Janet Yellen says farewell and the stock market sheds tears

Many things happened on February 2, the date the employment report for January came out. Before going into that, it´s worth looking at some history.

In January 2012, the Fed instituted a formal 2% inflation target. Curiously, from the January 2012 FOMC meeting, extending to the June 2013 FOMC meeting, the Fed anticipated that inflation would undershoot the target!

FOMC Meetings from Jan12 to June13

> The Committee also **anticipates** that **inflation over the medium term likely will run at or below its 2 percent objective.**

In July 2013, they must have realized that was a dumb thing to say, changing the wording to:

FOMC Meeting July13

> The Committee recognizes that ***inflation persistently below its 2 percent objective could pose risks to economic performance***, but it ***anticipates that inflation will move back toward its objective over the medium term.***

In the December 2013 Meeting they were more emphatic:

FOMC Meeting December13

> The Committee recognizes that inflation persistently below its 2 percent objective could pose risks to economic performance, and it is ***monitoring inflation developments carefully for evidence*** that inflation will move back toward its objective over the medium term.

Seven months later, in the July 2014 FOMC Meeting they were more optimistic:

FOMC Meeting July14

> The Committee judges that the ***likelihood of inflation running persistently below 2 percent has diminished somewhat***.

Three months later, in the October 2014 FOMC Meeting the optimism was tempered:

FOMC Meeting October14

> ***Although inflation in the near term will likely be held down by lower energy prices and other factors***, the Committee judges that the likelihood of inflation running persistently below 2 percent has diminished somewhat since early this year.

Two months later, they were again more sanguine, thinking the Phillips Curve trade-off would turn favorably:

FOMC Meeting December14

> ***The Committee expects inflation to rise gradually toward 2 percent as the labor market improves further and the transitory effects of lower energy prices and other factors dissipate. The Committee continues to monitor inflation developments closely***.

In the following meeting, they revised their optimism:

FOMC Meeting January15

> ***Inflation is anticipated to decline further in the near term***, but the Committee expects inflation to rise gradually toward 2 percent over the medium term ***as the labor market improves further*** and the transitory effects of lower energy prices and other factors dissipate. The Committee continues to monitor inflation developments closely.

In the next meeting they thought the decline in inflation had run its course:

FOMC Meeting Mar15

> ***Inflation is anticipated to remain near its recent low level in the near term***, but the Committee expects inflation to rise gradually toward 2 percent over the medium term as the labor market improves further and the transitory effects of energy price declines and other factors dissipate. The Committee continues to monitor inflation developments closely.

For the next five FOMC Meetings (April through October), inflation was “expected to remain near its recent low.”

In the December 2015 FOMC Meeting, which witnessed the first hike in rates for almost a decade, they again became upbeat:

FOMC Meeting December15

> ***Inflation is expected to rise to 2 percent over the medium term*** as the transitory effects of declines in energy and import prices dissipate and the labor market ***strengthens further***. The Committee continues to monitor inflation developments closely.

In the following month, however, they again back peddled:

FOMC Meeting January16

> ***Inflation is expected to remain low in the near term,*** in part because of the ***further*** declines in energy prices, but to rise to 2 percent over the medium term as the transitory effects of declines in energy and import prices dissipate and the labor market strengthens further. ***The Committee is closely monitoring global economic and financial developments and is assessing their implications for the labor market and inflation, and for the balance of risks to the outlook.***

From the March through September FOMC Meetings, inflation was expected to remain low. In November, in preparation for the second hike that would take place in December, they once again changed the tune:

FOMC Meeting November16

> ***Inflation is expected to rise to 2 percent over the medium term*** as the transitory effects of past declines in energy and import prices dissipate and the labor market strengthens further. Near-term risks to the economic outlook appear ***roughly balanced***. The Committee continues to closely monitor inflation indicators and global economic and financial developments.

In the January/February FOMC Meeting, they were confident enough to indicate that rate hikes would be more “systematic”:

FOMC Meeting January/February17

> The Committee expects that***, with gradual adjustments in the stance of monetary policy, economic activity will expand at a moderate pace, labor market conditions will strengthen somewhat further, and inflation will rise to 2 percent over the medium term***. Near-term risks to the economic outlook appear roughly balanced. The Committee continues to closely monitor inflation indicators and global economic and financial developments.

That stance remained in place for the remainder of the year. Anything that would affect inflation, like the first quarter slow growth or the storms later in the year, would be transitory, with “inflation on a 12-month basis ***expected to remain somewhat below 2 percent*** in the near term but to stabilize around the Committee’s 2 percent objective over the medium term.”

