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Sweet and Sour Pickles

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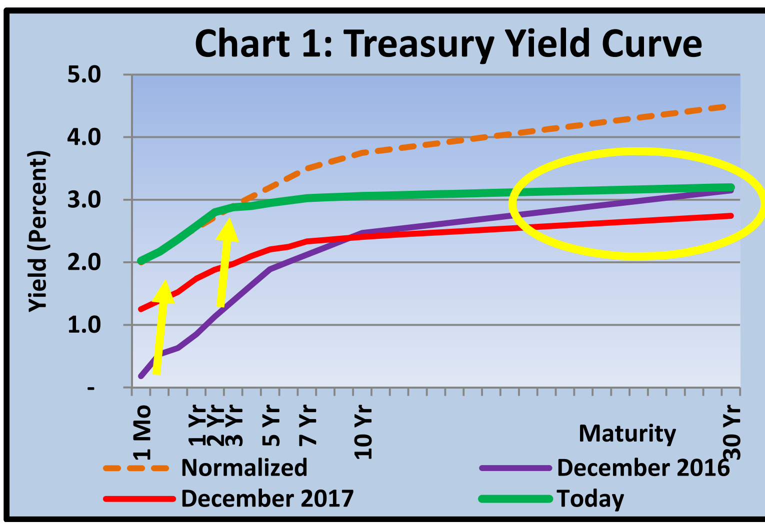
To the surprise of absolutely no one, the Federal Reserve increased its short-term interest rate by a quarter-point last week and said that its monetary policy was no longer "accommodative." Equity markets accepted the news with equally unsurprising calm, dipping a bit on Wednesday and then recovering nicely on Thursday; bond markets ticked up a tiny fraction. If the prices on Treasury futures contracts are to be believed, investors are all but certain that the same pattern of events will recur metronomically every quarter for at least the next year. The steady hum across Wall Street's trading floors seems to be the old Bobby McFerrin tune, "Don't worry, be happy."

When I read the Fed's statement last week, though, I was reminded of a different tune – Arlo Guthrie's witty rhyme, "I don't want a pickle, I just want to ride on my motorcycle."[1] Despite the Fed's show of predictability and unanimity, the central bank actually has a serious dilemma on its hands. Here's the pickle: Continuing its series of rate hikes risks inverting the yield curve and possibly causing a recession, while pausing the cycle risks an inflationary spiral in a too-hot economy. Chair Jerome Powell must ride his metaphoric motorcycle along a very thin line.

The case for continuing the rate hikes is easy to make: The economy is going great guns. The just-reported final estimate of June-quarter GDP growth was a robust 4.2%; unemployment is below 4%; weekly jobless claims are at levels not seen since 1969 (when the U.S. work force was barely half as large as it is today); wages and consumer prices are both rising at their highest rates in a decade; prices of lumber, copper, and other building materials have soared as much as 20% in the past year; tariffs may cause even further inflation in imported goods. The natural response to an overheating economy is to raise rates to cool it off a bit.

