so quick to hike this month and running the risk that markets sharply raise pricing for full cycle hikes. It is meant more as a guide to the debate on what the Fed *should* do in my opinion, rather than as a formal forecast of what they *will* do that obviously must heavily weight the Fed's policy signals. That will follow in a formal forecast update.

1. ECONOMIC DATA HAS BEEN SOFT OF LATE

Market pricing for a hike this month nearly tripled from around 30% last Friday this because of bullish data that matters to data dependent monetary policy, right? Far from it. Here's the rundown of this week's generally soft figures that should serve as a caution.

- core cap-ex orders fell;
- so did construction spending;
- consumer spending volumes fell and there is no consumption growth being tracked in Q1 with data we have on Q4 hand-offs and January thus far;
- pending home sales declined;
- Q1 GDP growth tracking declined to under 2%. The Atlanta Fed's 'nowcast', for instance, was revised down seven-tenths to 1.8% growth after the consumer data (here);
- The only good news has been that sentiment gauges like consumer confidence while ISM-manufacturing and ISM-non-manufacturing both climbed;
- A strong caution on the ISM measures, however, rests with the fact that the alternative Markit-manufacturing PMI and Markit-services PMI were both flat in contradiction to the ISM measures and are both materially lower than the ISM readings;
- In any event, sentiment is often disconnected from data as evidenced by at-best tenuous linkages between confidence and spending, and ISM and manufacturing output.

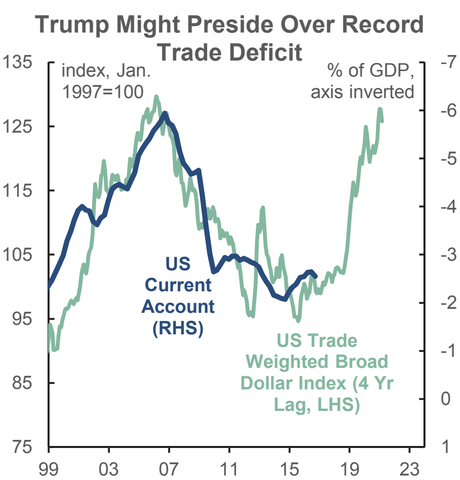
2. PAIN BEFORE AN UNCERTAIN GAIN ON TRUMPONOMICS

The backing up in mortgage rates and USD strength has arguably done the Fed's tightening work for it. Why add to that? Rates and the currency do more work against growth than stock market wealth effects do to lift it. It's not the least bit clear to me that the Fed needs to do more right now. With the momentum that has already been in play for the USD since 2014 and that became intensified post-election, the long 3-4 year lagged effects point to widening trade deficits as a sustained growth dampener that diminishes export competitiveness and raises the appetite for imports. See chart 1 that I've been using for a long time. The Spring

CONTACTS

Derek Holt, VP & Head of Capital Markets Economics
416.863.7707
Scotiabank Economics
derek.holt@scotiabank.com

Chart 1



Sources: Scotiabank Economics, Federal Reserve, Bloomberg.

housing market may be key in some parts of the country to assess the lagging effects of higher mortgage rates on housing demand as it migrates through the mortgage and housing supply chain.

3. TRADE POLICY UNCERTAINTIES

Trump didn't explicitly mention a border tax or ripping up NAFTA or walking away from the WTO in his speech on Tuesday night. But let's not lose our heads in suddenly thinking he's pro-trade. This is arguably the most anti-trade Presidency since Herbert Hoover somewhat begrudgingly signed into law the Smoot-Hawley Tariff. Stocks rallied for months after the House of Representatives passed the tariff in 1929 and fell before the Senate passed it. Hanging over the global economy remains the risk of the Ryan border tax/tariff by any other name and the risk of retaliatory measures the world over. The border tax is not a pure VAT consumption tax that should be more trade neutral and encapsulate domestically-derived consumer spending – it is a protectionist levy pure and simple. As written previously, I don't buy the assertions of the pro-tariff camp who agree the hit would be to foreign exporters to the US but quite possibly naively assume that foreign governments will turn the other cheek. Commerce Secretary Wilbur Ross is on the wires this morning speaking about being very aggressive against imports and boosting exports which may be a border tax reference on both counts.

