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Economic Update

June 2017

Preview of June 2017 Fed Meeting

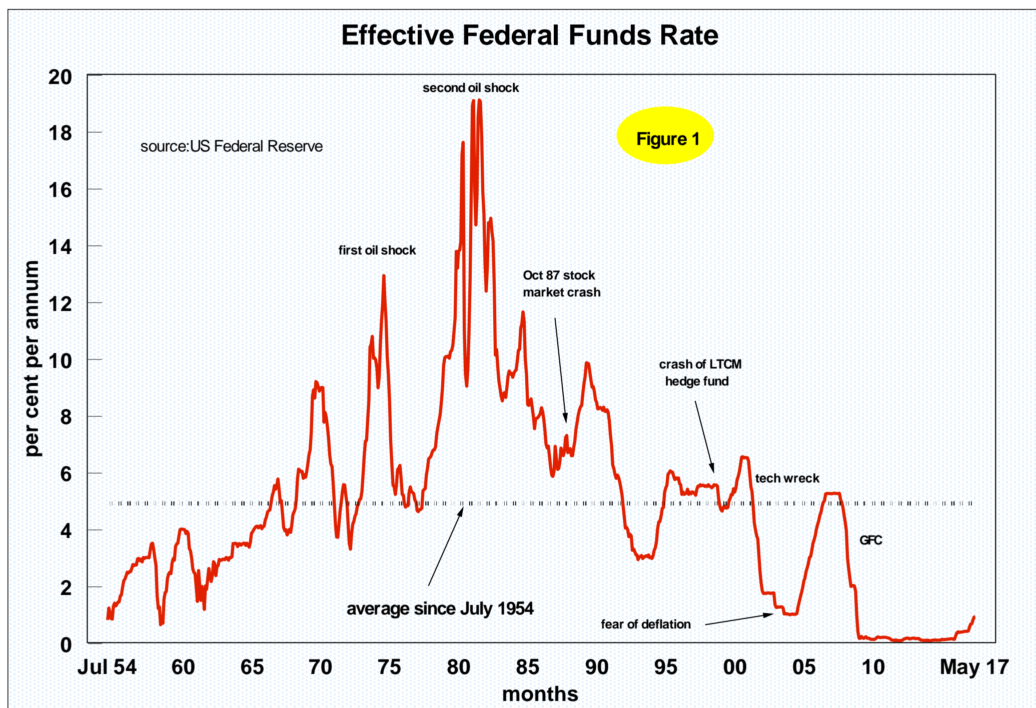
The Federal Open Market Committee (FOMC) of the US federal Reserve (the Fed) meets next week (the 14th and 15th of June) - although the latter is the key date, because the Fed will announce whether it has raised the federal funds rate (the US equivalent of the RBA's cash rate target) at the end of the meeting.

At every second meeting of the FOMC, the US central bank issues a "Summary of Economic Projections" (SEP), while the chair also fronts a press conference. The next meeting is one of the 'big ones'.

The FOMC currently has 17 members, 10 of which vote at each meeting. But the SEP issued after each second meeting is based on the forecasts of all 17 members of the committee (the FOMC17), not just those who vote at the meetings. Indeed, each member's forecasts are published, albeit anonymously.

The bit of the SEP that is interrogated by financial markets to within a nanometre of its life is the so-called 'dot points' summary of what the FOMC thinks is the most likely level of the funds rate at the end of not only this year, but 2018 and 2019 and in the "longer-run" to boot.

As at the last meeting incorporating an SEP (March) the median projections of the 17 FOMC members for the funds rate at the end of 2017, 2018 and 2019 were 1.4% pa, 2.1% pa and 3.0% pa respectively, the latter of which was also the median projection of the "longer-run" funds rate. If indeed 3 per cent is where the funds rate settles at, that would compare to an average effective federal funds rate of 5.4% pa since 1960, although since 2009, when US monetary policy has been exceptionally loose in the wake of the GFC, it has averaged just 0.19% pa (Figure 1).



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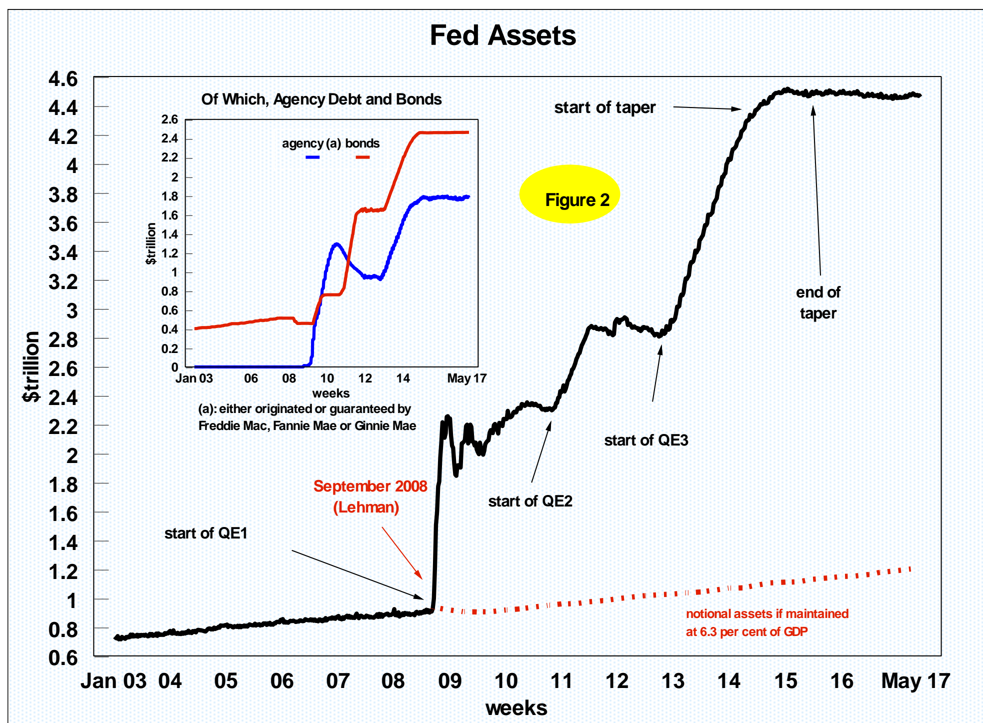
The funds rate target was lowered to its so-called ‘zero lower bound’ of between 0 and 0.25% pa on the 16th of December 2008, when it became apparent that the fallout of the collapse of Lehman Brothers three months earlier was likely to push the US economy into recession - although the Fed did not put it in as many central bank words.