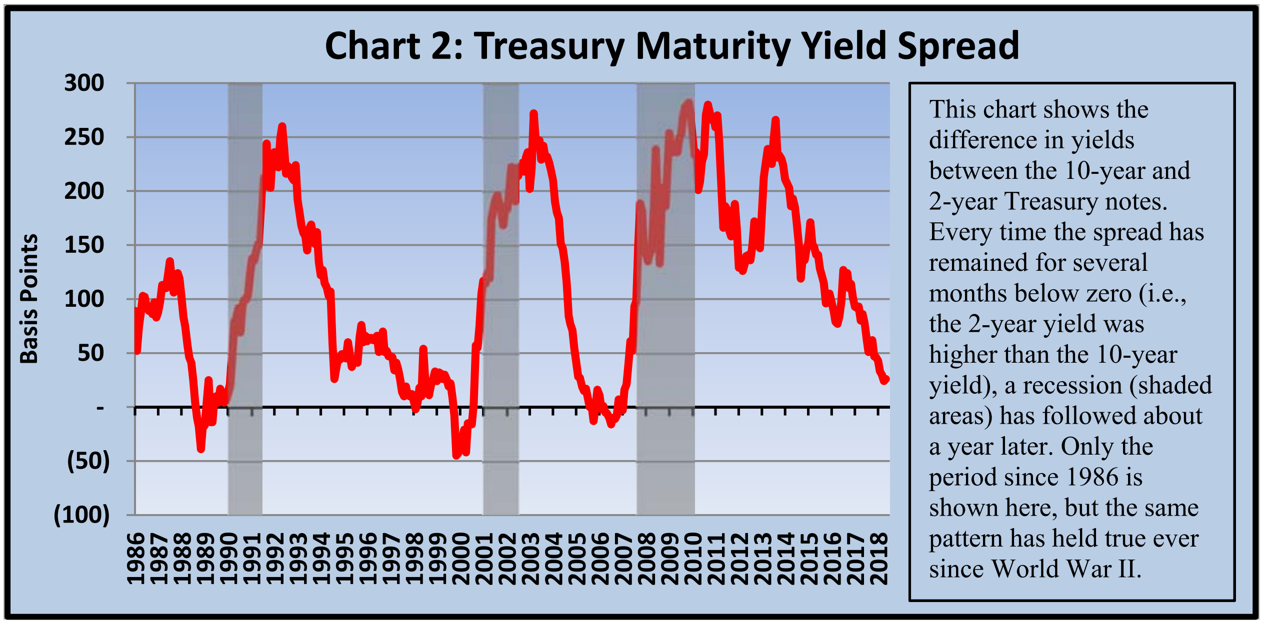


The effects of the Fed's series of rate hikes have been felt entirely at the short-term end of the yield curve (yellow arrows). At the long-term end of the curve (yellow oval), yields have been stuck around 3% for two years. Note that the yield curve has had a *positive* slope, but it is flatter today (green) than in 2017 (red) or 2016 (purple). An "inverted" curve would have a *negative* slope. The dotted orange line suggests what yields might be, absent competition from low-yielding foreign bonds.

Source: FactSet

[1] For readers too young to remember the tune, I can attest that the couplet really does rhyme. Find it on YouTube.

Then again, the case to pause or end the rate cycle is also fairly straightforward: The yield curve is nearly flat and may invert (see Charts 1 & 2); ballooning federal debt means that future government deficits will become a meaningful drag on economic growth; GDP growth will almost certainly slow as a result of tariffs; and the housing market has already shown signs of peaking. Any of these signals could point toward a recession and the need to cut rates, not raise them.

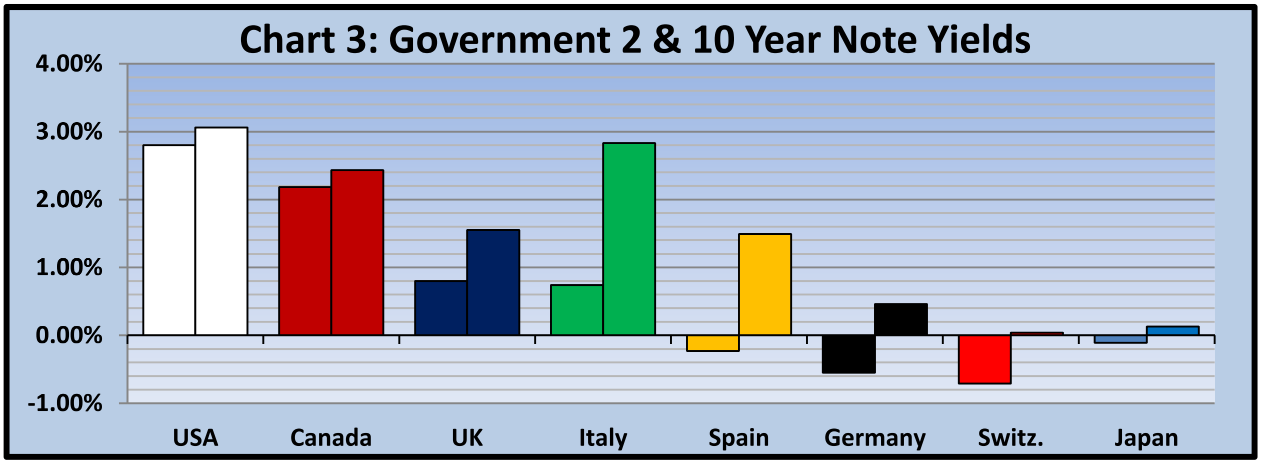


Source: FactSet

The Fed's pickle is therefore one of the half-sweet, half-sour variety. In a Goldilocks economy in which the meaningful data metrics are neither too hot nor too cold, should the Fed err to caution or to stimulus? To answer the question, it might be worth considering two oddities in the charts above.

First, Chart 1 shows that long-term bond yields have been stuck at around 3% for the past two years, despite steadily rising inflation and increasingly rosy economic projections. Normally, inflation and robust GDP growth are associated with a steeper yield curve, as long-term bond investors demand higher interest rates to protect themselves against the erosion of their purchasing power. Why haven't long-term yields risen along with short-term yields? In other words, why has the slope of the yield curve flattened rather than stayed steep (as it was in 2016) but at higher levels?

