Probing Powell's Patience: Retrospect and Prospect

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Good afternoon, it's great to be here again at the Levy Institute's annual Minsky conference. Since we met last year, the policy landscape has certainly shifted.

President Trump is proclaiming "the greatest economy in history," while also demanding a 50 basis point rate cut because there's very little inflation. President Trump even asked for a return to quantitative easing (QE) before reversing himself.

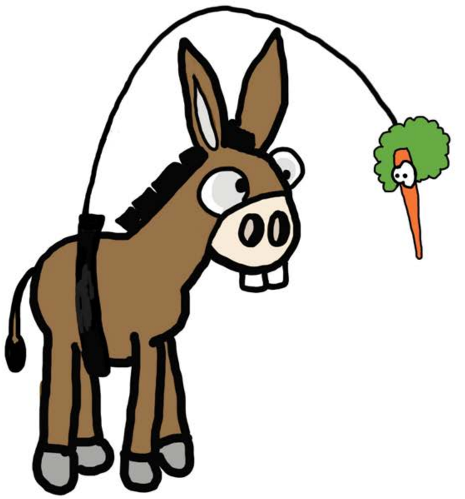
It is also notable that in June, when the current expansion will match the record long 1991-2001 expansion, the Fed will start a one-year "listening" tour to help it re-jigger its policy framework.

It sounds like both Trump and the Fed are saying the economy is doing great, or at least is in a good place, but it needs more support.

It's not news that the Fed can't really see recessions coming, but, as I'll explain, a bigger problem is that it doesn't seem to understand inflation cycles, and certainly can't predict them.

Chairman Powell has emphasized that "inflation expectations are now the most important driver of actual inflation," and he wants to raise them in order to stimulate consumption. Of course, low inflation has persisted despite the Fed setting an inflation target years ago. That's a huge problem for the Fed. Hence its listening tour is about finding ways to boost inflation expectations.

Or, as *Bloomberg* put it: "With all brakes, and no engine, central banks [are seeking] new inflation ideas." ▸▸



The Fed's quest for an "inflation engine" brings to mind the carrot-on-a-stick approach.

Its view is that inflation should follow the inflation target, believing that the target determines inflation expectations.

Yet, despite the target being in clear sight, actual inflation has been as stubborn as a mule, refusing to move toward the target.

From ECRI's point of view, there are two problems with this framing of inflation, and that's what I'd like to discuss today.

First, the years-long inflation undershoot is basically a structural problem.

Second, the Fed has lost its institutional memory about inflation cycles, which are distinct from the business cycle. ▶▶

The Risk of Mistaking Cyclical for Structural

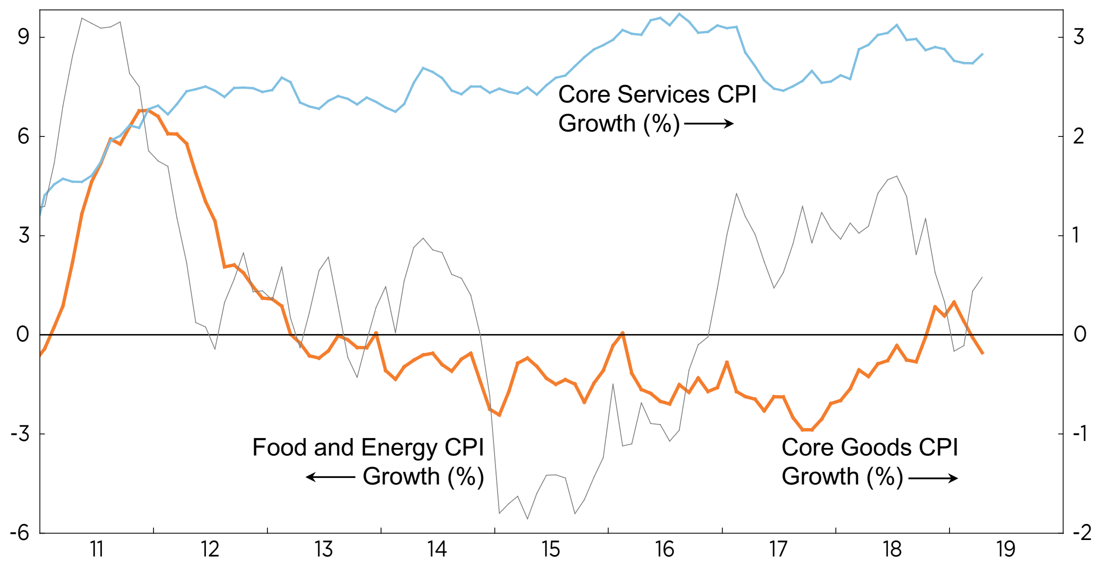
The long-term decline in advanced economy trend growth, driven by demographics and productivity, isn't over, despite wishful thinking to the contrary. But when that mistaken belief drives policy – in particular the timing of the big shift from quantitative easing to quantitative tightening on a global scale – monetary policy goes on a collision course with the economic cycle. If policy doesn't change course, that raises the risk of a new recession (April 2018).

