Market Commentary

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What Would Cause a Material Reassessment and Other Thoughts

Jim Palmer, CFA
Chief Investment Officer

In what I am sure is one of his favorite activities as Federal Reserve (Fed) Chairman, Jerome Powell provided the Fed's Semiannual Monetary Policy Report to Congress this week, kicking off with the U.S. House of Representatives on Tuesday. As expected, there were not a lot of new insights into the Fed's policy outlook. But there were a few points in Mr. Powell's report worth revisiting.

Inflation will move closer to 2% over the next few months. Agreed, but the move higher is a bit of a head fake. The primary reason inflation (measured by Core PCE) is expected to rise is that prices rose only 0.14% in Q119. The year-over-year roll-off that low level for even a marginally higher number – say 0.45% – in Q120 would push inflation up from 1.6% to 1.9%. This is more a stabilization of inflation below the Fed's 2.0% target than the start of a persistent increase in prices.

As the Fed's bill purchases continue to build reserves toward ample conditions, it intends to gradually transition away from the active use of repo operations. As a reminder, the repo operations discussed here were made in response to a mid-September 2019 spike in repo and other short-term rates. The Fed has continued those operations into the first quarter of 2020. I believe the Fed will ultimately wean funding markets off their current facilities, but a longer-term backstop seems inevitable. From a credibility standpoint, the Fed must reaffirm its ability to control funding market rates.

As reserves reach durably ample levels, the Fed intends to slow its purchases to a pace that will allow its balance sheet to grow in line with trend demand for its liabilities. We'll see. The Fed has had a difficult time determining just what is the level of ample reserves. My guess is the Fed will need to continue purchases longer than currently forecast to reassure markets and to lower the risk of funding market disruption. The Fed may believe recent T-bill purchases have not been a tremendous contributor to recent growth, as the primary financial impact of the policy is a simple system-wide swap of highly liquid assets i.e.,T-bills in exchange for excess bank reserves. That may be true, but in the face of slow global growth and the asymmetric risks from the coronavirus, a more likely path is for continued asset purchases and perhaps an extension into coupons. Regardless, Mr. Powell signaled the Fed's balance sheet may never shrink again.

If developments emerge that cause a material reassessment of its outlook, the Fed would respond accordingly. Which invites the question: "What would cause a material reassessment"?

1) The financial market's primary focus right now is on the impact of the coronavirus and Mr. Powell emphasized policymakers are closely monitoring the situation. Looking at credit spreads and the rebound in equity prices, investors have grown comfortable after a negative initial reaction. Looking at the decline in U.S. Treasury yields since the coronavirus story became the headline in mid-January, investors appear more pessimistic. Why the dichotomy? Simple risk management is my guess. Equity and credit assets imply the virus's fallout will not be severe or long-lasting, but Treasury markets – which are more driven by the outlook for Fed policy – are hedging their bets. In an environment where rate hikes are off the table, Treasury

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investors are saying the Fed is biased to react aggressively should the virus cause greater disruption in global growth. They're right, and it seems unlikely the yield curve can return to year-end levels until this cloud clears.

2) I have been warming to the concept that financial market volatility – primarily in the form of the VIX – is an important Fed input and perhaps the key catalyst for Fed easing. My guess is there is a formula along the lines of, "If S&P 500 declines > X%, the Fed cuts rates by Y basis points." Not a formal one of course, but the Fed has shown an inclination to respond to risk market declines with accommodation. Back in the day, this was known as the *Bernanke Put*. Today, with the economy on a decidedly firmer footing and market's needing less hand-holding, calling recent eases a *Powell Put* seems exaggerated. Instead, perhaps the VIX should be viewed as a decent real-time indicator of growth, financial conditions, unique risks and confidence all balled into one number, worthy of causing a material reassessment of the Fed's outlook.

VIX – The Chicago Board Options Exchange Volatility Index is a calculation designed to produce a measure of constant, 30-day expected volatility of the U.S. stock market. Investors look to VIX values as a way to measure market risk, fear and stress (a.k.a. *Fear Gauge* or *Fear Index*.)

Sources

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