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Perspectives on 2019 Monetary Policy

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

Introduction

Key themes

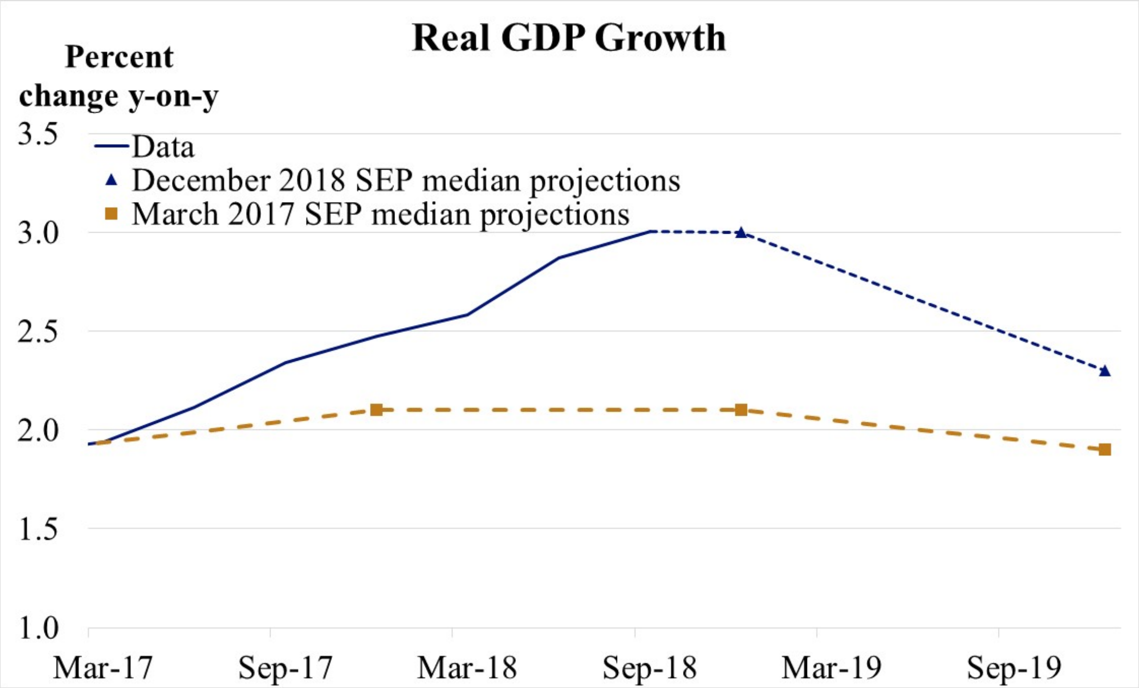
- U.S. macroeconomic performance surprised to the upside during 2017 and 2018, enabling U.S. policy rate normalization.
- Despite the significant upside surprise, inflation remains subdued.
- Market-based inflation expectations suggest that the Federal Open Market Committee (FOMC) will miss its inflation target on the low side for the eighth consecutive year in 2019.
- This is a market signal that U.S. monetary policy may be overly hawkish given the current constellation of data.
- The prospect for a further global growth slowdown is tangible.
- A meaningful yield curve inversion would send a bearish signal for the U.S. economy.