In 2009, the US, in concert with most other advanced economies - Australia being one of the notable exceptions - duly plunged into its deepest recession since the 1930s. So not only was the funds rate target lowered as far as it could be, it was left at the zero lower bound until December 2015, when it was finally raised to the heady level of 0.25% pa to 0.5% pa. And even then, it stayed at that level for a full year, until it was lifted to a range of 0.5 to 0.75%. And then once more only, in March this year, to its current rate of 0.75% to 1.0% pa.

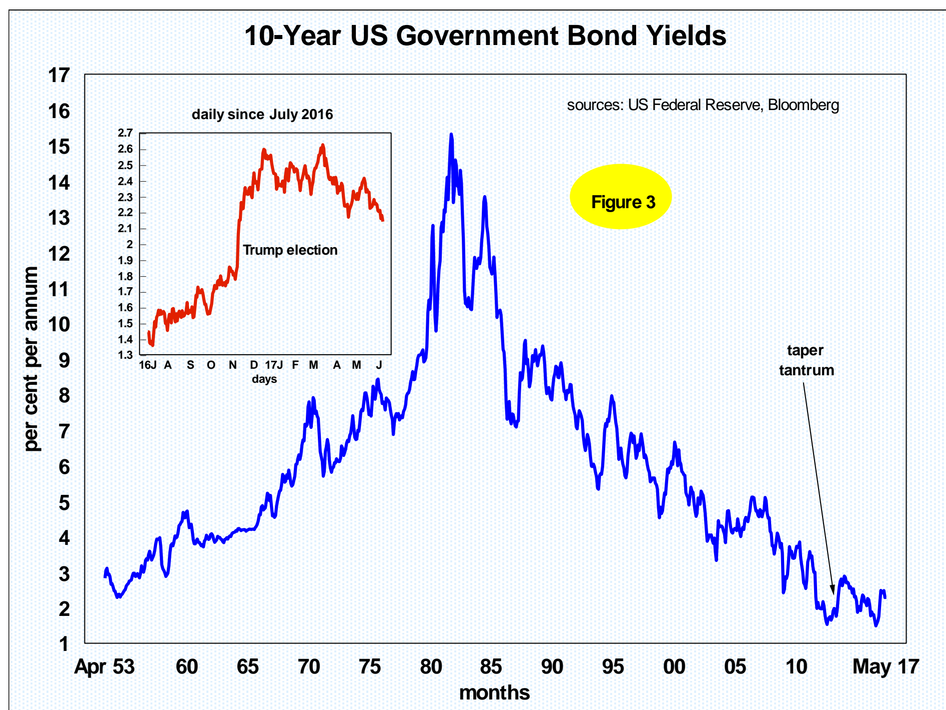
In the seven years that the funds rate target was 0 to 0.25% pa, the actual effective funds rate averaged 0.13% pa - exceptionally loose monetary policy in any language. But wait, there’s more. The Fed had realised, within days, if not hours or even minutes of the collapse of the once venerable New York investment bank in the middle of September of 2008 that conventional monetary policy - ie pushing the funds rate down to its zero lower bound - was not going to be enough. So it started to deploy unconventional monetary policy in the form of quantitative easing (QE), also within days of the collapse of the investment bank that had most assiduously manufactured and marketed the synthetic financial instruments that lost ‘value’ precipitously when the credit crunch, which had erupted in late July 2007, turned into the GFC.

Since QE commenced, the Fed has created around $3.2 trillion extra US dollars than it would have in the absence of QE and used the money to purchase and park on its balance sheet (Figure 2) around $1.4 trillion of US government bonds and exactly $1.8 trillion of debt either issued or guaranteed by the housing agency behemoths, Freddie Mac and the Mae sisters, Fannie and Ginnie (henceforth referred to as agency debt).



The Fed knew that Uncle Sam was going to need to issue lots of bonds to finance the fiscal stimulus needed to supplement easy monetary policy, while the collateral of the housing agencies' debt was getting hammered by the collapse of American houses, which would fall by 33 per cent peak to trough - in fact they are still 7 per cent below their April 2006 historical peak. The key aim of QE was to prop up the price of (meaning lower the yield on) the government bonds and agency debt in the aftermath of the GFC.

Assessment of the success of QE in holding down US government bond yields crucially rests on guesstimating what would have happened to them had the Fed not implemented QE - effectively meaning we will never know, any more than we will ever know if preventative Y2K action was really needed, or for that matter whether the deep recession of 2009 in most advanced economies would have worsened into the great depression of the 2010s had massive fiscal and monetary stimulus not been deployed. But there is no doubt that yields have indeed been exceptionally low since QE started (Figure 3) - yields on 10-year US government bonds have averaged just 2.48% pa since the start of 2009, dipping as low as 1.49% pa on a monthly average basis in July last year.