Now, the structural problem with economic growth was at the heart of my talk *last year*, when I concluded that the long-term decline in advanced economy trend growth isn't over, despite wishful thinking to the contrary. But, when that mistaken belief drives the big shift from quantitative easing to quantitative tightening, *monetary policy goes on a collision course with the economic cycle*.

To be clear, *this is the reason for the abrupt U-turn in Fed policy this year*.

So now let's delve into the structural problem with inflation. ▸▸

Components of U.S. CPI Inflation



Core services inflation is in a cyclical downturn (blue line), as is food and energy inflation (thin black line), except for a recent risk-on pop in energy prices.

Most importantly, core goods CPI growth fell into deflationary territory shortly after the Fed adopted its official inflation target in 2012 (orange line). And there it's stayed, with hardly any breaks. While there was a recent tariff-related pop, it's already dropped back below zero.

Basically, globalization and technological change, coming on top of the structural weakness in trend growth, has resulted in sustained deflation in the goods sector. This is a key reason why inflation kept falling short of the Fed's target for years on end.

But then, a cyclical upturn in inflation finally pushed overall personal consumption expenditures deflator growth above the Fed's 2% target in 2017, and again in 2018, in the course of the global growth upturn.

So, following last year's Minsky conference, the consensus crystallized around the inevitability of global monetary policy normalization.

In fact, the consensus was banking on a full-blown bond bear market. ▸▸

In August, with 10-year treasury yields approaching 3%, Jamie Dimon declared "I think rates should be 4% today... you better be prepared to deal with rates 5% or higher."

The pressure was on for higher rates.

But later that month at Jackson Hole, Fed Chairman Jerome Powell pushed back against conventional models – in particular, how unworkable they are in practice.

Indeed, he went on to draw a contrast, pointedly reminiscing about the success of the Greenspan Fed in the 1990s – a period I personally remember well. ▸▸

Greenspan's "Hunch"

"In mid-1996, the unemployment rate was below the natural rate … and many FOMC participants … were forecasting growth above the economy's potential. Sentiment was building … to raise the federal funds rate to head off the risk of rising inflation. But Chairman Greenspan had a hunch that the United States was experiencing the wonders of a 'new economy' in which improved productivity growth would allow faster output growth and lower unemployment, without serious inflation risks. Greenspan argued that the FOMC should hold off on rate increases. …"

– Jerome H. Powell, Jackson Hole, WY, August 24, 2018

According to Powell, in mid-1996, sentiment was building to hike rates to head off inflation, but Chairman Greenspan had a hunch that improved productivity growth would allow faster growth and lower unemployment without serious inflation risks. Greenspan argued that the FOMC should hold off on rate increases. ▸▸

Greenspan's Fortitude

"Over the next two years, thanks to his considerable fortitude, Greenspan prevailed. … Starting in 1996, the economy boomed and the unemployment rate fell, but, contrary to conventional wisdom at the time, inflation fell. … Greenspan was also right that the potential growth rate had shifted up … accommodat[ing] the very strong growth that actually materialized …"

– Jerome H. Powell, Jackson Hole, WY, August 24, 2018

Furthermore, thanks to his considerable fortitude, Greenspan prevailed, Powell said. The economy boomed and the unemployment rate fell, but, contrary to conventional wisdom, inflation fell. ▸▸

Greenspan’s Patience

“Under Chairman Greenspan’s leadership, the Committee converged on a risk-management strategy that can be distilled into a simple request: Let’s wait one more meeting; if there are clearer signs of inflation, we will commence tightening. Meeting after meeting, the Committee held off on rate increases while believing that signs of rising inflation would soon appear. And meeting after meeting inflation gradually declined.”