U.S. Economy Has Surprised to the Upside in 2017 and 2018

Upside surprises in 2017 and 2018

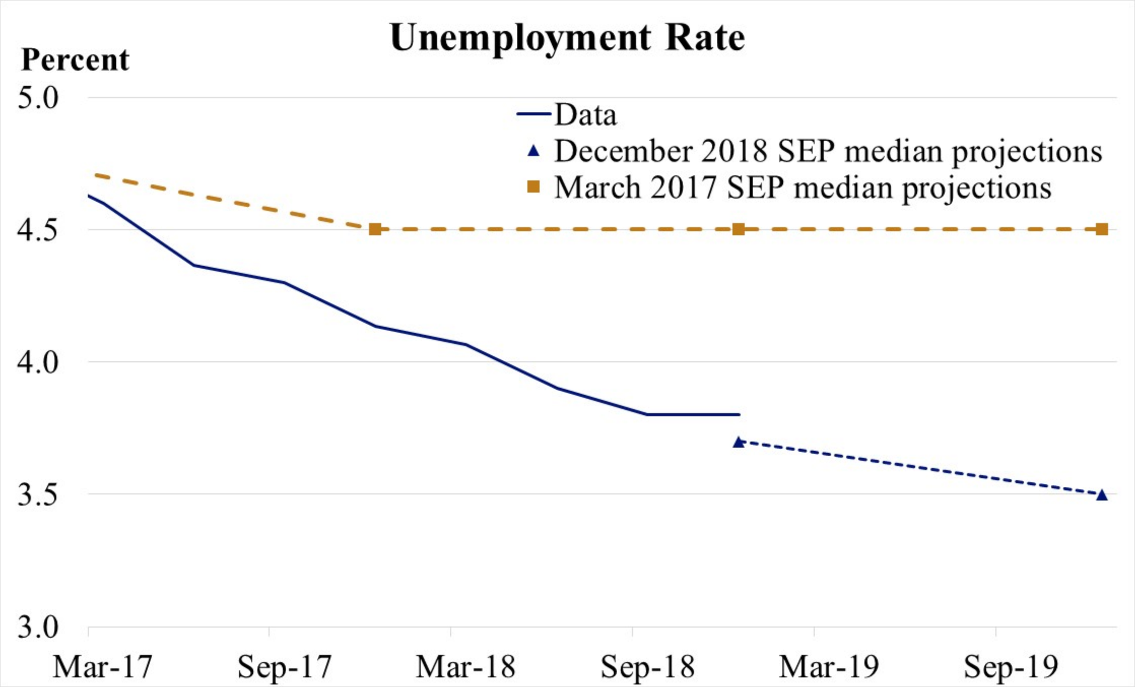
- The FOMC releases a Summary of Economic Projections (SEP) each quarter.
- In March 2017, the median projection was for stable and subdued economic growth in 2017, 2018 and 2019.
    - Relatedly, unemployment and personal consumption expenditures (PCE) inflation were projected to remain about constant over these three years.
- Actual real GDP growth has been stronger than expected, actual unemployment has trended lower than expected, and actual inflation has been somewhat lower than expected.

The U.S. growth surprise



Sources: Bureau of Economic Analysis and Federal Reserve Board. Last observation: 2018-Q3.

The U.S. unemployment surprise



Sources: Bureau of Labor Statistics, Federal Reserve Board and author's calculations. Last observation: 2018-Q4.