In the January 2018 FOMC Meeting, they set the stage for “systematic” rate hikes continuing into this year:

Jan18

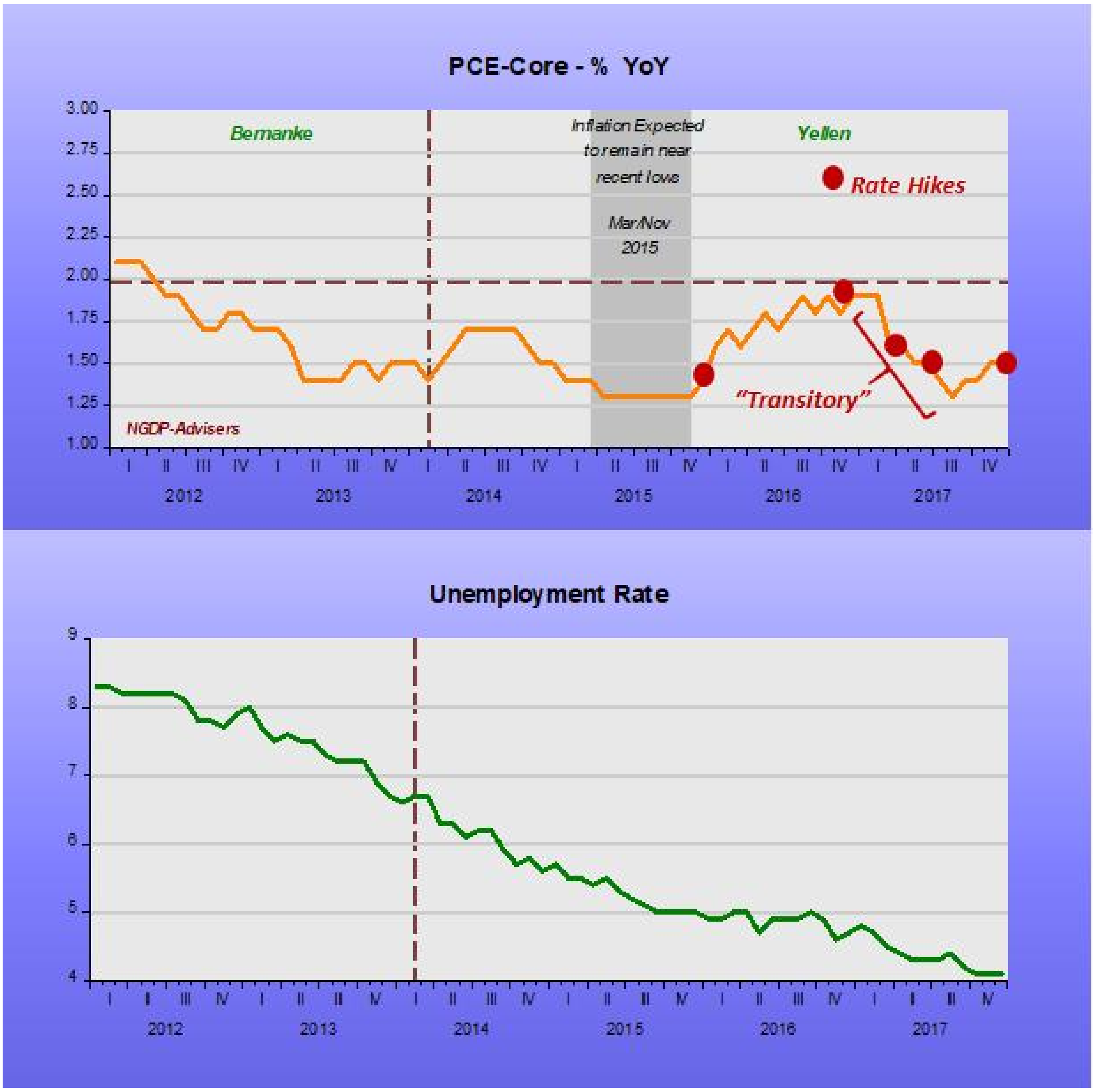
> The Committee expects that, with ***further*** gradual adjustments in the stance of monetary policy, economic activity will expand at a moderate pace and labor market conditions will ***remain strong***. Inflation on a 12-month basis is ***expected to move up this year and to stabilize around the Committee’s 2 percent objective over the medium term***. Near-term risks to the economic outlook appear roughly balanced, but the Committee is monitoring inflation

developments closely.

What do all those “statements” tell me about how the Bernanke/Yellen Fed conducted monetary policy?

