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Three Themes for Monetary Policy in 2019

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*Any opinions expressed here are my own and do not necessarily reflect those of the
Federal Open Market Committee.*

Introduction

Three themes for 2019

- The Federal Open Market Committee (FOMC) may miss its inflation target on the low side for the eighth consecutive year in 2019 based on current readings of market-based inflation expectations.
- The U.S. labor market is performing well, but feedback from labor markets to inflation is very weak.
- The Treasury yield curve has flattened significantly, and a meaningful and sustained yield curve inversion would send a bearish signal for the U.S. economy.

Market-Based Inflation Expectations Are Low

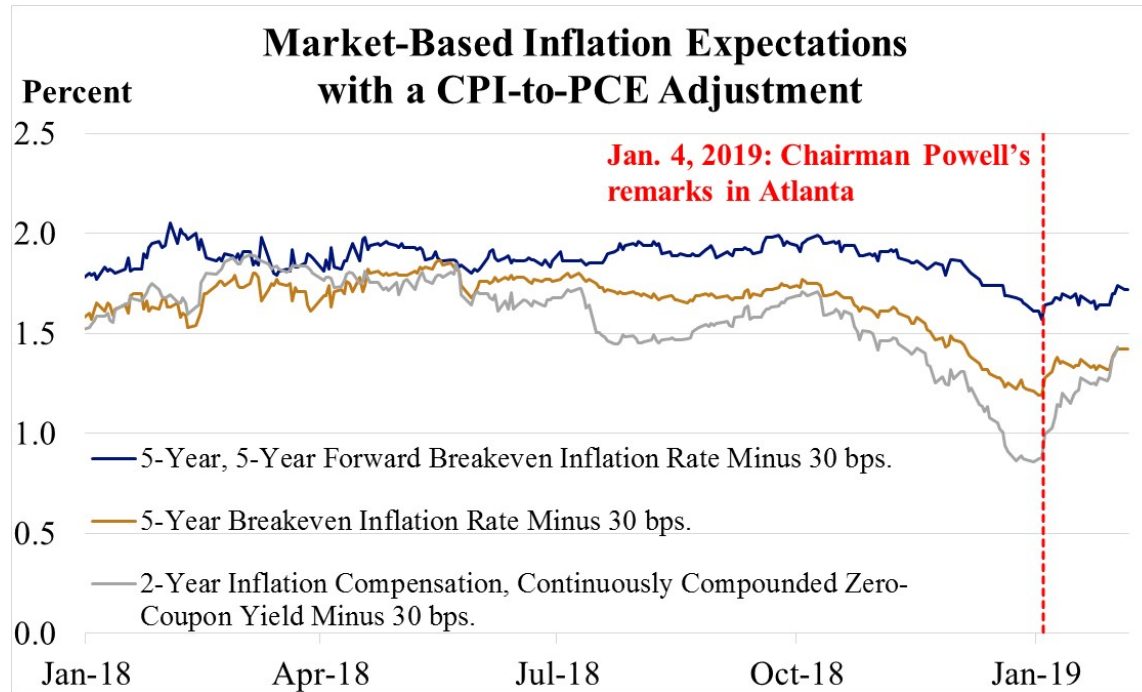
Market-based inflation expectations

- Market-based measures of inflation expectations provide an important benchmark for current monetary policy.
- Inflation-protected securities trade based on consumer price index (CPI) inflation, whereas the FOMC prefers to target personal consumption expenditures (PCE) inflation.
- Accordingly, we subtract 30 basis points from market-based measures of inflation expectations to roughly translate to a PCE inflation basis.

Inflation expectations remain subdued

- The FOMC has missed its PCE inflation target on an annual basis every year since 2012.
 - Core PCE inflation has averaged just 1.64 percent since January 2012.
- Market-based measures of inflation expectations suggest that financial markets believe the FOMC will again miss its PCE inflation target to the low side in 2019 and, indeed, for the next five years.
- These expectations take into account all available information affecting the likely evolution of inflation going forward.