By April 2013, the Fed had purchased about $870 billion of bonds over and above what they would have in the absence of QE, and $1.1 trillion of agency debt, and was purchasing a net new total of $45 billion of bonds, and $40 billion of agency debt each month (ie a total of $85 billion of net asset purchases each and every month). The statement following its meeting that concluded on the 1st of May of 2013 included the seemingly innocuous addition of the following text compared to its previous meeting:

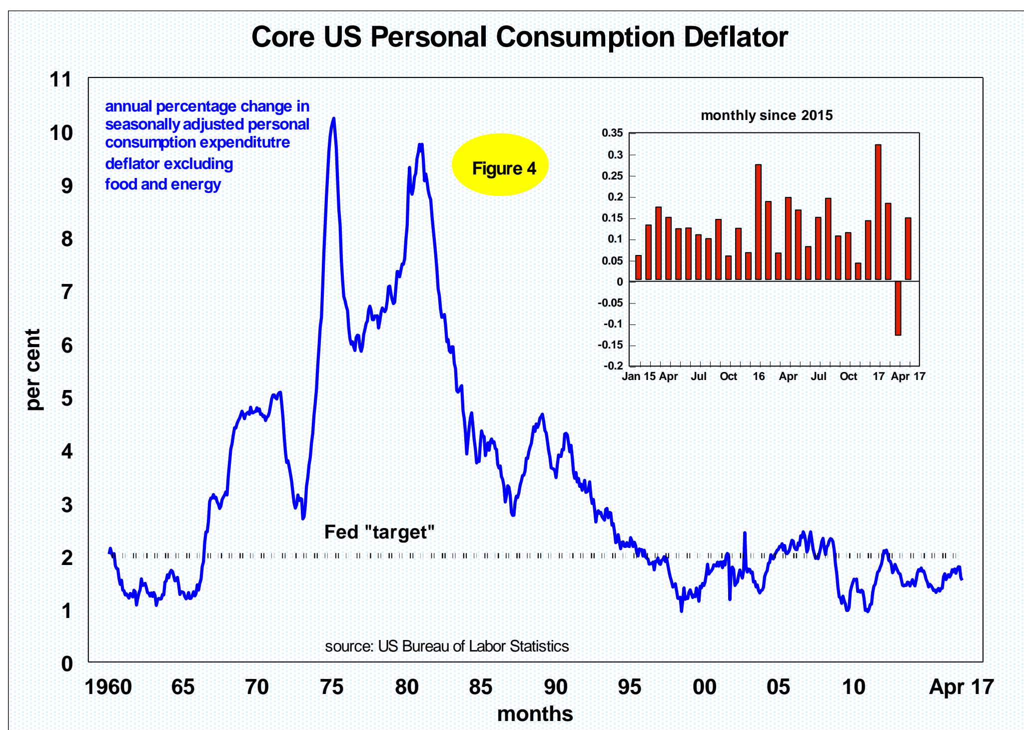
> "The Committee is prepared to increase or reduce the pace of its purchases to maintain appropriate policy accommodation as the outlook for the labor market or inflation changes".

Despite the Fed putting no greater emphasis on its preparedness to decrease asset purchases that it placed on the possibility of increasing them, the bond market placed significantly greater relevance to the 'decrease' option. So the infamous 'taper tantrum' started on May Day 2013. Yields on 10-year US government bonds rose from a monthly average of 1.75% pa in April 2013, to 1.92% in May, 2.3% in June, to a peak of 2.81% pa in September. A jump of more than 100 basis points at such low yields was a significant erosion of the value of the stock of longer-dated US bonds.

Stunned by the severity of the global bond market sell-off, the Fed had to back away from its taper rhetoric in September 2013, which duly arrested the taper tantrum. But the Fed was not able to commence the taper until December 2013. And even then, its force was hardly savage - from $85 billion a month of net purchases, to $75 billion. The pace of the taper was progressively increased (ie net purchases each month were reduced), until the end of net purchases was announced in late October 2014.

But ever since net purchases ended, the Fed has been replacing bonds and agency debt as they mature with assets of similar duration, such that the absolute size of its balance sheet remains at its elevated QE level, although expressed as a share of GDP it is retreating slowly.

As long as the Fed's preferred measure of inflation (Figure 4) remains below the its own 2 per cent target, the Fed does not necessarily have to run down its balance sheet quickly, but as and when the risk of inflation staying too low for too long dissipates - assuming it does - the Fed will want and need to absorb some of the $3 trillion plus of new money it has created since Lehman Brothers collapsed.