For as long as the risk of a sharp turn toward protectionism overhangs the outlook, the Fed should not be hiking. This is new information compared to the first hike in December 2015, but the information was at hand when the Fed hiked in December 2016 and presently. Recall former Fed Chairman Ben Bernanke's speech that was titled "On Milton Friedman's Ninetieth Birthday" now way back in November 2002 (here). He addressed the role of the Fed in driving the Great Depression and concluded Friedman was right. Bernanke's speech ended with the words "You're right, we did it. We're very sorry. But thanks to you, we won't do it again."

4. HARD EVIDENCE OF GLOBAL REFLATION IS TOUGH TO COME BY SO FAR

- Market based measures of inflation expectations have risen significantly. They have an at-best checkered track record at forecasting actual inflation. They often simply follow current price readings and particularly the year-ago percentage change in the current spot gasoline price. I personally do not view the inflation market as the arbiter of inflation risks than is sometimes assumed.
- But U.S. core PCE inflation has been stuck around 1.6-1.7% y/y since the start of last year after it climbed from mid-2015 lows. Has progress stalled? Headline PCE inflation is simply tracking commodities and year-ago base effects and its rise may be temporary.
- Core CPI figures in Japan, China and the Eurozone are signalling no underlying outburst of global reflationary developments. Chinese producer prices are rising only in confirmation of year-ago comps in commodity prices.
- Survey-based measures of inflation expectations remain fairly well anchored. Bloomberg consensus is forecasting U.S. core PCE to end 2017 at 1.9%, up two ticks from here. After riding beneath the Fed's 2% goal for eight long years minus just one quarter in 2012Q1, that's hardly a break-out that should be snuffed out at the first available opportunity. Patience should be on order, to see if there is more to inflation than simply the partial recovery in commodity prices and year-ago base effects. Patience should also be on order to see if core inflation upsides from tightening spare capacity are offset by downsides from dollar strength and largely absent real wage growth.

5. ONGOING LABOUR SLACK AND REAL WAGES

It's not clear that slack has been eroded in US labour markets. Real wage growth is almost non-existent as workers struggle to keep up with higher commodity prices. That could well be disinflationary on second round effects as higher relative prices for food and energy crowd out household budgets and get them spending less on everything else. Ergo the latest consumption report. Further, the labour force participation rate has been in long-term decline since before the crisis but the crisis brought it down a further 3 points and it appears to be bottoming more recently. Will discouraged workers rush back in to keep nominal wage growth in check for some time yet?

6. WHERE'S THE BEEF BEYOND THE POLICY HYPE?

We still haven't seen concrete fiscal, regulatory and trade policy plans from the Trump administration and probably won't see anything material for some time and perhaps not this year. The debt ceiling looms and may be temporarily lifted again for much of this year while still leaving open for a future date the battle over how much of Trump's fiscal wish list will be funded by greater debt. The issue divides the GOP. Will supply knock the bond market and sterilize stimulus? Will fiscal hawks sterilize stimulus measures within a fiscal budget itself?

7. ARE MARKETS BUILDING 'CASTLES IN THE AIR'?

If the Fed believes it can lean against periods of excess exuberance then perhaps it hikes now and sends a signal. If it believes more in the clean versus lean side of the debate on what to do with potential froth across much of the entire risk trade from equities to high yield and broader credit, then monetary policy cannot target asset valuations and this should not be used as a justification for hiking soon. I think most monetary policy makers these days believe they cannot control such market forces and don't make any better stock pickers than average.

In conclusion, let me confess that I have a much easier job than the policy makers who are in the hot seat. Their decisions will be judged by history with lasting consequences. There are risks to prematurely tightening policy and going too fast, and there are risks to waiting too long or going too slow as Richmond's Lacker indicated this morning. With the exception of the Great Depression, the Fed has usually waited too long at first and then over-tightened once the inflation genie had been sprung from the lamp. Today's cycle has shades of the circumstances that faced the Fed in the 1970s onward. It has shades of the circumstances that faced the Fed during the period of reference in Bernanke's speech namely record stocks and protectionist sentiment. I don't profess to know exactly which path we're headed along from here as the broad policy framework is in a state of flux across the trade, fiscal, regulatory, and geopolitical spheres of government influence. Against both of these broad types of risks of going too soon or waiting too long, however, I see no harm in waiting somewhat longer in order to allow nascent debates on policy matters that are germane to the monetary policy outlook to mature.