Real-time inflation expectations are low



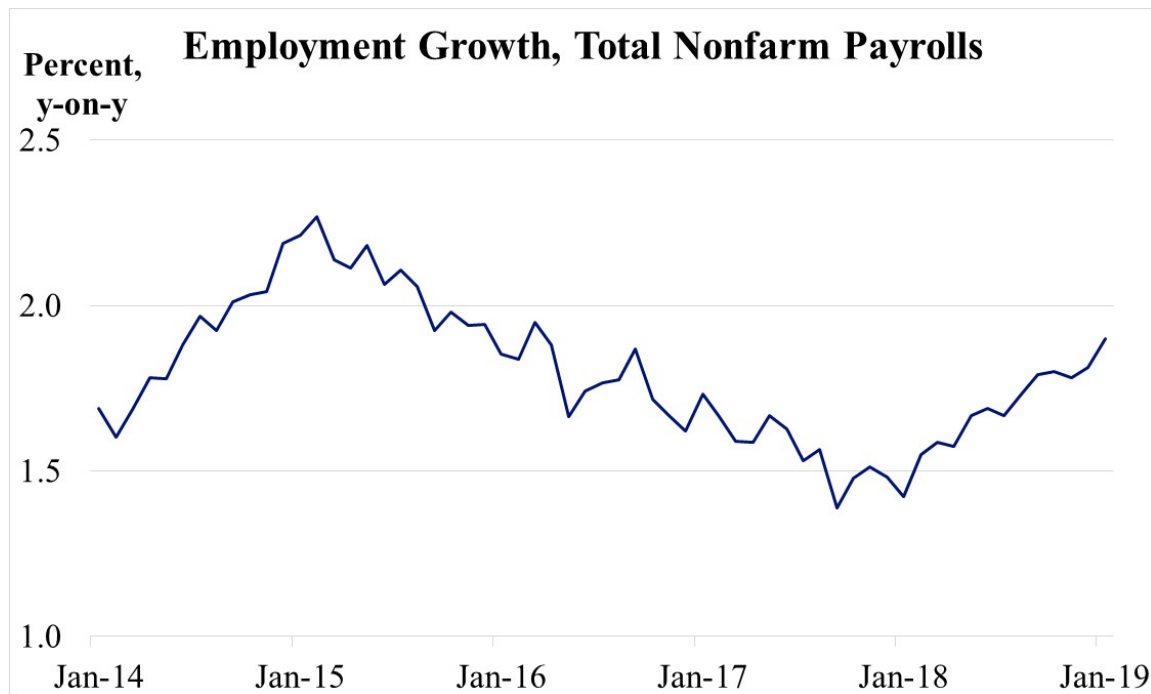
Sources: Federal Reserve Board and author's calculations. Last observations: Feb. 5 and Feb. 1, 2019.

Feedback from Labor Markets to Inflation Is Weak

Phillips curve correlations are weak

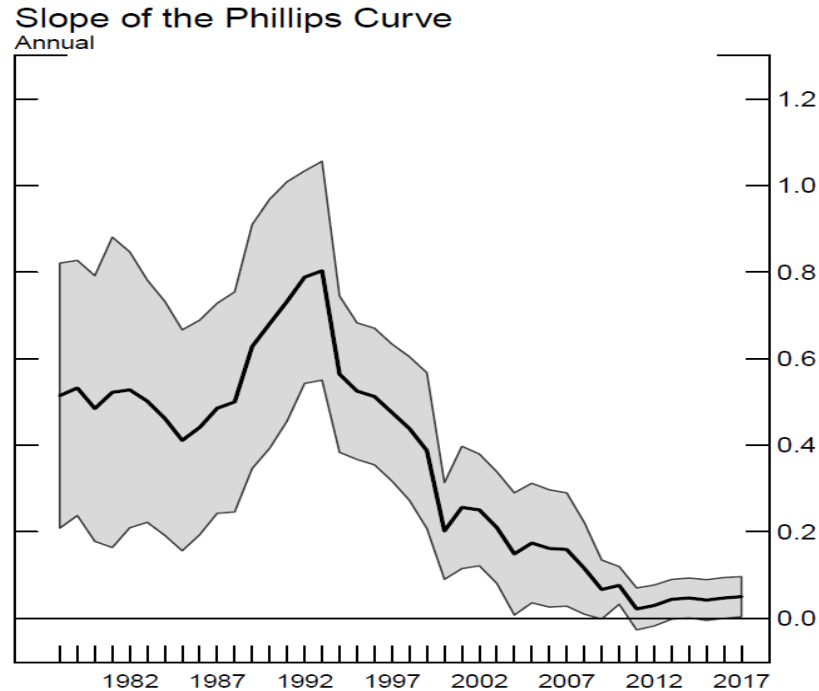
- U.S. monetary policymakers and financial market participants have long relied on the Phillips curve—the correlation between labor market outcomes and inflation—to guide monetary policy.
- However, these correlations have broken down during the last two decades, so they no longer provide a reliable signal.
- Policymakers have to look elsewhere to discern the most likely direction for inflation.