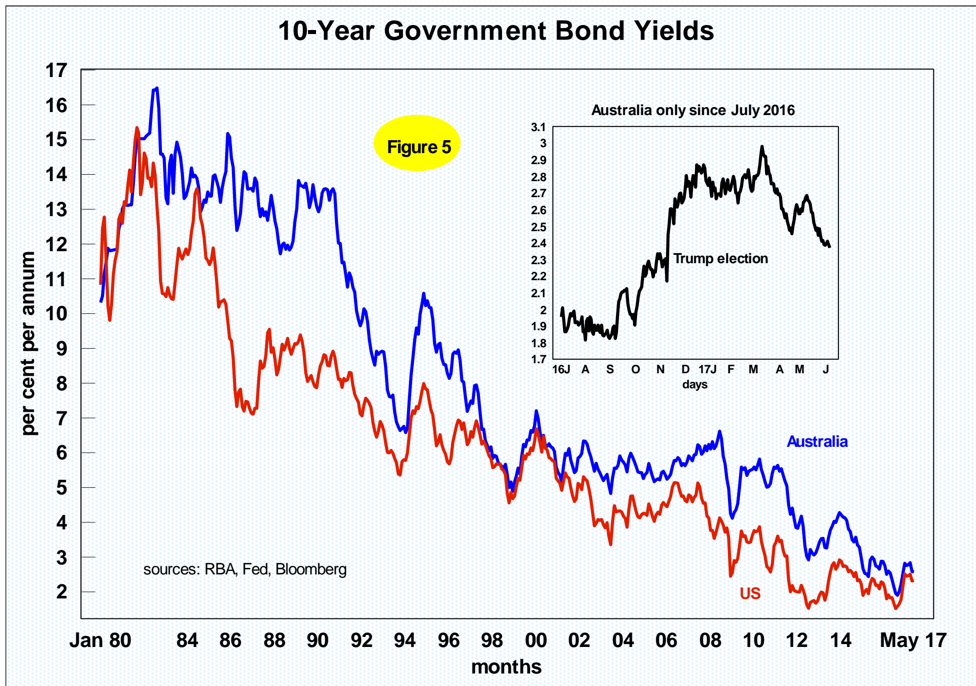


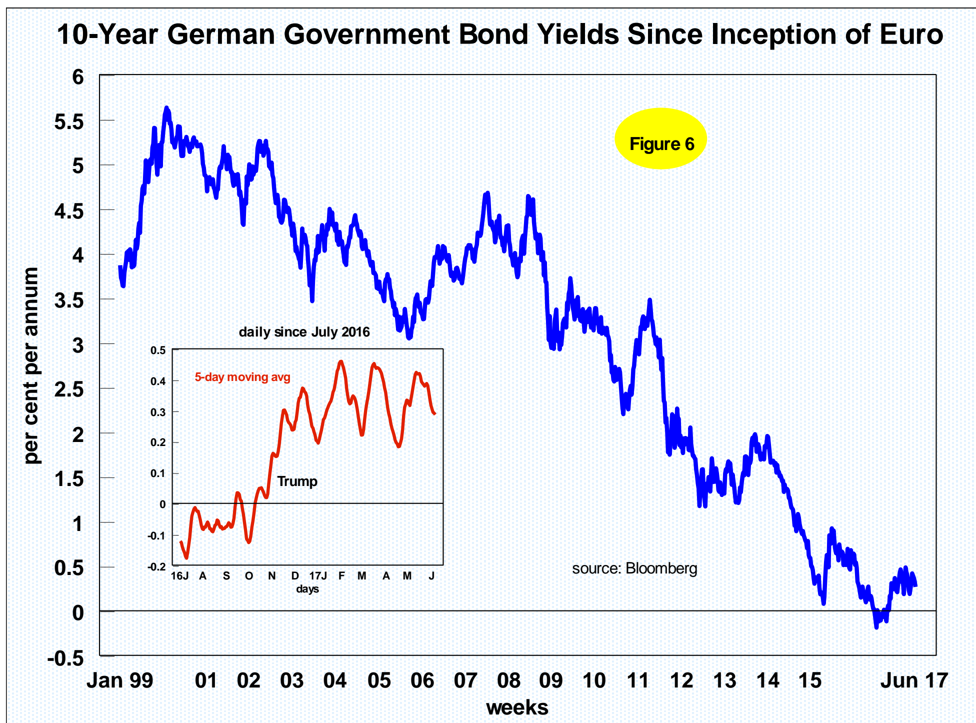
Ever since Australia's inflation rate re-converged with US inflation in the early 1990s, the broad trajectory of local bond yields has followed that of US bonds closely (Figure 5), even during the QE era, despite the RBA not having to resort to unconventional monetary policy. So just as the steep rise in US bond yields between October 1993 and November 1994 was mirrored in an even steeper basis point increase down under, so too the Australian bond market was not insulated from the taper tantrum almost 20 years later.

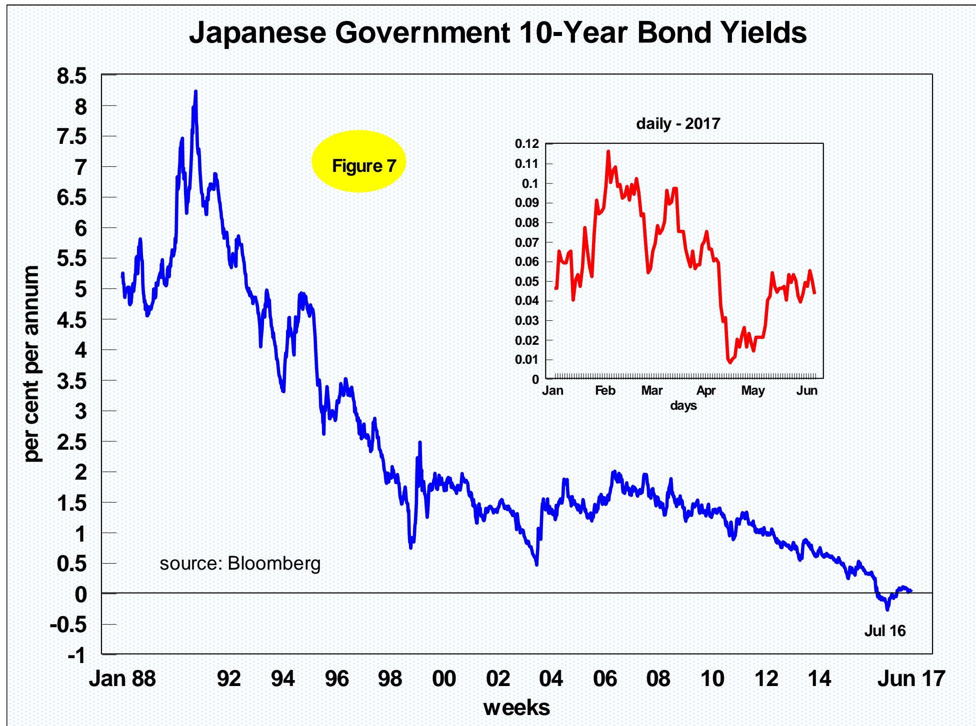
Similarly, unless the Australian economy grows at a much slower clip that its US counterpart as and when the Fed starts to run down its balance sheet, the Australian bond market is very unlikely to be able to withstand a steep rise in US bond yields if inflation stateside starts to gather a head of steam.

And true to form, when US bond yields rose steeply within a day of the outcome of the US presidential election last November, so too did local yields.

And if it did nothing else, the election of the unelectable candidate extinguished the risk of German bond yields dipping back below zero (Figure 6) and even propelled Japanese bond yields above zero within a couple of days (Figure 7).


10-Year Government Bond Yields
Figure 5
Australia only since July 2016
Trump election
days
Australia
US
sources: RBA, Fed, Bloomberg
per cent per annum
Jan 80
84 86 88 90 92 94 96 98 00 02 04 06 08 10 12 14
May 17
months


10-Year German Government Bond Yields Since Inception of Euro
Figure 6
daily since July 2016
5-day moving avg
Trump
days
source: Bloomberg
per cent per annum
Jan 99
01 02 03 04 05 06 07 08 09 10 11 12 13 14 15
Jun 17
weeks



The jump in global bond yields immediately following the US election was based on the idea that likely fiscal stimulus and tax cuts in the world's largest economy would unleash inflation and require a steep and substantial, rather than gradual and modest increase in US bond yields - in turn because it was assumed that the Fed would be forced to tighten both conventional (the funds rate) and unconventional (QE) monetary policy aggressively. And the so-called 'bond market vigilantes' were never going to wait for inflation top breach 2 per cent, they were always going to sell first and ask questions later.