Many factors may be underlying the flattening of the yield curve over the past two years, but one of the most important is the broader context in which global bond investors operate. Long-term bond yields are set by the market, not by the Fed, and investors can choose among sovereign debt issued by dozens of nations. In considering whether to buy debt issued by the U.S. Treasury, Britain's Chancellor of the Exchequer, or their counterparts in Canada, Switzerland, Japan, or any other country, investors consider both price (yield) and quality (default or downgrade risk). Chart 3 shows a representative sample of government bond yields.



Source: FactSet

Each of the pairs of columns in Chart 3 shows the yield on 2-year (left) and 10-year (right) government bonds for the countries shown. Looking at the right side of each pair, it's evident that the yield on 10-year U.S. Treasury debt is higher than the comparable yield for any other country in the chart; the only country whose yield even comes close is Italy, and it's plainly evident that the United States is a far safer borrower than Italy is – our economy is more diverse and growing faster, our political institutions are more stable, and we control our own currency. For countries whose economies are more like ours, the yields on long-term debt are much lower – in fact, near zero in the cases of Japan and Switzerland.

How is it possible that long-term U.S. debt is both safer and cheaper than any other major sovereign debt? The U.S. navigated its way out of the 2009 recession more deftly and quickly than any other nation did, and we are now two years into a rate-hike cycle as our economy runs hot. Conversely, European governments bungled their economic policies in the 2009-2013 period, their economies are still struggling, and their central banks are still far behind the Fed. While the Fed stopped its bond-buying program two years ago, the European Central Bank is only now planning to ease out of its corresponding program late this year, and the Bank of Japan has said it has no end in sight. In other words, central bank intervention in long-term bond markets worldwide has kept yields artificially low in other countries. Global bond investors thus find U.S. Treasury debt comparatively alluring.

Turning back to Chart 1, the dotted orange line suggests that the Treasury yield curve might be much steeper today were it not for the effects of foreign central bank bond purchase programs. The Fed recognizes this, of course, and its economists also recognize that the effects may dissipate as the ECB gradually ends its bond-buying program.[2] As other central bank policies eventually turn less accommodative, the Fed is hoping that our yield curve may shift closer to that orange line.

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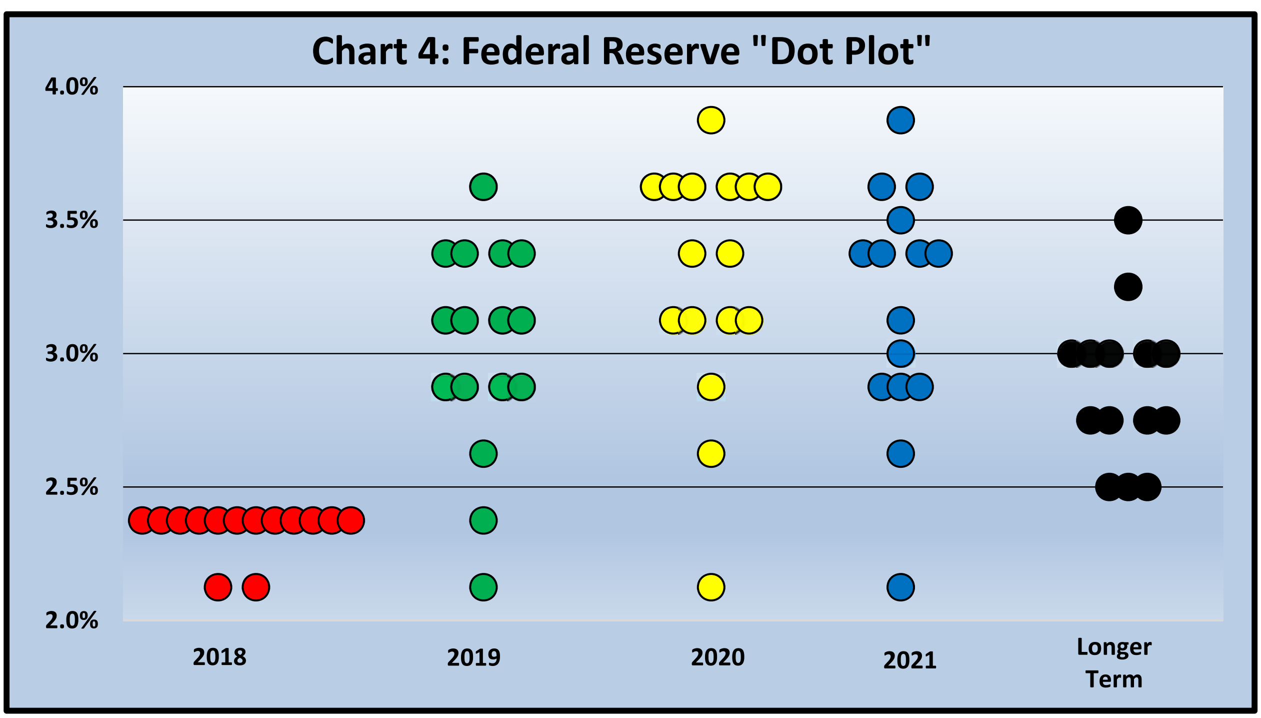
[2] It's also true that foreign investors often want to hedge their currency exposure; because the U.S. is two years into a tightening cycle while monetary policy elsewhere is still extremely loose (as seen in the left-hand columns of Chart 3), hedging costs are fairly high for foreign investors. That may further dilute the appeal of U.S. vis-à-vis foreign debt. For these reasons, some economists believe that long-term U.S. rates may drift higher as the Fed continues raising short-term rates, averting the possibility of a yield curve inversion.