Labor markets are performing well ...



Sources: Bureau of Labor Statistics and author's calculations. Last observation: January 2019.

... but feedback to inflation is weak



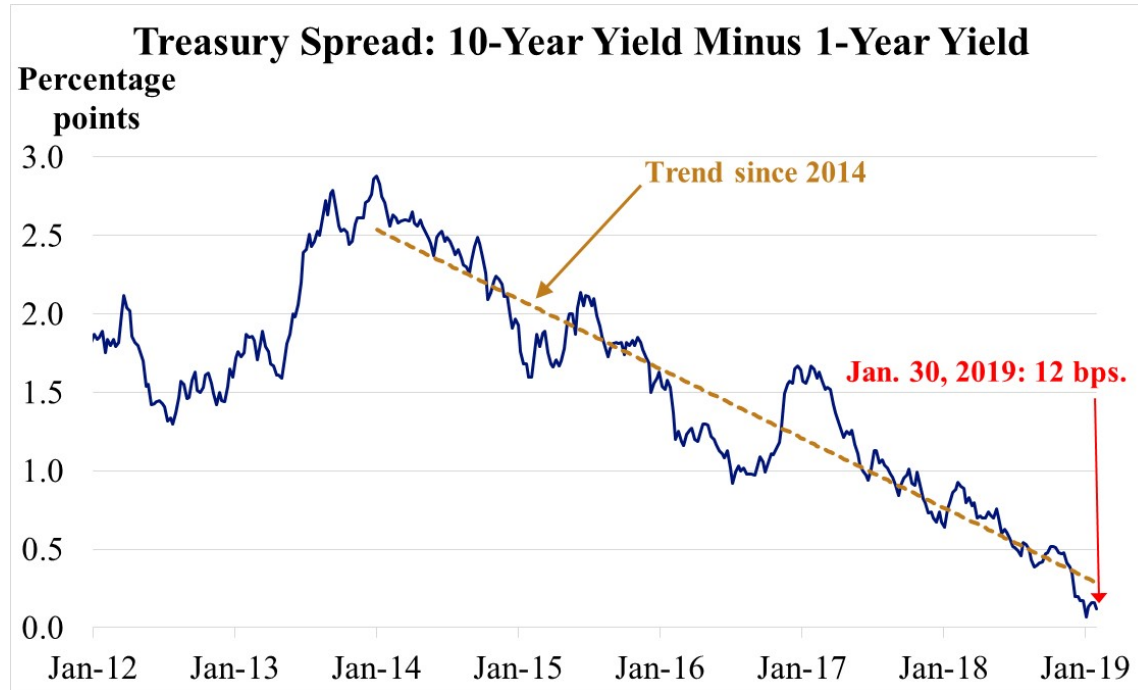
Source: J.H. Powell, "[Monetary Policy and Risk Management at a Time of Low Inflation and Low Unemployment](#)," remarks delivered at the 60th Annual NABE Meeting "Revolution or Evolution? Reexamining Economic Paradigms," Boston, Mass., Oct. 2, 2018. Last observation: 2017. Note: Rolling 20-year window estimates and confidence bands; negative of the Phillips curve slope portrayed.