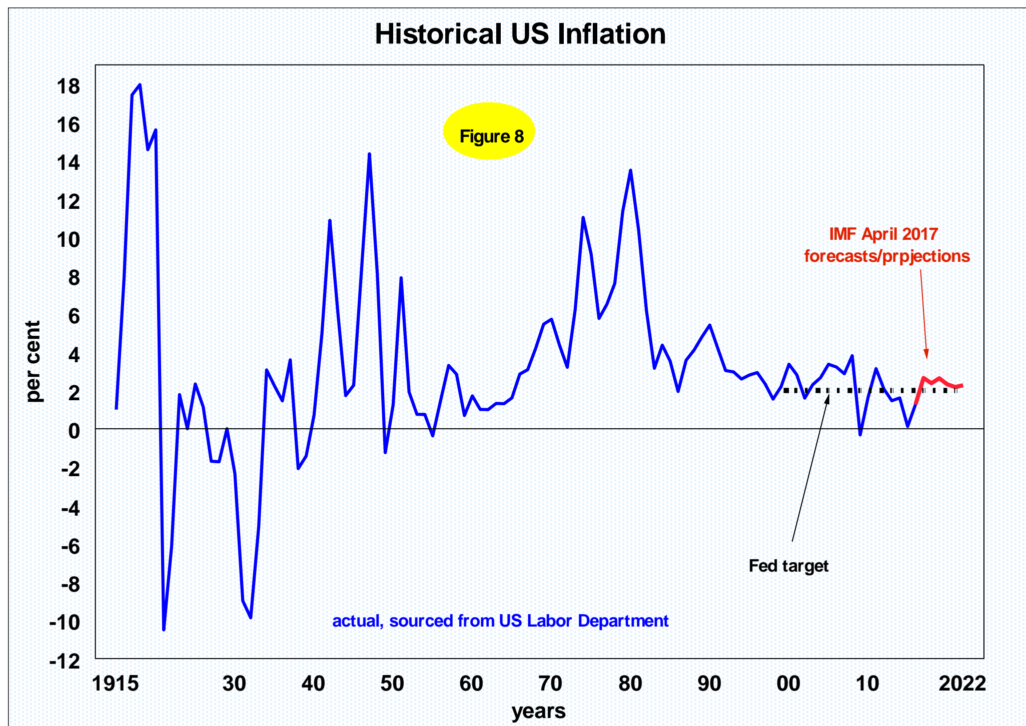
But fiscal stimulus and tax cuts in the US cannot be enacted by executive order, so as the political realities facing the newish Trump administration has hit home, bond yields have retreated, although at 2.16% pa, 10-year US government bond yields remain around 40 basis points above what they were at the start of November of last year, and well above the 1.36% pa they dipped as low as in early July 2016.

Apart from prospective fiscal stimulus - which, even if it were carefully targeted, is likely to require the issuance of more bonds by Uncle Sam, pushing down their price (ie raising their yields) - the Trump administration's 'America first' manifesto, including its open hostility to existing and prospective trade liberalisation agreements, poses a significant upside risk to US inflation - unless constriction of trade agreements worsens to outright suffocation of actual trade flows, in which case upside inflation risk will be the least of anyone's worries.

Although suppression of bond yields was the chief primary aim of QE in the US, the Dow's monthly average value had already shed 33 per cent of its value by the end of 2008, en-route to what would be a 44 per cent peak to trough decline by the time global equity markets found their floor in March 2009. Stemming the bleeding of equity markets was a key collateral aim of QE, and continues to overhang the Fed's deliberations each time it meets to map out the next phase of the journey back to 'normal' US interest rates - whatever that might mean in the post-GFC era.

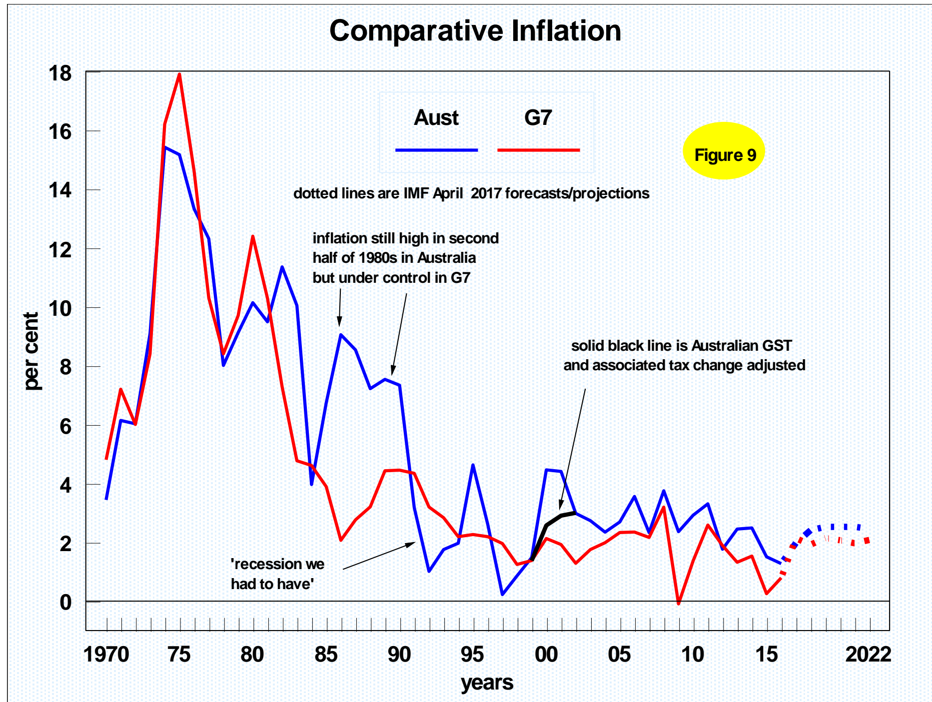
The FOMC17's March estimate of a 3 per cent "longer-run" funds rate is as good a starting point in the search for the normal level of interest rates as any, although that doesn't necessarily help that much for estimating what the normal yield on longer-term interest rates might be. The US bond market's theory that as and when the Fed starts to run down its balance sheet it will not need to be so forceful in raising the funds rate has some merit as long as inflation only breaches the Fed's 2 per cent target briefly and by just a bit. But the winding back of trade liberalisation, coupled with possible untargeted fiscal stimulus and tax cuts that rely on overly optimistic US economic growth assumptions collectively pose legitimate medium to longer-term upside US inflation risk - although as recently as April of this year, the IMF was projecting US inflation to remain well and truly compatible with a modest rise in US interest rates in coming years (Figure 8).