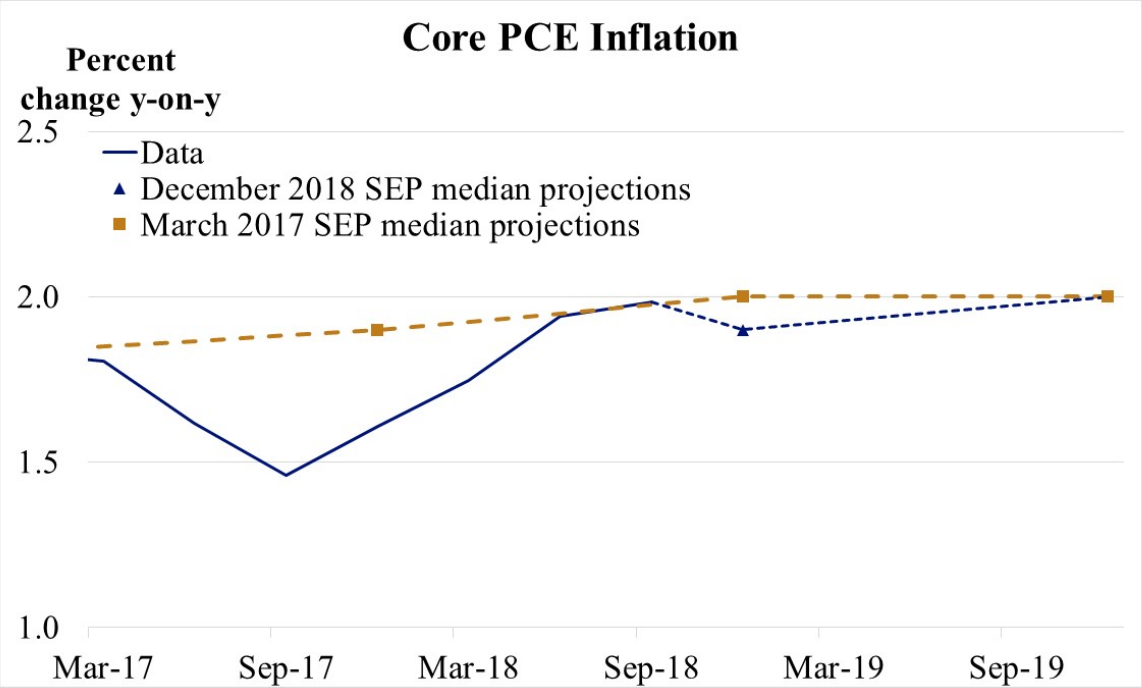
Subdued Inflation

Inflation has remained subdued

- Because the real economy performed better than expected in 2017 and 2018, many anticipated higher inflation.
- However, actual inflation readings have remained subdued.
- Core PCE inflation, a commonly used benchmark measure, has been lower than expected during the last two years.
- This is further confirmation that older Phillips curve correlations—linking low unemployment to high inflation—have broken down and cannot be relied upon to provide a guidepost for today's policymakers.*

** J. Bullard, "The Case of the Disappearing Phillips Curve," remarks delivered at the 2018 ECB Forum on Central Banking Macroeconomics of Price- and Wage-Setting, Sintra, Portugal, June 19, 2018.*

U.S. core inflation has been lower than expected



Sources: Bureau of Economic Analysis and Federal Reserve Board. Last observation: 2018-Q3.