My answer is that inflation is something that happens beyond their control! Why else would they think, for one and a half years, that inflation would undershoot the target they had just specified? After that, it was mostly “we expect inflation to rise to 2% over the medium term”. To the FOMC, in addition, the concept of medium term is very “flexible”.

How did inflation (PCE-Core) and unemployment behave during 2012 – 2017?



The Bernanke/Yellen Fed monetary policy was guided by (“imaginary”)

Phillips Curve trade-offs. This, as Robert Hetzel indicates is an “activist” monetary policy and, to my mind, the source of much trouble for the Fed.

Setting the stage for the February 2 (extending to the next trading day, Feb 5) stock market rout, we look back to the signing of the Tax Cut in December 2017. From many accounts, that would be a “game changer” for growth.

Long-term yields rose as would be expected following an increase in growth expectations. However, if increased growth expectations were the driving force behind the long-term yield rise, we would tend to observe a tendency for the dollar to rise.

As the charts show, this was not what happened. The increase in the bond yield goes together with a down trending dollar. However, that yield-dollar combination is consistent with the rise observed in inflation expectations.

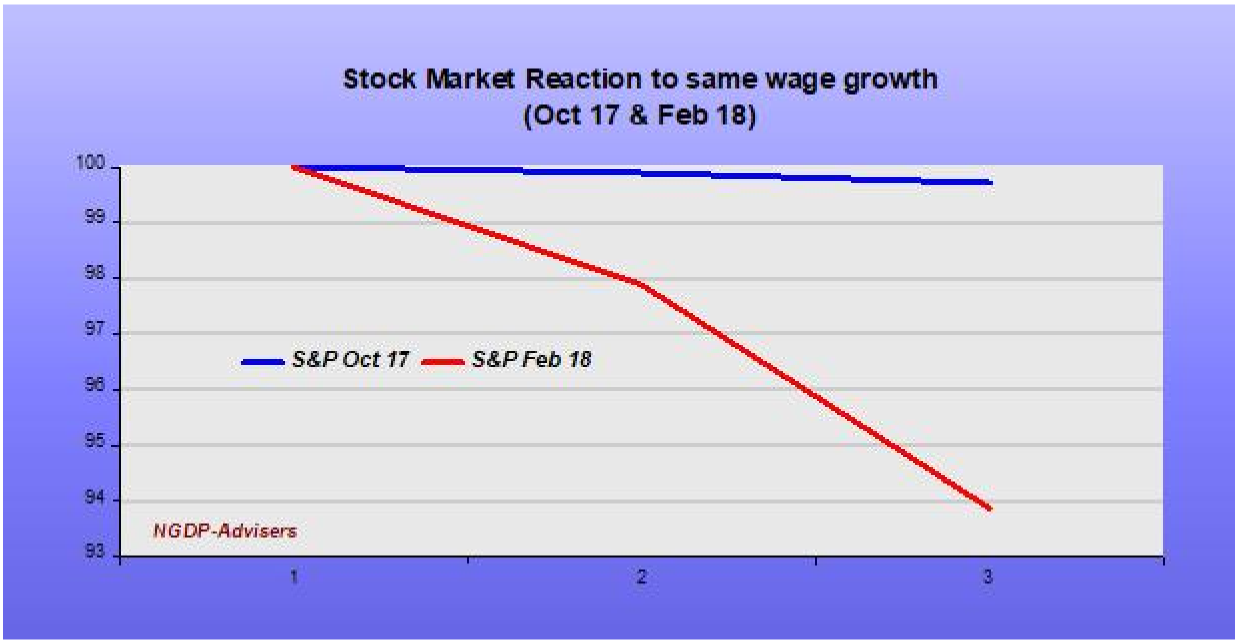
The 2.9% “trigger”

On February 2, the employment report said unemployment had remained at 4.1% for the fourth consecutive month and that payrolls had come in at 200k, higher than expected. The linchpin, however, was the 2.9% growth in average hourly earnings for all employees, touted as the highest since June 2009.

A few remarks:

1 June 2009 was the bottom of the Great Recession!

2 In September 2017, that same wage growth gouge was also 2.9%, later revised down to 2.8%. The stock market reaction, however, was very different.



The other distinguishing factor on February 2 was that it marked the change of the guard at the Fed, and new Fed chairs are expected to show their anti-inflation credentials…

Who is Jerome Powell?

Jerome "Jay" Powell came to the Federal Reserve Board in May 2012. By September of 2012, the Federal Reserve was once again debating yet more QE; a third round.

Powell was among the more skeptical of the FOMC members. He never dissented, but may, nevertheless, be counted as a "hawk". He acknowledge that the economy was weak, but what stands out is his interpretation of the weakness.