Yield Curve Inversion Threatening

Yield curve issues

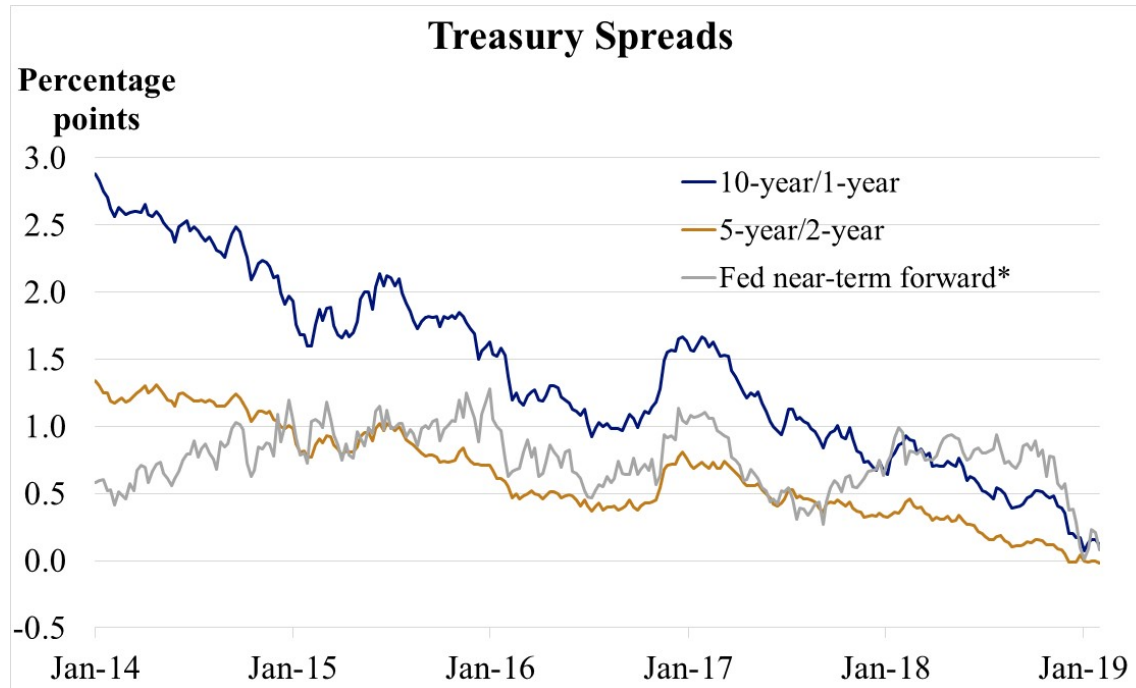
- A meaningful and sustained inversion of the Treasury yield curve would be a bearish signal for the U.S. economy.
- An inversion would suggest that financial markets expect less inflation and less growth ahead for the U.S. economy than does the FOMC, which influences the short end of the curve.
- Inversions have been associated with recessions in the postwar U.S. data.

The yield curve has been flattening



Sources: Federal Reserve Board and author's calculations. Last observation: Week of Jan. 30, 2019.

Various measures are all trending toward inversion



Sources: Federal Reserve Board, Bloomberg and author's calculations. Last observation: Week of Jan. 30, 2019.

* For details, see E. Engstrom and S. Sharpe, "[The Near-Term Forward Yield Spread as a Leading Indicator: A Less Distorted Mirror](#)," Finance and Economics Discussion Series 2018-055, Board of Governors of the Federal Reserve System.

Conclusion

Conclusion

- I have outlined three themes for U.S. monetary policy in 2019.
- Labor markets have been performing well, but the feedback from labor markets to inflation has weakened considerably in the last two decades.
- Market-based signals such as low market-based inflation expectations and a threatening yield curve inversion suggest that the FOMC needs to tread carefully going forward.
- Through its normalization program, the FOMC has already been sufficiently pre-emptive over the last two years to contain upside inflation risk.



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