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Much Ado About Nothing Much

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The financial media did their best to make last week's Federal Reserve meeting seem like a big deal. Mere minutes after the Fed's Open Market Committee released its policy statement on Wednesday afternoon, the headlines started flying. It wasn't enough that the Fed raised its benchmark interest rate by 0.25%, as everyone expected; the media instead latched onto the Fed's apparently new and more hawkish economic view and policy: The economy is growing too fast, inflation is ratcheting up, and so interest rates have to be raised more quickly.

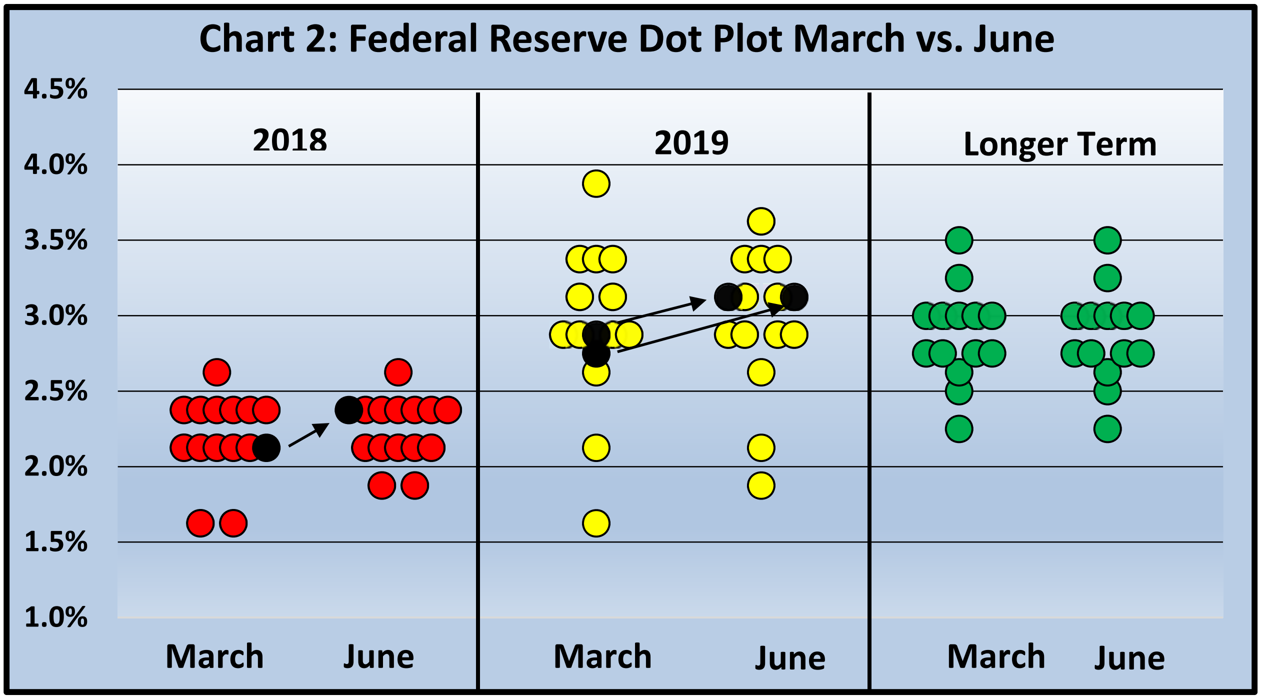
The only problem with that interpretation is that it's mostly wrong. The Fed did indeed upgrade its estimate of economic growth, but the change from its March assessment was actually very minor. Chart 1 shows the evolution:

Chart 1: Economic Assessment	March	June	Change
Gross Domestic Product Growth			
2018	+2.7%	+2.8%	+0.1%
2019	+2.4%	+2.4%	--
2020	+2.0%	+2.0%	--
Longer-Term	+1.8%	+1.8%	--
Unemployment Rate			
2018	3.8%	3.6%	-0.2%
2019	3.6%	3.5%	-0.1%
2020	3.6%	3.5%	-0.1%
Longer-Term	4.5%	4.5%	--
Core Inflation			
2018	1.9%	2.0%	+0.1%
2019	2.1%	2.1%	--
2020	2.1%	2.1%	--
Longer-Term	2.0%	2.0%	--

Source: Federal Reserve

The changes in the Fed's view over the past three months are all extremely minor, ranging from zero to just two tenths of a percentage point. The more important conclusion isn't the *change* in the Fed's view, but rather the *consistency:* In both of its assessments this year, the Fed's view is of an economy currently growing above its long-term sustainable rate, with lower unemployment and yet still modest inflation. This consistency also feeds through to the central bank's view of its expected monetary policy over the next few years, with very gradual tightening as the economy decelerates toward a more sustainable growth rate. The Fed is in a tight spot, hoping to cool off a possibly overheating labor market in the context of tame inflation and persistently low long-term bond yields.

Chart 2 shows how the Fed's thinking has evolved. This chart is the famous "dot plot", here redrawn to show how the plot has changed in the last three months. Each dot represents one Fed Governor's expectation of where the benchmark fed funds rate should be at the end of the respective year. The fed funds rate ended last year at 1.375%.



Source: Federal Reserve, Eastern Bank Wealth Management

In the left section, depicting year-end 2018 expectations, exactly one Fed Governor (highlighted as a black dot) switched from 2.125% to 2.375%. That was enough to shift the overall balance from narrowly expecting three hikes this year (to 2.125%) to expecting four hikes (to 2.375%). Similarly, the center section shows that two Governors (again in black) modestly upgraded their expectations for 2019, pulling the median guess from 2.875% to 3.125% (three hikes); note that this still implies three 2019 hikes, as it did in March, albeit from a slightly higher starting point.

The most interesting part of Chart 2 is the right section, showing that the Fed's longer-run expectations are completely unchanged – and that they are slightly lower than their current guess for 2019 rates. This is consistent with the data in Chart 1, in which the Fed's long-term economic expectations are modestly below what the bank sees for 2019. The *changes* highlighted by the media are far less important than the *consistency* the bank has shown.

The key to understanding the Fed remains former Chair Ben Bernanke's famous phrase, "data dependent." Today, inflation is tame but the labor market arguably is getting too hot. Modest tightening is appropriate, but only with care not to invert the yield curve – and that's why Europe's persistently low long-term bond yields have constrained any Fed impulse to tighten too quickly. If Europe's developing anemia or rising commodities prices cause our economy to slow down a bit, we shouldn't be surprised to see a Governor or two downshift at a future Fed Open Market Committee meeting, bringing the median expectation back down to three hikes this year.

In this context, the headlines and the panting coverage on financial news cable channels amount to much ado about nothing much.[1] Markets have figured this out, too: Both stock and bond markets shrugged off the Fed's actions last week; the ongoing saga of threatened tariffs and trade war with China had a much larger effect on the markets' behavior. We think that's as it should be; a trade war could have a much larger adverse effect on the economy (and on corporate earnings) than minor and potentially reversible Fed policy shifts.

[1] Shakespeare had all this figured out four centuries ago. Don Pedro and Benedick may have thought that Balthazar's famous song in *Much Ado About Nothing* was about the fickle nature of men's passions, but it seems evident that Shakespeare meant that economists, not "men, were deceivers ever:"

> *One foot in sea and one on shore,*
> *To one thing constant never.*
> *Then sigh not so, but let them go*
> *And be you blithe and bonny,*
> *Converting all your sounds of woe*
> *Into hey, nonny nonny.*

Today, the Fed's economists are more hawkishly "in sea." Tomorrow, they may shift seaward or shoreward depending on which way the economic winds are blowing. Their "constancy" isn't toward the sea of higher rates or the shore of lower rates, but rather to the stable keel of steady economic growth and low inflation.