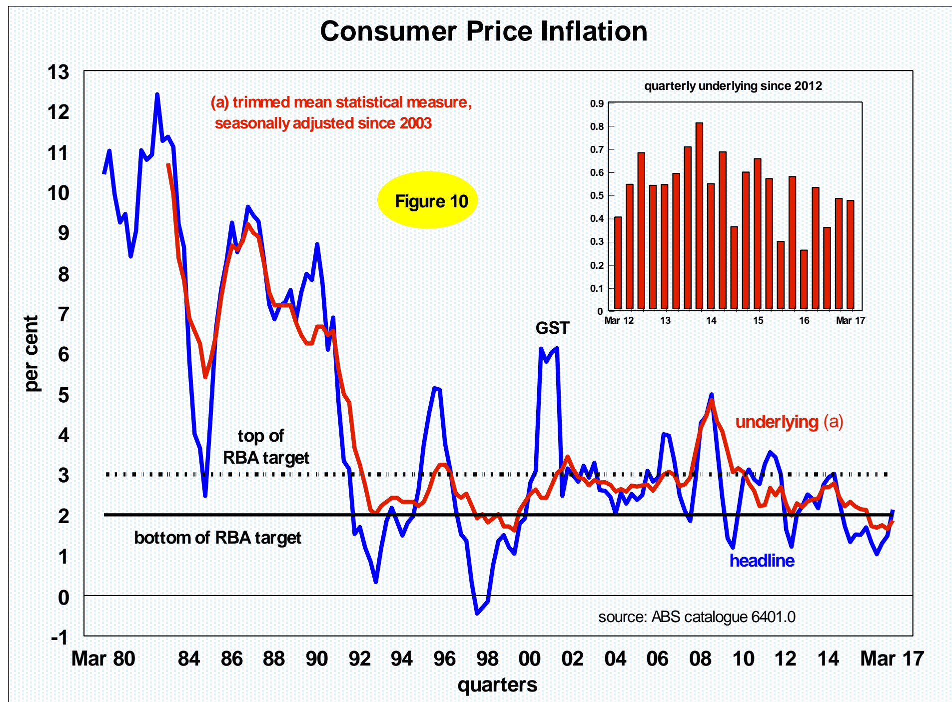
Nevertheless, after such a long period of unequivocally abnormally low interest rates, it would hardly be surprising if the Fed had to keep them a bit above normal for a while at some stage in the next few years to limit the extent and duration of the breach of its 2 per cent inflation target. That's not say that anything more than a brief and small breach of the target is a lay down misere in the face of technological changes that constrain workers' bargaining clout and businesses' capacity to raise prices, but rather that the forces that were suppressing inflation even before the GFC sent it dangerously low are under assault by hostility to trade liberalisation.



Australia took quite a bit longer to bring inflation to heel than most advanced economies (Figure 9), but the recession we apparently 'had to have' did the trick - although the subsequent suppression of local inflation even when the economy had recovered from its last recession a quarter of a century ago requires are more robust explanation - the trade liberalisation policies Australia unveiled during the depths of the recession of the early 1990s chief among them.

Until the most recent local inflation reading, both headline and underlying (core) inflation were below the bottom of the RBA's 2-3 per cent target range. To be sure, the core measure still is, having been so for six quarters on the trot (Figure 10). The RBA lowered the cash rate at its first opportunity after the publication of the March and June 2016 inflation reports, but left it unchanged even when the September quarter CPI was below 2 per cent on both key measures.


Comparative Inflation
Aust
G7
Figure 9
dotted lines are IMF April 2017 forecasts/projections
inflation still high in second half of 1980s in Australia but under control in G7
solid black line is Australian GST and associated tax change adjusted
'recession we had to have'
per cent
18
16
14
12
10
8
6
4
2
0
1970
75
80
85
90
95
00
05
10
15
2022
years

