THE ECONOMIC OUTLOOK GROUP

475 Wall Street
PRINCETON, NEW JERSEY 08540 Tel: 609 - 529 - 1300
www.economicoutlookgroup.com

ECONOMIC TALKING POINTS

Bernard Baumohl
Chief Global Economist

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Confronted by swirling crosscurrents, the Fed chooses to chill out… for now

The current economic expansion is just months away from becoming the longest ever recorded in the US. It is usually at this late stage of the business cycle that the Fed most closely monitors one particular economic metric among the many released each month, and that is inflation. With the economy strong and labor markets exceptionally tight, you would expect to see inflation pressures build. But it's not happening and that is a departure from historical trends.

Remember, the Fed has two principal mandates, maximizing employment and keeping inflation under control, ideally with prices rising at around 2%. The first of the mandates had been accomplished some four years ago. And there's certainly no need to worry about the job market these days, not with the unemployment rate holding below 4%.

So the Fed's main focus is on emerging price pressures. Are there any signs inflation will soon materially heat up? So far not! The Fed's main inflation metric, changes in the personal consumption expenditure price index, has been safely hovering between 1.5% and 2% throughout 2018 --- and there's no evidence it will suddenly change course and take off.

Given that backdrop, the Fed decided that after three years of gently nudging up short-term rates, it made sense to stop lifting them further. That bold action sent an important message. It typically takes 12 to 18 months for a change in interest policy to ripple through the economy. So the Fed seems sufficiently sanguine that inflation will continue to behave ---at least in the short run.

Why be so optimistic?

To begin with, there are many conflicting forces that determine the path of inflation. Imagine a tug of war with two opposing sides, each seeking to overwhelm the other. On one side there deflationary forces at work, which help boost real economic growth and provide households with extra purchasing power.

These deflationary forces would include a slowing global economy, a decline in energy prices, and only modest increases in wages. The single biggest reason that keeps prices in check has been the pervasive impact of e-commerce. The Internet has become the single most powerful deflationary engine in modern history. It empowers consumers to become savvy shoppers and seek out bargains. At the same time, the growth in e-commerce has made it more difficult for many companies to achieve significant pricing power. For if they attempt to raise prices in an era of online shopping, those merchants could lose customers and thus market share. Once you lose market share, it is hellishly difficult and costly to get it back.

Now look at the other side of this tug of war. Driving prices higher are health care expenses and those industries that have no choice but to raise prices to offset the higher cost of tariffs, which the White House imposed on imports from Asia. So far, however, these last two drivers are unable to move the inflation needle much higher.

And so the Fed is prepared -- for now -- to keep short-term interest rates in the range of 2.25% to 2.50%. It is even content --- for now --- to accept the real neutral fed funds rate at about 0.5%, an unusually low level compared to past trends. Nor is there an urgent reason for them at this time to reduce the run off of its balance sheets, since doing so would only startle financial markets. The pace of shrinking the Fed's account will thus continue at $50 billion a month ($30 billion less in treasuries and $20 billion in mortgage-backed securities).

But there is was one other important message that came out of Fed chief Jerome Powell's press conference: There is a real risk the current quiescent inflation environment may be just the calm before the storm. That's because there are many questions that now loom large.

• Will the White House ramp up tariffs to a full 25% on all $250 billion of imported goods from China at the end of next month?

• If so, what kind of retaliation can we expect from China?

• Will the labor market soon crossed that critical threshold where conditions become so tight that we could see a quick acceleration in pay and possibly bring on a destructive wage – price spiral?

• Could OPEC and the other major oil producers that promised to slash output overdo it and cause a spike in the price of crude?

• Can the US economy possibly get a second wind this year and grow much faster than consensus projections?

• With the government shutdown over (at least for now) and the postponed economic indicators coming back on line, will there be some data that will alarm the Fed and prompt future rate increases --- or perhaps the reverse?

In short, the Fed senses that we in a period of economic interregnum. Something will have to give soon. There are just too many scenarios to ponder and too little clarity on which could emerge in the weeks and months ahead.

Thus the Fed's decision to chill out makes sense at this moment. Those charged with carrying out monetary policy might well agree with the awkward but understandable words once expressed by Donald Rumsfeld: There are just too many "known unknowns and unknown unknowns."