FIRST PRINCIPLES CAPITAL MANAGEMENT

Has monetary policy become impotent?

June 2019

- Central banks in developed countries have struggled for years to create higher inflation and growth through zero to negative policy rates and Quantitative Easing (QE).
- The U.S. economy, although solid today, is projected to slow in the coming months/quarters
- The Fed no longer has sufficient ammunition to rescue the economy or the stock market ten years into the recovery.

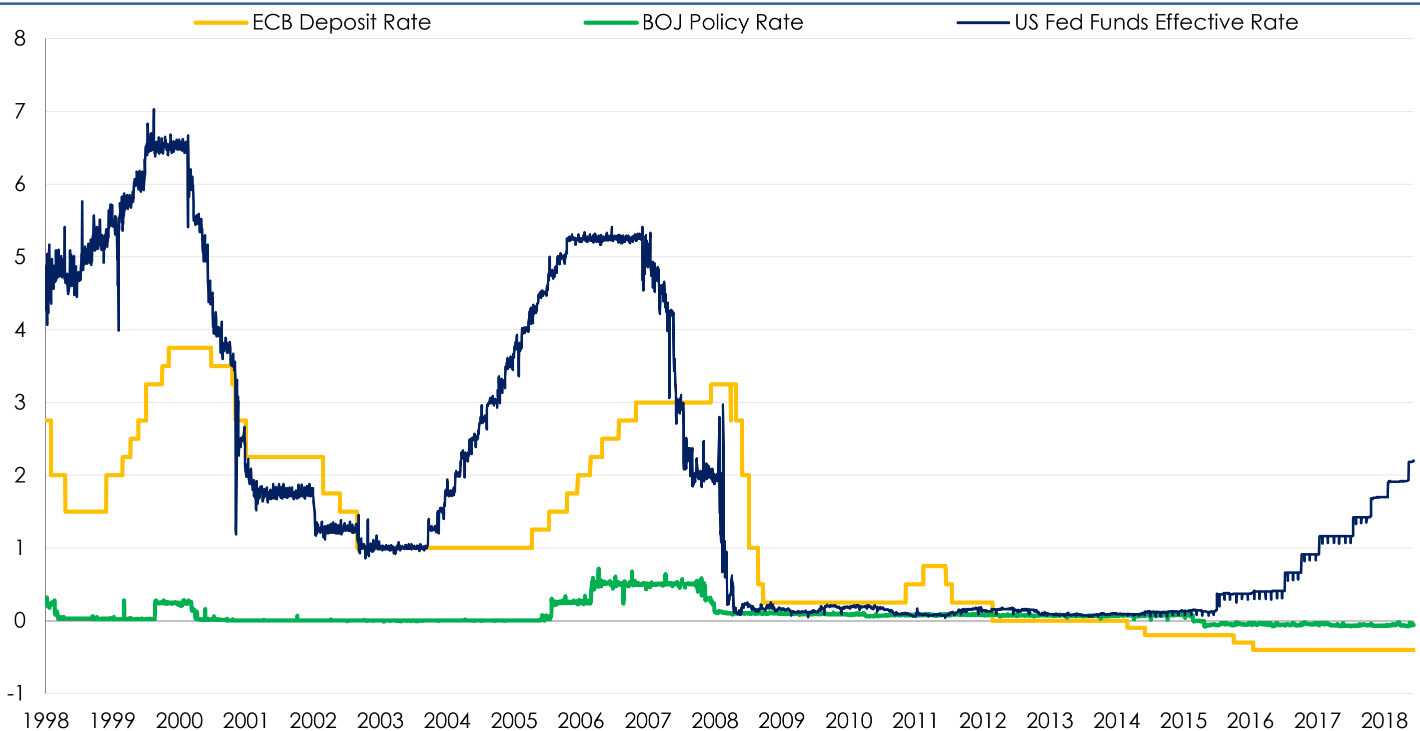
Monetary policy's asymmetric effectiveness

Since 2007, through the crisis and the eventual recovery, Federal Reserve monetary policy has arguably been one of, if not the largest factor in the evolution of U.S. financial markets, perhaps most noticeably in equity and bond markets. The most recent demonstration was at year-end 2018 when U.S. equity markets were down nearly 20% from the peak on fears of a hawkish Fed; only to reverse, recouping those losses in Q1 of 2019, driven by relief that the Fed would at the very least be patient, if not accommodative.

Yet during this period of over ten years, with rates at or near zero for most of the time, inflation - as measured by Personal Consumption Expenditures (PCE) (the Fed's metric of choice) - has spent most of that time lower than its stated 2% target. With inflation at roughly 1.5% today, the logical conclusion is that monetary policy (low rates and QE) alone cannot push inflation up to 2% in a sustainable way.