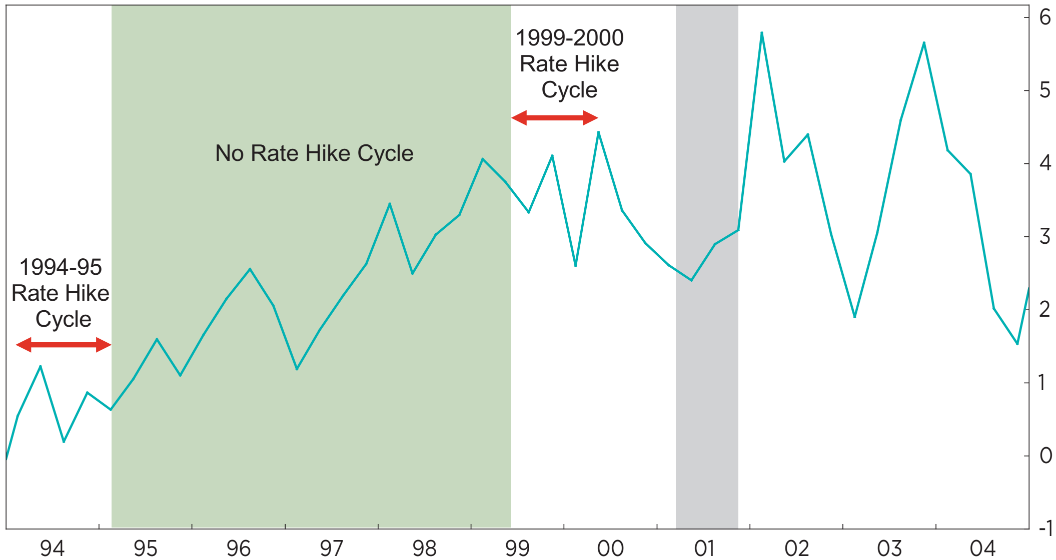
– Jerome H. Powell, Jackson Hole, WY, August 24, 2018

Powell went on to say that the Committee converged on a simple risk-management strategy: Let’s wait one more meeting; if there are clearer signs of inflation, we will commence tightening. Meeting after meeting, the Committee held off, and meeting after meeting inflation gradually declined.

So, Powell’s apparent bottom line was to be patient and wait to see the “whites of inflation’s eyes” before rushing to tighten, the way Greenspan was patient, having recognized the productivity miracle.

So let’s look at productivity growth in the 1990s. ▸▸

U.S. Productivity Growth (%)



Gray-shaded area represents U.S. business cycle recession.

Productivity growth certainly did strengthen, moving from the 1-2% range in 1996 to the 3-4% range by 1999.

But if strong productivity growth curbing inflation allowed Greenspan's "patience" for years (green shaded area), why did the Fed launch an aggressive rate hike cycle in 1999-2000, even as productivity growth remained robust?

That rate hike cycle doesn't jibe with Greenspan's productivity miracle "hunch" being the rationale for his patience.

From ECRI's cyclical perspective, the explanation is straightforward. It has everything to do with inflation cycles and, in particular, the decisive upturn in our U.S. Future Inflation Gauge (USFIG), which is designed to anticipate turning points in the inflation cycle.

So where did the USFIG come from? ▸▸

ECRI co-founder Geoffrey H. Moore turned his attention to inflation cycles after developing the original index of leading economic indicators over half a century ago. He did this because the stagflationary 1970s had shown that inflation cycles were distinct from business cycles. That's why Dr. Moore focused on forecasting inflation cycle turning points, culminating in the development of the USFIG.

