The President and the Chairman

In an August 20th interview, President Trump told Reuters he is "not thrilled" with the Federal Reserve's (Fed) rate hikes and reportedly suggested at a fundraiser he had expected Fed Chairman Jerome Powell to be a "cheap-money chairman." I don't know, but the Powell-endorsed pre-2018 rate hikes and balance sheet reduction kick-off probably should have been a tip-off. Interestingly, there was muted market reaction to the President's comments, indicating perhaps investors have grown immune to – or at least used to – the President's unconventional broadsides against powerful institutions. Needling the Fed was just a matter of time.

To be fair to President Trump, past Administrations have clashed with the Fed as well – just not as frontally. But let's face it, subtlety has never been the President's strong suit and he may even have a legitimate gripe. Here we are with a sub 4% unemployment rate and 4% GDP growth and the economy can barely scratch out a 2% core inflation rate. In the past decade, the year-over-year (yoy) Personal Consumption Expenditure (PCE) Core Index averaged 1.56%, exceeding 2.0% only 8 out of 120 months, the last time being in April 2012. In its Open Market Committee statements, the Fed has explicitly referred to its 2% inflation objective as symmetric, implying some comfort with inflation slightly above or below 2%. Yet, the Fed continues on its path of gradual rate hikes and measured balance sheet reduction. So, at least to me, the Fed's persistent tightening actions and the outlook for more imply 2% is more of a ceiling than a desired equilibrium point. The President can probably be forgiven if he feels the Fed has been a tad disingenuous regarding its inflation targets and intentions.

One explanation for the Fed's tightening in the face of contained inflation is simply that it remains prudent to move toward policy normalization. I think this concept has a lot of merit. The Fed's Zero Interest Rate Policy and Quantitative Easing were essential steps in keeping the economy from slipping into a deflationary death spiral after the financial crisis. But as the crisis faded, the risks from the misallocation of capital caused by these policies overtook deflation risk and the Fed appropriately began tightening monetary conditions. So, if we can agree the Fed's direction has been correct, we are really quibbling over the question: What is the appropriate point to pause – or even halt – policy normalization?

The argument for higher rates generally points to two key sources of future inflation: trade wars and tight labor markets. Tariffs can certainly increase prices paid on imported products, but this type of inflation is politically driven, not a function of excess liquidity and not something the Fed can control. If anything, trade wars tend to restrain growth which should result in looser rather than tighter policies. The theoretical connection between tight labor markets and inflation is rather straightforward – low unemployment leads to higher wages, leading to higher input costs, leading to higher retail prices demanded, leading to higher inflation – a phenomenon explained by the Philips Curve. Sounds logical, but count me as a skeptic. The current economy has almost certainly blown through any traditional measure of the Non-Accelerating Inflation Rate of Unemployment (NAIRU), all while inflation and wage growth remain non-threatening. Perhaps there is a surprisingly large pool of workers willing and able to come off the sidelines to keep a lid on wage growth. The labor force has actually grown 1.178 million workers in the past year. Unfortunately, the

Jim Palmer, CFA
Chief Investment Officer

Phillips Curve: An economic concept developed by A.W. Phillips stating that inflation and unemployment have a stable and inverse relationship.

Non-Accelerating Inflation Rate of Unemployment - NAIRU: The specific level of unemployment that is evident in an economy that does not cause inflation to rise up. NAIRU often represents equilibrium between the state of the economy and the labor market.

usbancorp
Asset Management, Inc.

number of persons not in the labor force has grown 1.531 million over the same period, which kind of spoils that theory. It's too bad really, as an expanding labor force would be an indisputable positive for the economy with the potential to meaningfully extend the current expansion…or perhaps deregulation has improved production efficiency…or maybe businesses are simply finding new and innovative ways to manage costs and improve productivity, as they always seem to do. Regardless of the reason, Nonfarm Productivity surged to 2.9% in the second quarter, while Unit Labor Costs declined 1.0%. Those numbers are hardly the stuff of runaway wage-push inflation.

And the yield curve appears to agree. As of September 11th, ten-year U.S. Treasury yields – the portion of the curve controlled mainly by inflation – have fallen to 2.96% after peaking at 3.11% on May 17th. Two-year U.S. Treasury yields – the portion of the curve controlled mainly by actual and anticipated Fed rate policy – have risen to 2.73% from a beginning of the year low of 1.89%. Not surprisingly, the two- to ten-year portion of the yield curve has tightened to 23 basis points (bps) from a February 12th high of 78 bps. The dual implications are obvious – investors expect more rate hikes and inflation to remain benign. On the second point, we feel the secular forces leaning against inflation – demographics, technology, deregulation, disruptive business models – are capable of offsetting tightening labor markets. On the first and more important point for our strategies, the Fed is undoubtedly going to raise rates from current levels but the ultimate number of hikes is increasingly uncertain.

On the June 13th Dot Plot, the Fed projected two additional rate hikes in 2018 (we agree and look for moves at the September 26th and December 19th meetings) and three more in 2019 (we'll take the under). Why the under? First, we believe inflation will not reach levels warranting a 3.00% - 3.25% target funds rate. Second, the Fed's rate hikes have begun to bite into emerging markets, reflected by the 16% and 20% declines from the 2018 highs in the JP Morgan Emerging Markets Currency Index and MSCI Emerging Markets Index (equity), respectively. More aggressive tightening would expose vulnerable borrowers in emerging countries, which would likely roil global markets (witness recent events in Turkey), organically tightening financial conditions and abrogating the need for further Fed tightening. Finally, despite some public comments to the contrary, we feel Fed officials would be concerned if the yield curve inverts. Steepening the curve would require either pushing long rates up by raising inflationary expectations or keeping short rates low – both of which can be achieved through reduced tightening.

Our market outlook for two more 2018 rate hikes argues for short to benchmark duration positioning and a focus on securities at the front end of the yield curve. The investment rationale for this strategy is direct – reduced interest rate sensitivity and the ability to more rapidly re-invest portfolio proceeds into expected higher-yielding securities. There is also solid risk management support for our strategy:

1) Portfolios would be better positioned for more aggressive Fed action and a steeper yield curve should inflation begin to accelerate.

2) The opportunity cost of a short duration strategy is relatively low due to the flatness of the yield curve.

3) While a short duration strategy would be detrimental to performance should the economic outlook turn unexpectedly worse and / or there is a major financial market disruption, we view these risks as lower probability events in the near term.

Despite the President's protests, the Fed will almost certainly meet our expectations and raise rates at the September 26th meeting. Will President Trump chide Chairman Powell for doing so? Probably. Will it help his case? Probably not. Which may be beside the point, as President Trump seems happy to openly cast the Fed as the villain should the economy falter. "Not thrilled" may be just the beginning.

Jim Palmer will be speaking at the 2018 Association for Financial Professionals Conference in Chicago, Illinois. For those planning to attend, we encourage you to sit in on his session titled "Repositioning for Rising Rates" on Tuesday, November 6th from 2-3 p.m. in Room W176. Hope to see you there!

Sources:

Bloomberg

Bloomberg, "Trump complains about Powell's Rate Hikes to Hamptons Donors," August 20, 2018

Federal Reserve, FOMC statement, August 1, 2018

Federal Reserve, FOMC statement, June 13, 2018

Reuter's, "Exclusive: Trump demands Fed help on economy, complains about interest rates," August 20, 2018

Investopedia

usbancorp Asset Management, Inc.