In the early 1980's, Paul Volker, then Fed chairman, tightened monetary policy and successfully brought down stubbornly high U.S. inflation. That paradigm held true through the next two decades, including Alan Greenspan's chairmanship. When faced with the financial crisis, Ben Bernanke's Fed quickly and dramatically reduced rates in 2007 from 5.25% to 2% and then to 0% when Lehman failed. This made sense, particularly because it was the most severe financial dislocation since the Great Depression and banks needed ready access to cheap liquidity to stay afloat. Various QE programs were subsequently implemented to reduce intermediate and longer term rates to stimulate the economy, with an emphasis on reducing unemployment and avoiding deflation.

Federal Reserve, ECB & BOJ historical policy rates [YoY %]



Source: Bloomberg, Federal Reserve Bank, Bank of Japan, European Central Bank

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Fast forward to 2015/16. Following several years of robust employment gains, the Fed's concerns were financial conditions (stock market volatility) and stubbornly low core inflation, which led to a delay in its policy rate normalization program until 2017. Today, some Fed governors are citing below target core inflation as a reason to cut rates again from a mere 2.4% peak, despite a robust labor market and real GDP growth of close to 3% in 2018/19.

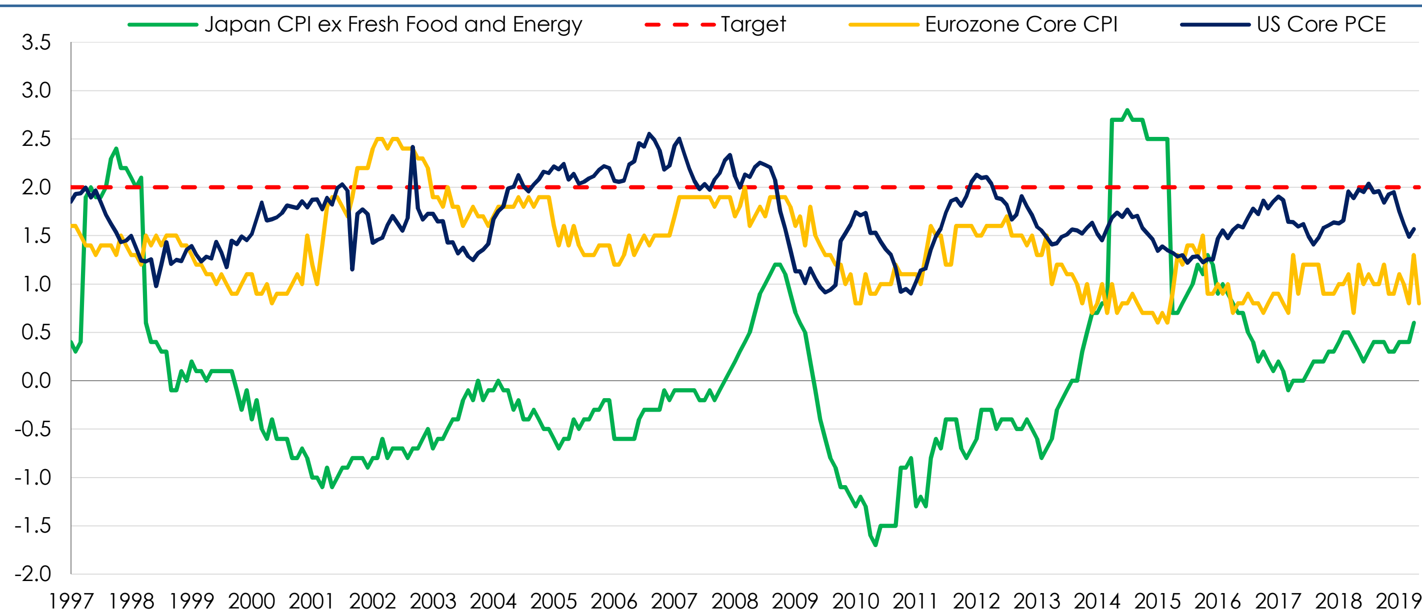
Historical evidence from central banks

Two other large developed economies, Japan and the Eurozone, have adopted zero to negative rate policies along with large QE programs. Japan has been at it since 1999, when it first implemented its zero interest rate policy followed by QE to combat deflation, and has yet to achieve 2% inflation, apart from explicitly raising the consumption tax by 3% in April 2014. The ECB's deposit rate went to zero in July 2011, then negative in June 2014, and has been at -0.4% since March of 2016 with no anticipated increase in sight, while simultaneously growing a €2.6 Tn QE portfolio as core inflation in the Eurozone has not only never achieved it's 2% target it is currently falling further below. Approximately 20% of developed market global government bonds are currently trading at negative yields in anticipation of perpetual easing by these two major central banks.