Please recall that the 1994-95 rate hike cycle was a huge surprise to the markets, and Greenspan was grilled about it in Congress. Our leading inflation indicators came up during the question and answer segment of his testimony, when he basically said that anything his former professor Geoffrey Moore did, he looked at "very closely."

I can personally recall a lot of back and forth between the two until Dr. Moore passed away in March 2000, and being hounded in those years by bond traders who wanted our leading indicator data.

In essence, the 1994-96 period was about preemptive rate-hike and rate-cut cycles – but not based on the Phillips curve. ▸▸

Greenspan's Disbelief in the Phillips Curve

"[T]he experience of the past three decades has demonstrated that what appears to be a tradeoff between unemployment and inflation is quite ephemeral and misleading."

– Alan Greenspan, Congressional testimony, February 22, 1994

25 years ago, it was already obvious to Greenspan that the Phillips curve was "quite ephemeral and misleading."

And his was not a solitary view – other FOMC members agreed. ▸▸

When to Act

On principle, I prefer not to tighten monetary policy on the basis of strong output and employment growth or even a low unemployment rate. I know that we should not wait to see the "whites of inflation's eyes" before acting, but I do think we might well wait for some leading indicators of rising inflation before we act.

– Robert McTeer, FOMC Meeting, July 2-3, 1996

During the July 1996 meeting that Powell referenced at Jackson Hole, Dallas Fed President Robert McTeer explained why he didn't support rate hikes at the time.

First, he also didn't believe in the Phillips curve, preferring in principle not to tighten policy on the basis of output or job growth, or the unemployment rate.

Second, he wasn't waiting for coincident measures like CPI inflation – "the whites of inflation's eyes" – but explicitly wanted to wait for *leading* indicators of inflation before acting.

By this time, even the mainstream American Economic Association (AEA) had recognized just how critical Dr. Moore's insights were, giving him their highest award in 1996.

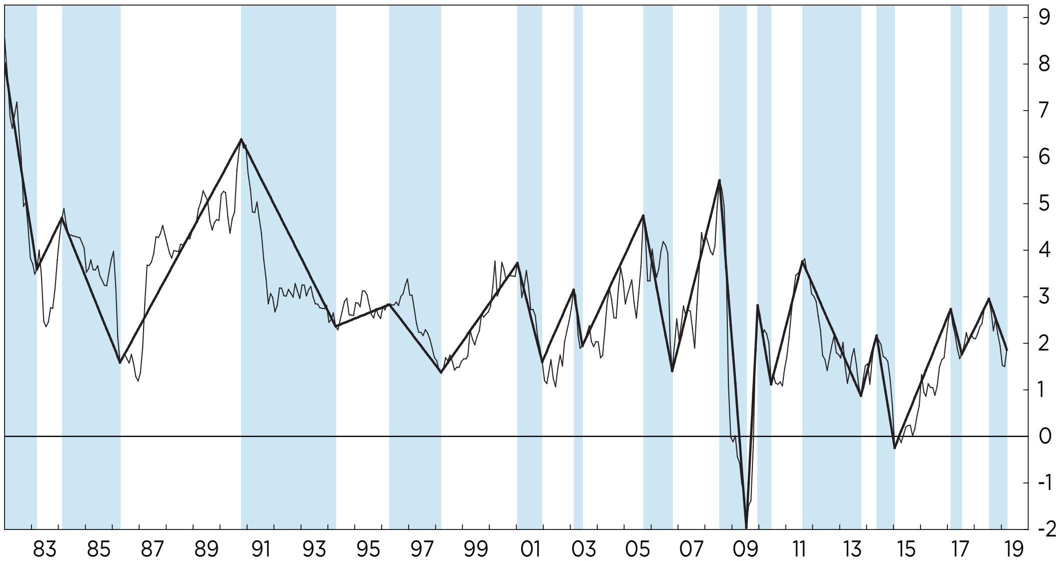
So, in the mid-1990s, inflation cycles were front and center for the FOMC, the AEA and the bond market.

Yet, Powell's Jackson Hole description of what transpired in 1996, which reflects the current consensus view, doesn't even touch on the centrality of leading indicators of inflation to monetary policy.