From the September 2012 FOMC transcripts:

> MR. POWELL My conversations with a group of about 10 diverse industrial companies—this is not autos, so it's away from one of the real strengths. The other parts of the industrial sector, let me say, are pretty weak, and they strongly confirm that last point about employment. Outside of a couple of bright spots like housing and light vehicles, it's soft everywhere, especially in Europe.
>
> Big customers are postponing orders; they're not canceling them. It's nothing like from 2008 to 2009, but the softness that began about six months ago is now the new normal for these companies. The game is about share gain and taking

> out costs. ***It's a low-growth environment***. All new projects are on hold, and there is no hiring.

How, then, could he be skeptical about QE3? To him, QE3 was somewhat an overreaction:

> MR. POWELL The question that looms is—and I'm going to, again, ***leave aside monetary policy***—when do we break out of this? ***And I really do believe that we will. We always have***. I can remember many of these cycles where you really wonder if this is it and we're never going to get out.
>
> I really do feel that if you look at our own projections, essentially, all of us project that we're going to have those 3 percent, 4 percent catch-up years. They're now scheduled for 2014 and '15, but really, there's a ton of uncertainty around that. So I'm going to share this highly anecdotal evidence in an effort to end on something of a high note.

His "high note" is "appealing" to his professional specialty, Private Equity, as "evidence".

> MR. POWELL I talked to both private equity investors and hedge fund investors, and it's always very interesting to compare the two of them.
>
> The hedge fund investors are in a really difficult environment. They're traders who get marked every quarter, and, in a world that has very few ways for them to make money, they're generally very conservatively positioned, and their investor base seems to be fine with that.
>
> Private equity firms are feeling quite differently about things. They basically think about creating value over a three- to five-year period, and many ***PE firms right now, large and small, think that this is a great time to buy***.
>
> In fact, a string of large industrial properties, which would ordinarily have been expected to trade to corporations, has traded to private equity. There are three reasons why the private equity firms are feeling