Markets Are Not Expecting Inflation to Rise

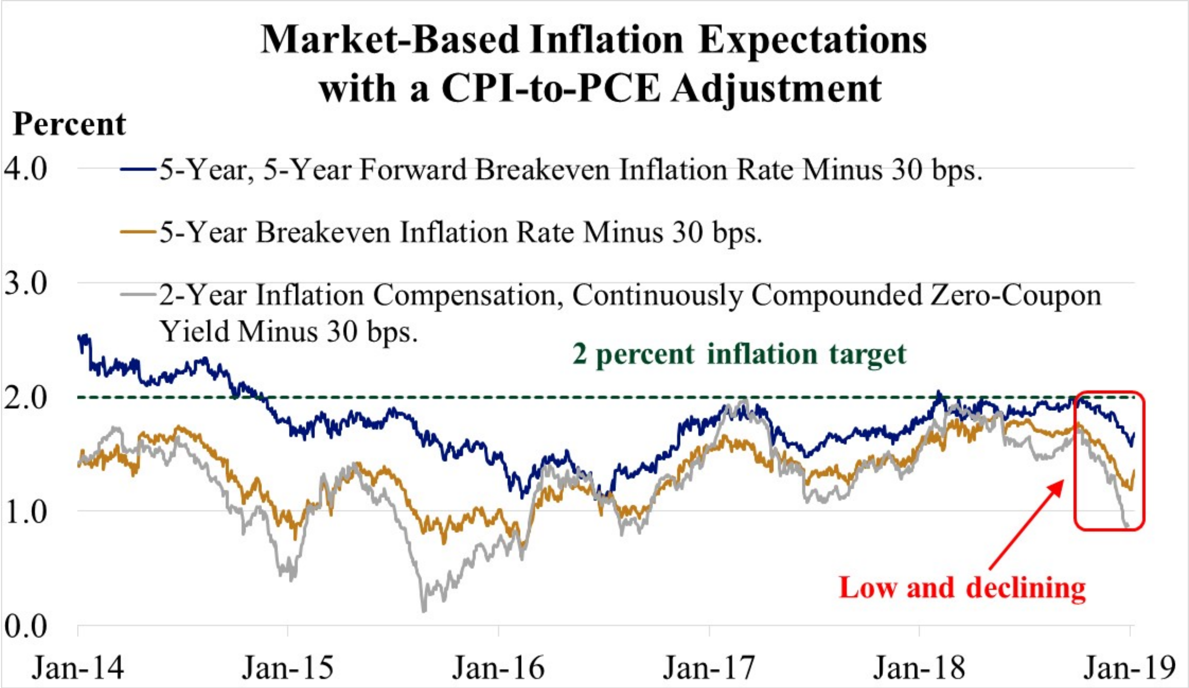
Market-based inflation expectations

- 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 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.
- 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.
- This is a market signal that the current stance of monetary policy may be too hawkish.

Real-time inflation expectations are low



Sources: Federal Reserve Board and author's calculations. Last observations: Jan. 8, 2019, and Dec. 28, 2018.

Risks of Further Slowing of Global Growth

Global growth during 2018

- Global growth was modestly slower than expected during 2018.
- As one barometer, we can consult the International Monetary Fund's World Economic Outlook, focusing on the largest economic areas.
- During 2018, the IMF reduced its growth forecasts for much of the world outside the U.S., most significantly in Europe.
- Because a substantial portion of the profits of many large U.S.-based firms are earned overseas, this slowdown may have fed into the sell-off in U.S. equities during the last several months.
- The IMF did not lower its forecast for China, but other data suggest the Chinese economy is also slowing.

A modest slowdown in global growth

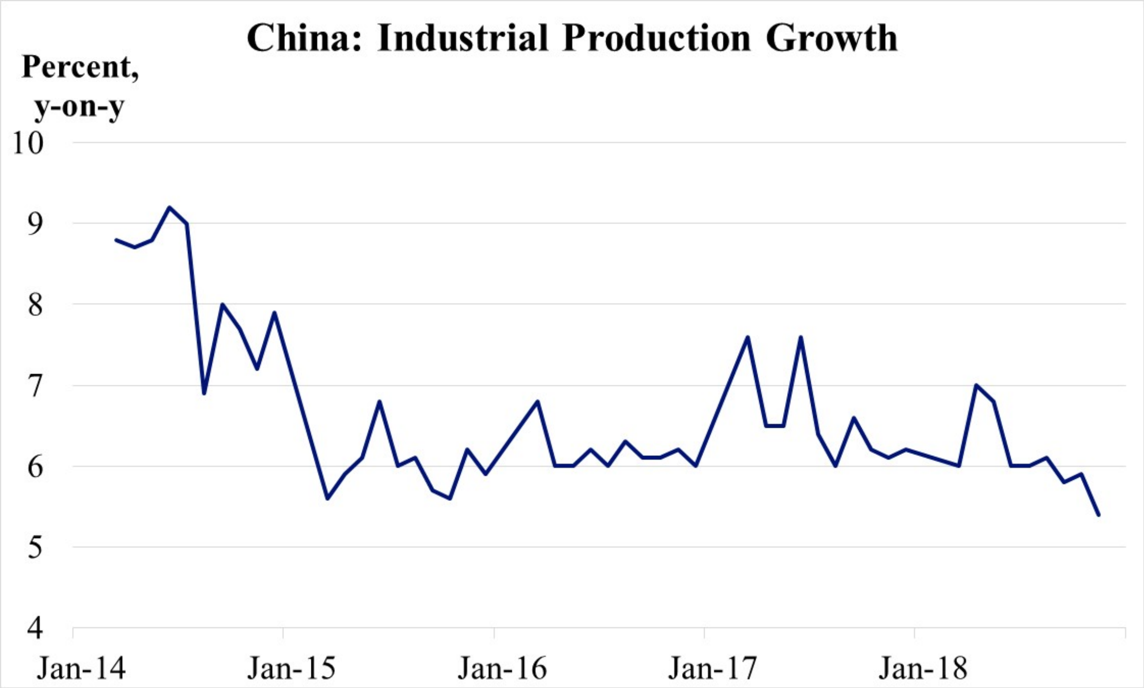
	2018 projected in Apr. 2018 [1]	2018 projected in Oct. 2018 [2]	Difference Oct. 2018 – Apr. 2018
U.S.	2.9%	2.9%	0.0%
Euro area	2.4%	2.0%	–0.4%
U.K.	1.6%	1.4%	–0.2%
Japan	1.2%	1.1%	–0.1%
China	6.6%	6.6%	0.0%

