INSIGHT & OPINION

Economic Pulse

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The "Harbinger of a Deterioration in Economic Activity?"

The minutes from the March 19-20 FOMC meeting—released yesterday—provide some insight into why the Committee pivoted from forecasting two rate hikes in 2019 to zero—all in the span of three months. In line with the recent reduction in the IMF's outlook for global economic output, the Committee cited **risks to foreign growth** as a primary reason for their downgraded assessment. Nonetheless, reading between the lines, **it's clear that many members of the Committee do not see risks to either growth or inflation as balanced.**

While upside risks to the forecast assembled by the Fed staff include "household spending and business investment that could expand faster than projected" as well as "still strong" labor market conditions and "upbeat" consumer sentiment, on the downside, the "recent softening in a number of economic indicators" have the potential to be the "harbinger of a substantial deterioration in economic activity." Below, we highlight the risks the FOMC sees to its forecast that warrant "patience" with regard to the conduct of monetary policy.

On the positive side…

While the Committee expressed considerable doubt regarding the economic outlook (the word "uncertain" was used nine times in the minutes), there were several reasons why "members continued to view sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2 percent objective as the most likely outcomes for the U.S. economy in the period ahead." Among those cited: **"Favorable" business conditions** (including **solid growth in household incomes**, **improvements in financial conditions** and **in households' balance sheet positions)** and **upbeat consumer sentiment**. A **strong labor market** also was likely to support growth going forward—whether measured by the "very low unemployment rate, a further increase in the labor force participation rate, [the] low number of layoffs, near-record levels of job openings and help-wanted postings, and solid job gains, on average, in recent months."

…and on the negative

Topping the list of concerns from the Committee was "**disappointing news on global growth**" as well as "**less of a boost from fiscal policy** than had previously been anticipated"—perhaps as evidenced by the slower growth of household spending in the first quarter. (December's weakness in retail sales was "notable," particularly again the backdrop of a robust labor market.)

Also among the "number" of risks: 1) The "high level of uncertainty" associated with **international developments**, including ongoing **trade talks** and **Brexit deliberations** 2) The possibility of "sizable spillovers" from a greater-than-expected **economic slowdown in Europe and China** 3) Persistence of the **softness in spending** and 4) A sharp **falloff in fiscal stimulus**. If the above weren't sufficiently dire, a "few participants observed that an economic deterioration in the United States, if it occurred, might be amplified by **significant debt service burdens** for many firms" while "several participants pointed to the **increased debt issuance and higher leverage of nonfinancial corporations** as a development that warranted continued monitoring." And don't forget the "**continued softness in the housing sector**" — although "recent reductions in mortgage interest rates" were noted as providing "some support for construction activity."

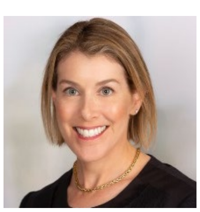
On "alternative interpretations" of inflation growth

The Committee has consistently overestimated the pace with which core inflation would return to near two percent on a sustained basis; "it was noteworthy that [inflation] had not shown greater signs of firming in response to strong labor market conditions and **rising nominal wage growth**, as well as to the short-term upward pressure on prices arising from **tariff increases**." Why the lack of inflation, even as real wages are firmly in positive territory? The Fed offered the following "alternative interpretations" for the "subdued" inflation pressures in the current environment: 1) **Low inflation expectations** that were exerting downward pressure on inflation relative to the Committee's two percent inflation target and 2) A "**less tight labor market**" than would be suggested by common measures of resource utilization (which would imply a *lower* longer-run unemployment rate consistent with 2 percent inflation than was previously thought.) Nonetheless, while the Committee highlighted "upside risks" to the outlook for inflation that included the possibility that "wage pressures could rise unexpectedly and lead to greater-than-expected price increases"—there are few indications that the trajectory of wage growth is likely to accelerate anytime soon.

Worried about that yield curve inversion? The FOMC isn't.

Since the change in the FOMC outlook on March 20th, 10-year US Treasury yields have fallen by 15 bps. Moreover, the spread between 3-month Treasury bills and 10-year yields has fallen below zero on six days since then. However, if the FOMC is worried about the implication of a yield curve inversion, their comment in the minutes indicates otherwise. What does the Fed think? While "several participants…noted that historical evidence suggested that an inverted yield curve could portend economic weakness…their discussion also noted that the unusually low level of term premiums in longer-term interest rates made historical relationships a less reliable basis for assessing the implications of the recent behavior of the yield curve."

The market is now pricing in a 57% chance of a rate cut in 2019, up from the 40% probability on the last FOMC meeting date. If the market sees something the Fed doesn't, the Fed's strategy of being patient may not prove to be a virtue.



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