> aggressive.
>
> First, their natural competitors, these big companies, are all frozen on the sidelines, sitting on their cash, ruled by risk-averse public boards, and out of the game. If anything, they're going to wind up being net sellers as the recession goes on.
>
> Second, leveraged finance markets, as Andreas was discussing this morning, are very attractive, with low rates and issuer-favorable terms that are just about ***reminiscent of the bubble days***, and all of that provides critical flexibility in case deals don't go well.
>
> Third—and really the one that's relevant for this policy exercise—***private equity firms think about the medium term, and they see the future as better***.
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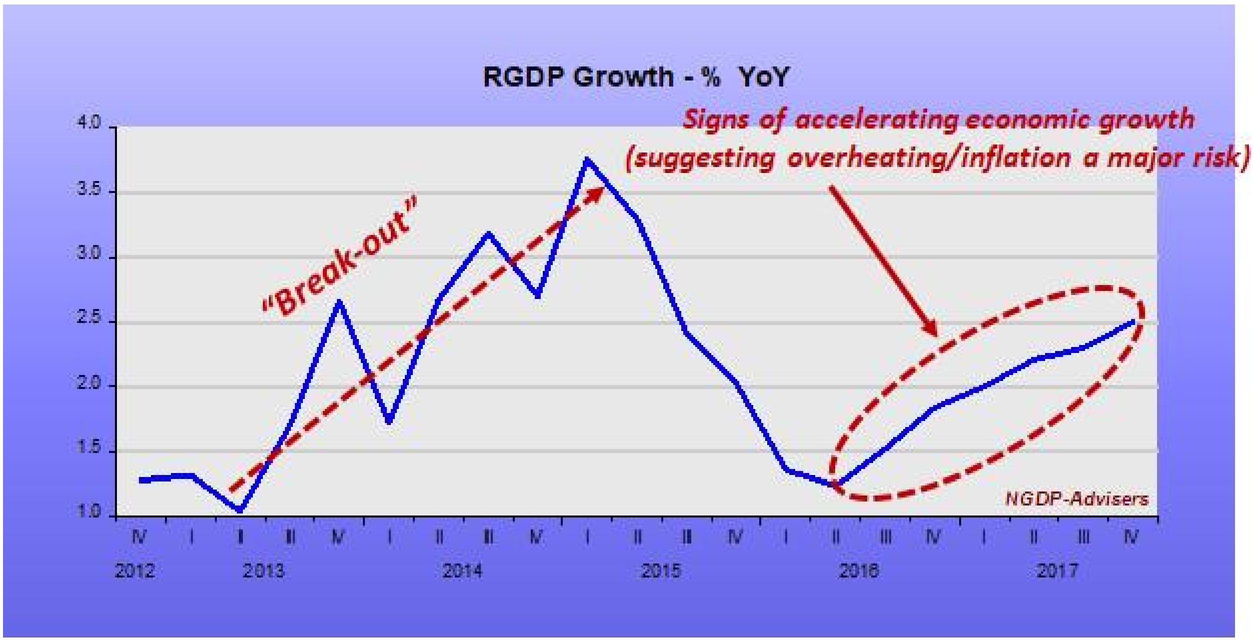
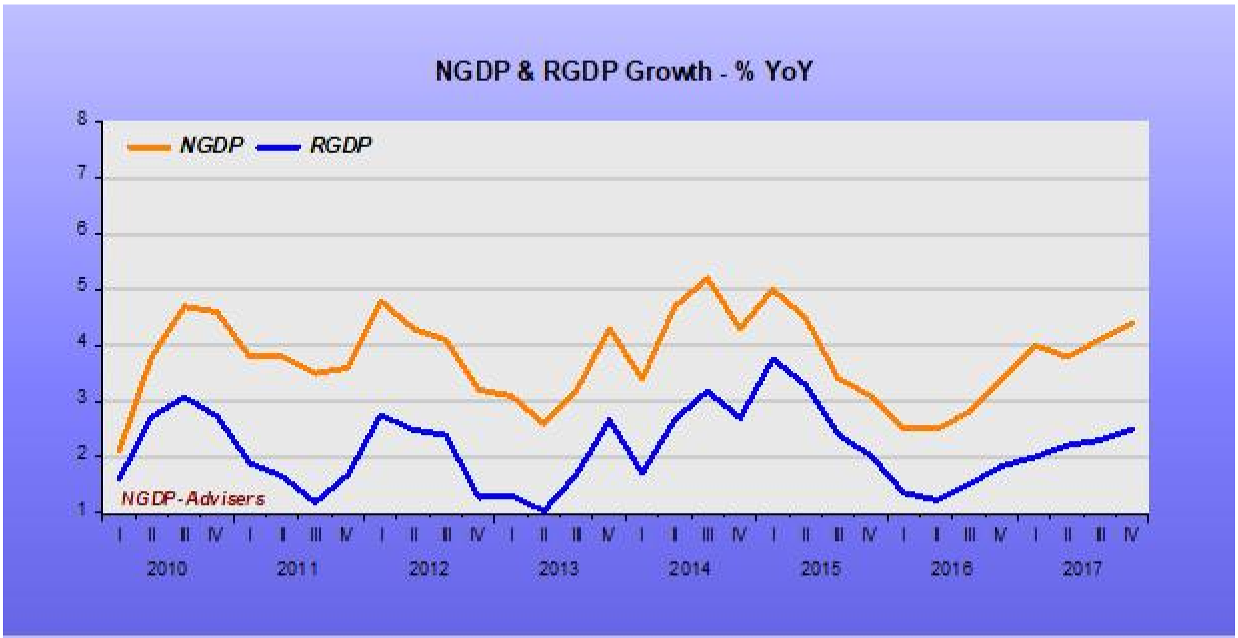
> These large private equity firms are completely global; they each own hundreds of companies in every major economy and in every vertical; and they systematically mine the data that they get and they've got the talent on board to do that. This is not the private equity industry of 20 years ago. ***So they're seeing something. They really are***.
>
> …So the question is, why take any signal from this, right? I realize it doesn't tell us anything at all about the next few quarters. ***But I will say that it's a bit of a signal to me because this is a group of investors with very successful and, in some cases, long track records that were looking ahead to strong growth in the medium term, and they were willing to put more than just an opinion on the line in that belief***.

Interestingly, 2013 – 2014 witnessed a "break-out". It was, however, short lived. More recently, a "gentle recovery" from the ensuing slowdown is touted a "sign of accelerating growth"!



The idea is that the stock sell-off reflects the view that employers will have to pay higher wages, cutting into profits, and that higher inflation will cause the Fed to raise rates faster, is wrong!

There is no indication that growth will be more robust or that inflation will surprise on the upside, at least not while monetary policy, the stance of which is partly determined by NGDP growth (partly, because the initial level of NGDP also matters), shows no sign of "breaking out".



Furthermore, the unemployment rate could be (and will be) lower but nothing would change!

Therefore, if the Fed doesn´t go “off the rails” under the new (and untested) management, things should “quiet down”, with inflation expectations coming back down somewhat, with the same being said of long yields. The dollar downtrend should also reverse.