Growth rates are year-over-year; differences are expressed in percentage points.
Sources: *(1) International Monetary Fund,* World Economic Outlook, *April 2018;*
(2) International Monetary Fund, World Economic Outlook, *October 2018.*

Global growth prospects

- According to the IMF data in the previous table, global growth was slower than expected during 2018, but only modestly so.
- Financial markets are concerned that the modest slowdown may turn into a more significant slowdown during 2019.
- Some of the data from China, in particular, may be feeding into this view.
- In addition, global oil prices have fallen significantly in recent months, which is sometimes interpreted, in part, as a falloff in global demand.

Chinese industrial production growth is slowing



Source: National Bureau of Statistics of China. Last observation: November 2018.

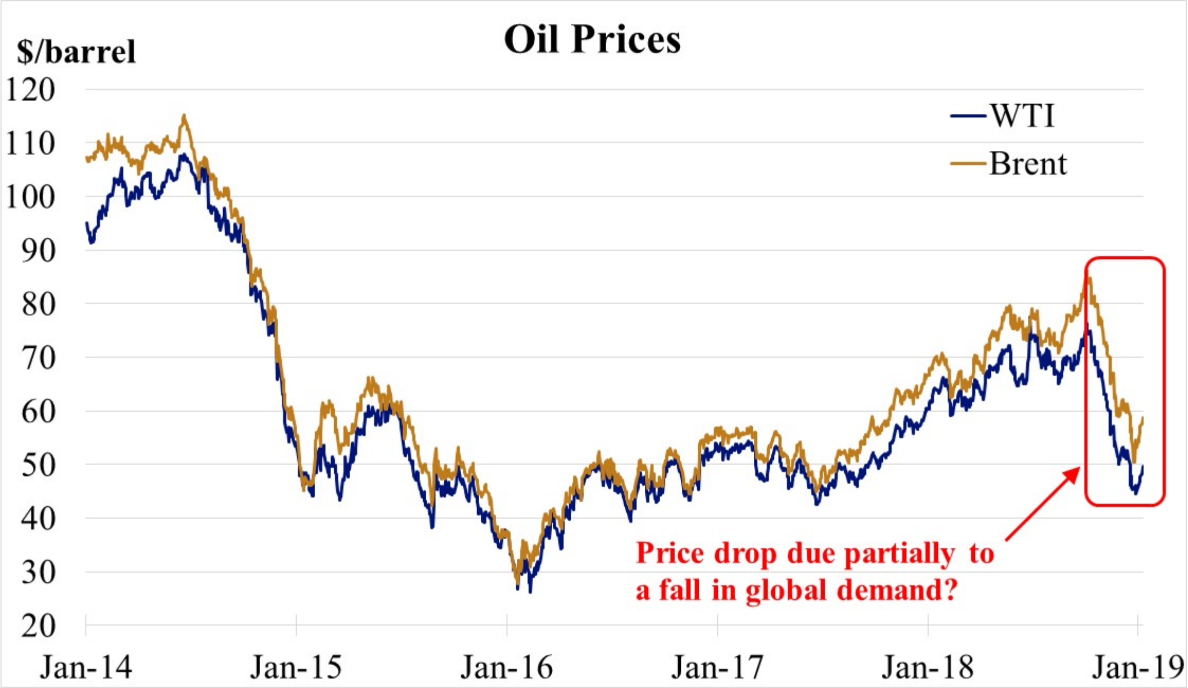
Chinese retail sales growth is trending down

Source: National Bureau of Statistics of China. Last observation: November 2018.