Historical evidence in developed countries is that monetary policy is effective in bringing inflation down substantially but is not effective in pushing it up materially. In today's economy, inflation is kept in check by globalization, technology, and competition with transparency, despite the price of basic necessities, such as housing, medical care and higher education in the U.S. rising faster than wages over the past 5-7 years, rendering the costs of these basic necessities already so high that the vast majority of U.S. consumers need to bargain hunt when making other purchases. High market cap companies like Amazon and Uber are willing to forego profits to gain market share through lower prices, and anecdotal evidence from newly imposed tariffs on Chinese imports indicates that businesses feel the need to eat at least part, if not all, of the cost increases to remain competitive.

Questionable quest to boost inflation

The Fed is undertaking a review of its monetary policy framework this year, which includes a possible change to "targeting average inflation over a multiyear period and price-level targeting" rather than current year inflation, with the implication that the Fed could lower the policy rate and leave it there longer to make up for past inflation that has been below their target.



Source: US Bureau of Economic Analysis, Bloomberg, Eurostat, Japanese Ministry of Internal Affairs and Communications

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There are several reasons to doubt that lowering U.S. rates today for the purpose of boosting inflation to 2% will succeed, or that even aspiring to raise inflation makes sense for consumers:

- Monetary policy has not achieved sustained target inflation over an extensive period of years of zero and negative rates plus QE in the US, Japan, and the Eurozone. Why would it work going forward?
- What is so magical about a 2% symmetric inflation target in today's environment, and what makes PCE the appropriate metric? When the Fed first adopted it's 2% inflation target in January 2012, PCE was at 2.6%, but fell below 2% within months and has rarely revisited the target level.
- Post crisis, 1–2% measured inflation has been necessary to keep the U.S. consumer afloat, to maintain growth and low unemployment. What is the rationale for the Fed to promote higher inflation than exists today? Moreover, given the blunt nature of monetary policy tools, how could the Fed calibrate its response to distinguish between 1.5% (where we are today) and 2% inflation?

Esther George from the Kansas City Fed, a voting FOMC member, addressed these issues in a recent speech in Minneapolis:

"As I listen to business and community leaders around my region, I hear few complaints about inflation being too low. In fact, I am more likely to hear disbelief when I mention that inflation is as low as measured in a number of key sectors. This leads me to the observation that inflation as experienced by households and businesses is fundamentally different from inflation as viewed by financial market participants and many economists. Households see the prices of everyday goods such as food, energy, rents, and health care rising and don't understand why the Fed would be concerned that inflation is too low."

"The current level of inflation may perplex central bankers and financial market participants, but in the context of a growing economy and job gains, it doesn't demand a Fed policy response in my view. Steering what is currently a low and stable rate of inflation up by 20-50 basis points to reach a precise numerical target, while disregarding the labor market, the other leg of our dual mandate, strikes me as a degree of fine-tuning that goes beyond our span of control."

If bond and stock markets are now expecting the Fed to lower rates by as much as 75 basis points in 2019, merely because core inflation is below target regardless of the level of employment, they might be wrong. The more likely impetus for lowering rates would be another precipitous drop in the stock market accompanied by a deceleration of growth. Under such a scenario, lowering rates from a starting point of less than 2.5% will likely provide relatively little stimulus for the real economy and, therefore, little help for equities. Easy monetary policy has effectively become an overused antibiotic and has already generated financial asset inflation. The Fed's QE portfolio is over $3.5TN, nearly four times larger than 2007/08, with corporate and household balance sheets now at a point where they have little capacity for new debt/leverage to spur new fundamental growth, even at zero rates.

It is very possible that new fiscal stimulus in the form of federal government spending is the only policy tool available with a chance to be effective as we head into the next slowdown/recession in the U.S. Unfortunately, given the current harsh political environment, absent a severe crisis, expectations for an agreement on meaningful legislation should be tempered until after the 2020 elections.

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About the Author

Steve Miller, Managing Director, has over 30 years of experience in risk management and analysis of fixed income for both cash and derivatives markets.

Since joining FPCM in 2004 Mr. Miller has focused on risk oversight and market strategy, working closely with existing and prospective institutional clients on investment strategy and solutions. Mr. Miller is a member of the FPCM investment committee.

Prior to joining FPCM, Mr. Miller was a Managing Director at J.P. Morgan in charge of market risk management coverage of the institutional fixed income and equities businesses. During his 17-year career at J.P. Morgan he also served as Global Head of Derivatives Research, and prior to that he was a founding member and head of the European Hybrid Derivatives trading group.

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