Moore's cyclical framework stands in sharp contrast to the current received wisdom, and this framework is just as critical today for understanding the behavior of inflation as the Fed embarks on its "listening" tour.

Sadly, the Fed has forgotten what it once knew - that inflation is not only cyclical, but also that it has its own distinct cycles. ▸▸

Inflation is Cyclical



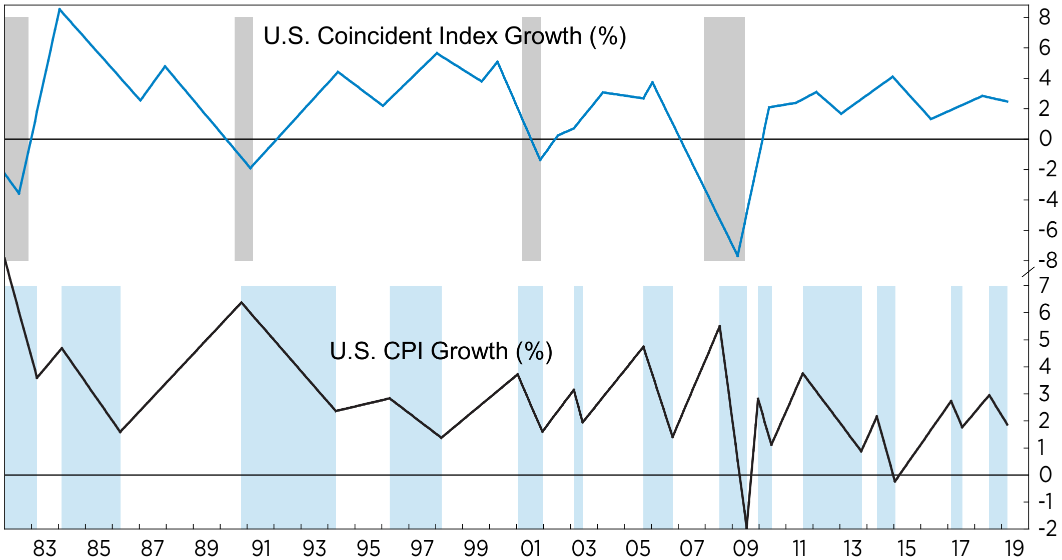
Shaded areas represent U.S. inflation cycle downturns.

Here's what we mean by inflation cycles.

The thin line shows actual CPI inflation since the early 1980s, and the thicker line segments show upturns and downturns in the inflation cycle, with inflation cycle downturns shaded in blue.

In fact, there are many more inflation cycles than business cycles. ▸▸

The Inflation Cycle is Not the Business Cycle



Gray-shaded areas represent U.S. business cycle recessions, and blue-shaded areas represent U.S. inflation cycle downturns.

That is evident from this chart, showing business cycles in the upper panel and inflation cycles in the lower panel. As you see, the vast majority of inflation cycle downturns occur away from recession .

The zigzag lines in the upper panel show the cyclical upswings and downswings in ECRI's U.S. Coincident Index (USCI) growth rate, with gray shaded areas marking off recessions.

The zigzag lines in the lower panel show the upswings and downswings in the inflation cycle, as in the previous chart.

Around recessions the Phillips curve seems to hold – because recession kills inflation, and also drives up the jobless rate – making it look like inflation and unemployment are cyclically linked.

But inflation cycles occur *far* more frequently than business cycles, so the vast majority of inflation cycle downturns occur away from recession.

This is precisely why the Fed's reliance on the Phillips curve is so damaging: the Fed's framework is likely to function reasonably well only in the aftermath of recession.