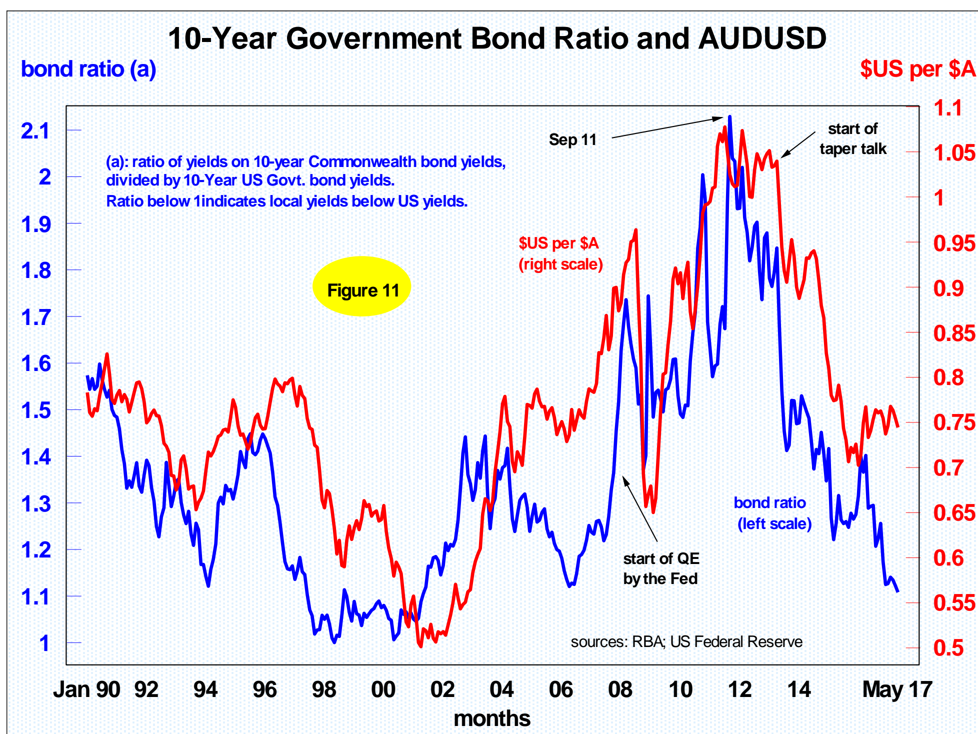

Consumer Price Inflation
(a) trimmed mean statistical measure, seasonally adjusted since 2003
Figure 10
quarterly underlying since 2012
GST
top of RBA target
bottom of RBA target
underlying (a)
headline
source: ABS catalogue 6401.0
per cent
Mar 80
84
86
88
90
92
94
96
98
00
02
04
06
08
10
12
14
Mar 17
quarters

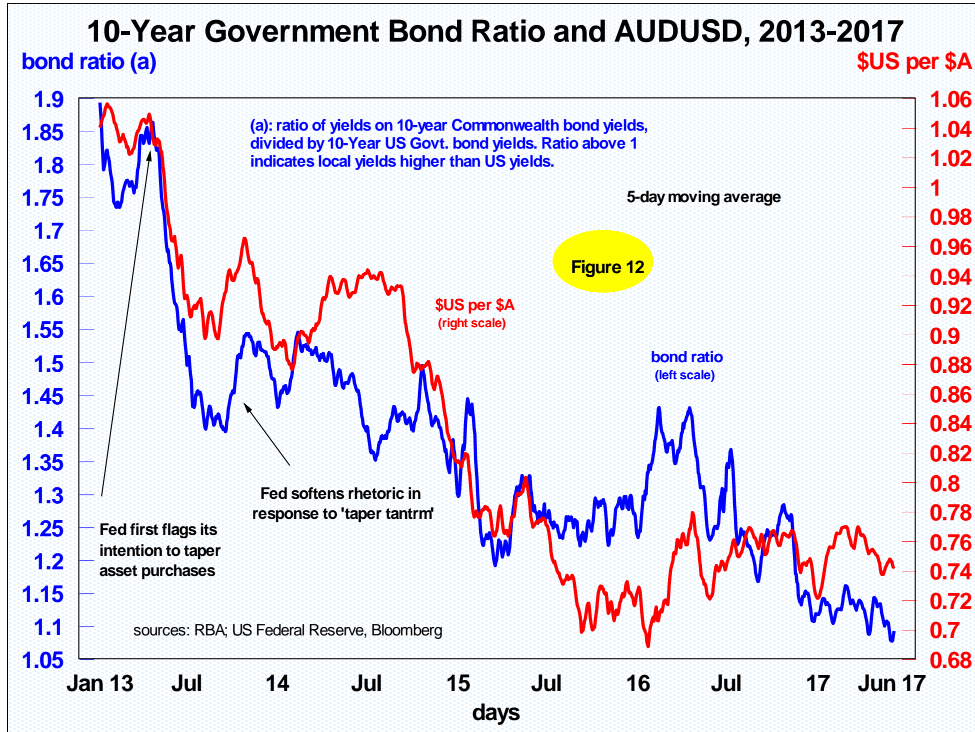
Which is where the concept of the balance of risks comes into conventional monetary policy. The RBA was lowering the cash rate aggressively in late 2008/early 2009 even though both headline and underlying inflation were more than two percentage points above the top of the target. The RBA correctly judged that downside risk to the economy far outweighed further upside risk to inflation, which would take care of itself as the economy slowed markedly in the wake of the GFC.

The balance of risks is not nearly as clear-cut now as it was in the dark weeks and months after Lehman's collapse. But unless the RBA amends its target, which is unlikely, residual downside risk of inflation falling too far and staying too low for too long was by no means fully extinguished by the March quarter CPI.

Further depreciation of the Australian dollar would do its bit to prevent inflation falling too far, just as the RBA continues to judge that appreciation of the currency conversely would "complicate" the transition of the Australian economy away from its earlier heavy reliance on the construction of major resource and energy projects.

Which is just another reason local financial markets have more than a passing interest in what the Fed does in the next few months. While local bond yields take a big lead from the US bond market, they do not move in lock step, because if they did, the differential between the two would be flat. It isn't - it never has been, and moreover is a key - arguably the most important - driver of the bilateral exchange rate between the Australian and US dollars (Figures 11 and 12).