The second oddity is revealed by a close look at Chart 2. Note that the yield curve inverted briefly in 1998, but that no recession followed. Asian currencies collapsed in late 1997, leading to a crisis of confidence in global bond markets. One large and very highly leveraged hedge fund, Long Term Capital Management, was so badly wrong in its positioning that its impending failure could have destabilized the global monetary system. Panicked investors piled into Treasury debt for safety, which inverted the yield curve despite healthy economic conditions and a rising-rate cycle here in the United States. The Fed was brilliant in its response to this crisis, sharply reversing course to cut short-term rates and bail out LTCM. As markets realized that the crisis had passed, the Fed returned to its rate-hike cycle and bond trading normalized again. It wasn't until the dot-com bubble a couple of years later that a more sustained yield curve inversion preceded a recession.

The lesson from 1998 is that the mere existence of a yield curve inversion is not a sufficient reason to expect an imminent recession. The Fed acted decisively and quickly when conditions merited. The same may be true today: If the macroeconomic metrics suddenly stall because interest rates rose too far too quickly, the Fed's "data-driven" philosophy gives it latitude to reverse course quickly. In this respect, it's noteworthy that in a recent speech Chair Powell conspicuously used the phrase "for now" in describing the Fed's steady rate hike policy; he is all too aware that circumstances may change, so he is consciously stepping away from the bank's recent practice of "forward guidance." The Fed's economists know they can't predict the future much better than we can, so they are giving themselves more maneuvering room.

This subtle change in philosophy is also evident in the "dot plot" that the Fed publishes every three months (Chart 4). Each dot on the chart shows where one Fed governor thinks the overnight fed funds rate will be at the end of each year shown.



Source: Federal Reserve

The most immediate inference from the dot plot is that the Fed's governors are nearly unanimous in thinking that the fed funds rate will end this year at 2.375%, which implies a fourth 2018 hike in December. That's not news, and bond markets have long ago reflected this near-certainty. The patterns for 2019 through 2021 and for the longer term are much more interesting and important.

Starting at the far right of Chart 4, the Fed's governors clearly have not reached a consensus as to what the longer-term rate should be. They consider this number to be the "neutral" level at which monetary policy is neither "accommodative" nor "restrictive." The figure appears to be settling in the 2.5% to 3.0% range, which is well below the long-term historical average; that's why it's noteworthy that the Fed no longer considers current monetary policy to be "accommodative." The Fed seems to be acknowledging that our demographics have changed, and that an aging society is no longer capable of the GDP growth seen in the post-WWII era. Lower long-term interest rates suggest that investors need to shift more of their assets to equities and that future cash flows will need to come increasingly from price appreciation, not just bond coupons.

The intermediate columns in Chart 4 are also instructive. Most obviously, no consensus exists; in fact, it's almost comical how disparate the various governors' guesses are, ranging from 2% to 4% for the imminent future. This is a healthy sign that the governors are engaging in active discussion and are open-minded as they form their opinions. Chair Powell is giving his colleagues ample room to develop their perspectives over time. This is the mark of a truly data-driven thought process, and of an institution that can change direction when needed.

Even without consensus, though, the Fed seems to be directionally looking for continued rate hikes in 2019 but not beyond that; the pictures for 2019, 2020, and 2021 aren't very dissimilar. This suggests that the Fed is already considering how and when to conclude the current rate-hike cycle. We've seen eight quarter-point hikes since late 2015, and the middle columns of Chart 4 suggest that we may get only another handful before the Fed stops. In its totality, a dozen hikes spread over five years, starting from an exceptionally low base, is a far less severe rate cycle than the 17 consecutive hikes imposed from a higher base by the Greenspan Fed in the 2000s.

Half-sour or half-sweet? The Fed's pickle is both, and Chair Powell appears to have found a way to ride his metaphorical motorcycle out of the dilemma. By indicating that rates will continue rising for a while, at least, he is suggesting that the Fed won't let the economy overheat; but by curtailing forward guidance and welcoming a broad array of opinions about the future, he is also telling investors that he won't tighten too much or invert the yield curve. It's a delicate balance, but then so too is the taste of a really good pickle.