Chinese investment is slowing

Source: National Bureau of Statistics of China. Last observation: November 2018.

Oil prices have declined in recent months



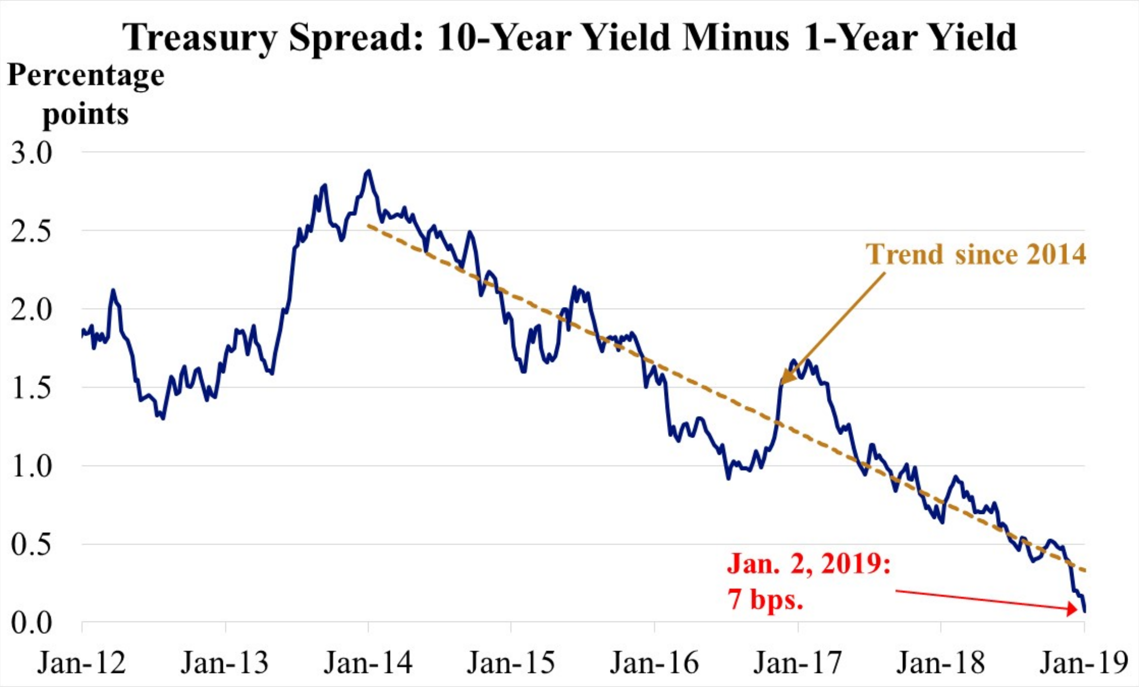
Sources: Energy Information Administration and Financial Times. Last observation: Jan. 8, 2019.

Yield Curve Inversion Threatening

Yield curve issues

- A significant 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 FOMC should moderate its normalization campaign given that the yield curve is getting close to inversion.

The yield curve has been flattening



Sources: Federal Reserve Board and author's calculations. Last observation: Week of Jan. 2, 2019.

Various measures are all trending toward inversion

Sources: Federal Reserve Board, Bloomberg and author's calculations. Last observation: Week of Jan. 2, 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

Conclusions

- U.S. monetary policymakers reacted to the upside surprise in macroeconomic performance during 2017 and 2018 by taking the opportunity to normalize U.S. short-term interest rates.
- Market-based signals such as low market-based inflation expectations and a threatening yield curve inversion suggest that this window of opportunity has now closed.
- The FOMC should heed these important signals in order to keep the U.S. expansion on track for the next several years.
- The FOMC has already been sufficiently pre-emptive over the last two years to contain upside inflation risk.

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