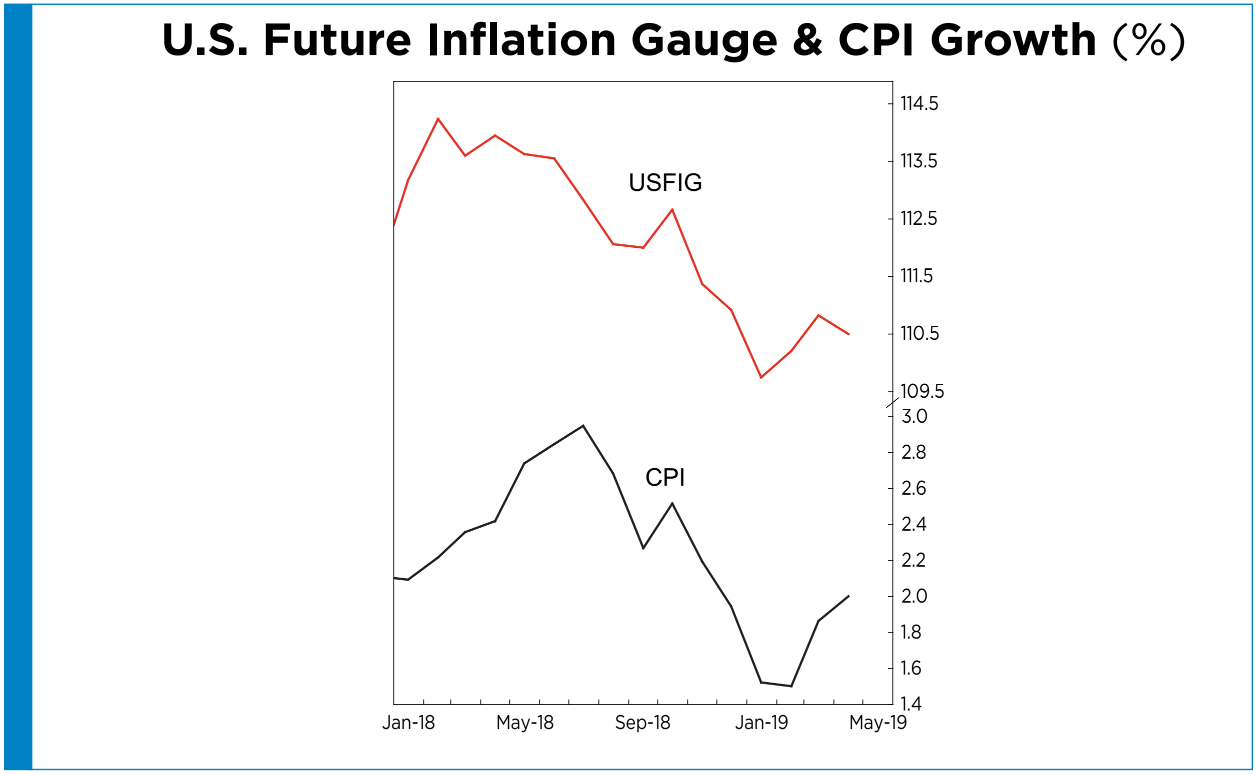
The recent Powell "pivot" exemplifies the problem.

If you think back to last September, we'd just had a 4.2% Q2 GDP print, and the unemployment rate was at a 49-year low.

No wonder the Fed was so hawkish.

And the bond bears were also on the prowl, which is why 10-year yields rose to 3¼% in early October and again in early November.

But unbeknownst to both the Fed and the markets, the inflation cycle was already in a downturn. ▸▸



We knew this because the USFIG had already turned down decisively (red line), and CPI inflation was following suit, after peaking in July (black line). Now we are watching the latest uptick in the USFIG to see if it develops into a cyclical upturn.

Today, plenty of people say the December rate hike was a mistake, but ECRI was not at all surprised by the Powell pivot. In fact, *Barron's* wrote up our view six months ago, in October, provocatively headlining their story: "Why Trump May Be Right About the Fed."