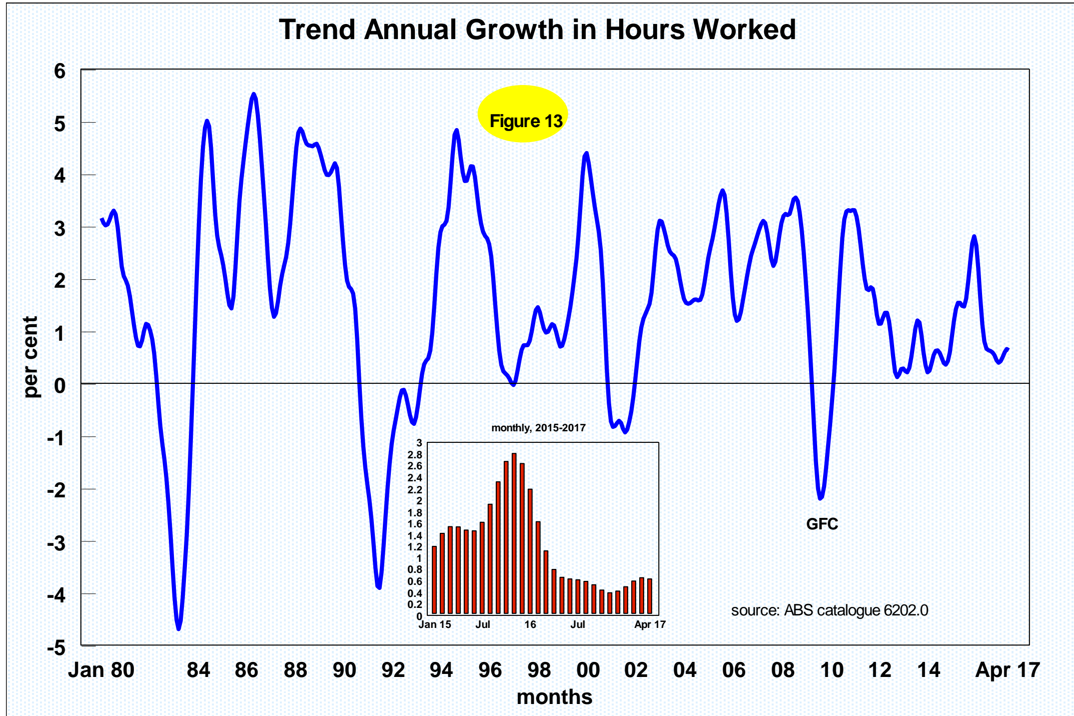
The Australian dollar peaked in July 2011, the same month the multi-currency denominated RBA index of commodity prices hit a historical peak. But until the Fed started its 'taper talk', the currency lost less than 4 per cent of its peak value, whereas commodity prices fell by 18 per cent. But in the space of just four months after the Fed first flagged that QE could, and indeed would not go on expanding indefinitely, the Australian dollar's value for the US dollar fell by 13 per cent, during which time commodity prices fell by another 9 per cent.

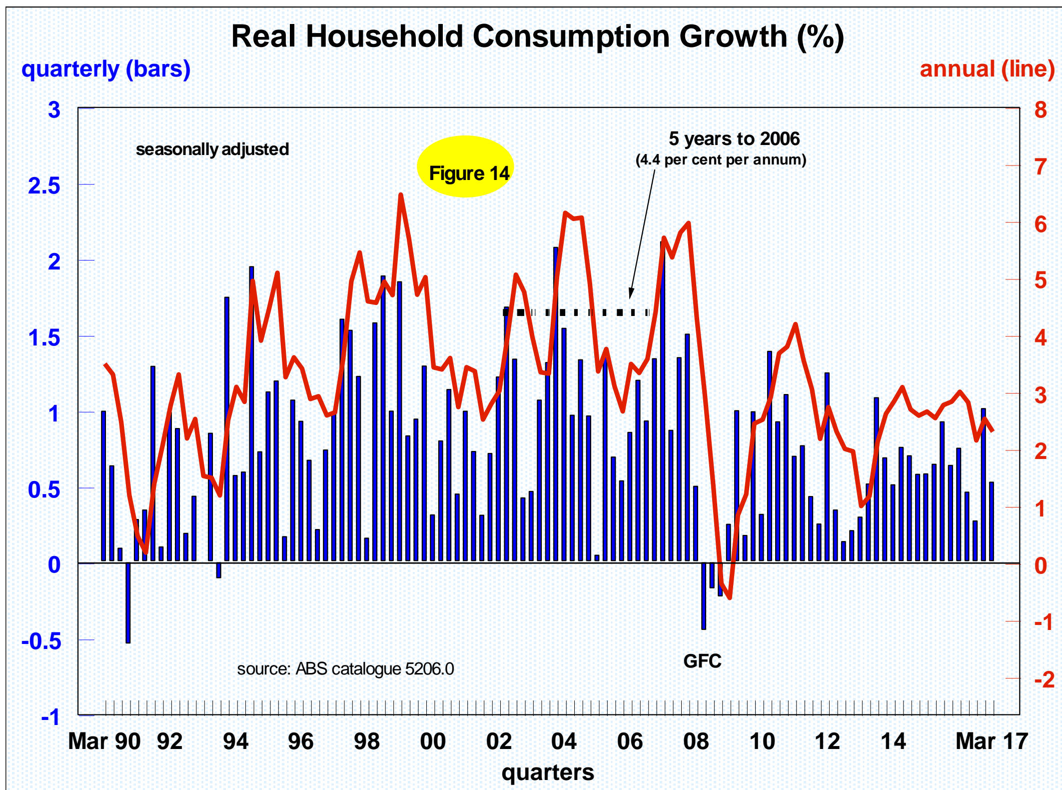
As the Fed backed away from its taper talk to sooth global bond markets, the Australian dollar regained its footing, but the recovery of the local currency gave way to another leg down two months before the Fed actually started its taper.

The bilateral exchange rate between the Australian and US dollars occasionally gets out of kilter with the trajectory of the bond ratio, but never for long. So as and when the Fed starts to wind back its balance sheet, unless the RBA has switched back to a tightening bias, the Australian dollar is more likely to fall a bit more, or at least find plenty of resistance on the upside.

There was no hint of a switch to a tightening bias in Tuesday's unchanged cash rate announcement. If anything, soft readings on total hours worked (Figure 13) and household consumption (Figure 14) make a switch back to a modest easing bias a bit more likely than a move to a tightening bias at least until the end of this year.

But neither case is as strong as the one that has the cash rate on hold until well into 2018.


Trend Annual Growth in Hours Worked
Figure 13
per cent
6
5
4
3
2
1
0
-1
-2
-3
-4
-5
monthly, 2015-2017
Jan 15
Jul
16
Jul
Apr 17
GFC
source: ABS catalogue 6202.0
Jan 80
84
86
88
90
92
94
96
98
00
02
04
06
08
10
12
14
Apr 17
months


Real Household Consumption Growth (%)
quarterly (bars)
annual (line)
seasonally adjusted
Figure 14
5 years to 2006
(4.4 per cent per annum)
GFC
source: ABS catalogue 5206.0
3
2.5
2
1.5
1
0.5
0
-0.5
-1
8
7
6
5
4
3
2
1
0
-1
-2
Mar 90
92
94
96
98
00
02
04
06
08
10
12
14
Mar 17
quarters