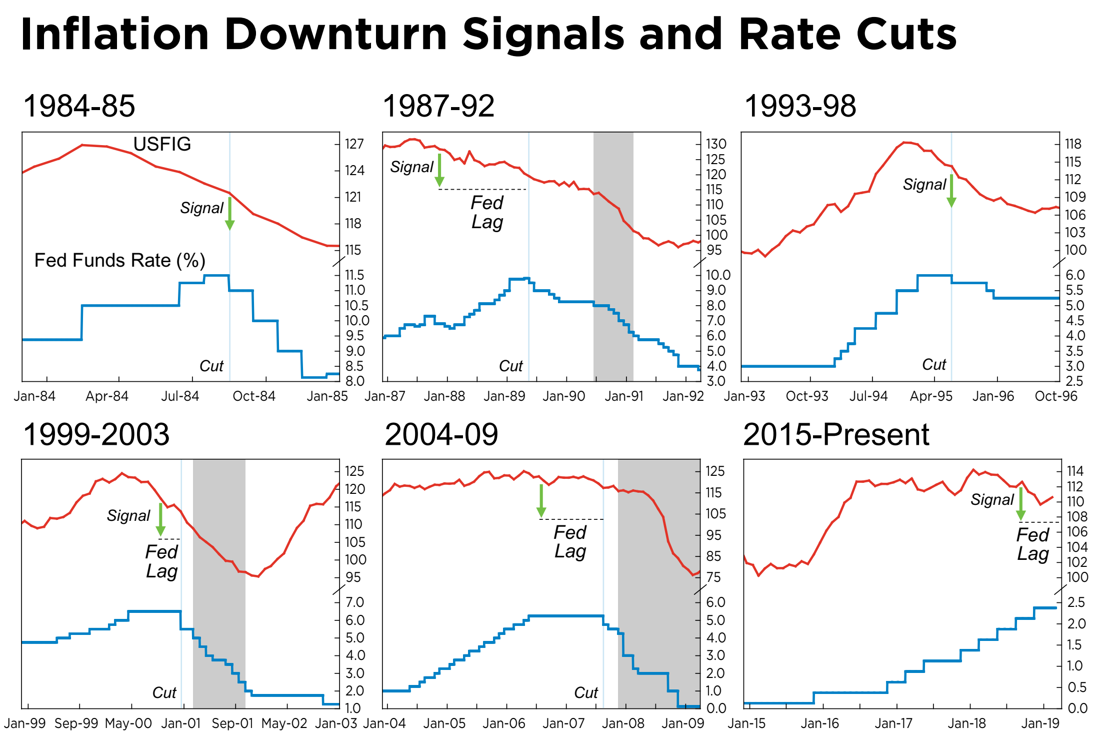
Actually we'd said that the U.S. was already in a stealth slowdown, and inflation was headed lower, given this downturn in the USFIG. And this isn't the first time that the Fed's plans have run smack into the economic cycle. The same thing happened in 2016, with Fed Chair Janet Yellen's year-long rate hike "pause."

Having provided a very different perspective on Fed policy in the 1990s – talking about Greenspan, Dr. Moore, and the U.S. Future Inflation Gauge – it is clear that we're now in a different era. But I have to say at ECRI we got a bit of a chuckle out of the New York Fed's nomenclature when they released something called the "underlying inflation gauge," or UIG, a couple years back.

The name aside, it has little to do with inflation cycles, as Yellen found out in 2017 when the UIG was predicting higher inflation during an inflation cycle downturn that she called the "biggest surprise" of the year. The USFIG wasn't fooled.

While the UIG had ramped up to 3⅓% in the lead-up to the September 2018 rate hike, and was still above 3% ahead of the December hike, the USFIG was in a decisive downturn.

But, the USFIG can also provide other insights into monetary policy. ▸▸



Shaded areas represent U.S. business cycle recessions.

According to *The Wall Street Journal*, "policy makers appear to have pivoted in time to prevent" a recession. This is an assumption worth examining.

These charts show the past half dozen Fed rate hike cycles in the context of the USFIG. Three of them ended in recessions, two in soft landings, and the last episode is still unfolding.

Following the Fed-engineered recessions of the early 1980s, we had a soft landing in the mid-1980s, shown in the top left chart. The USFIG turned down in March 1984 (red line). Of course, we could only recognize that USFIG downturn after the fact, which we do based on an objective process. In this case, that downturn signal occurred in September 1984 (green arrow). The rate cut cycle started the very same month, as shown by the fed funds rate (blue line).

There was a zero lag between the inflation downturn signal and the Fed's first rate cut. The upshot was a soft landing, rather than a recession.

The top center chart shows that, in the 1987-92 period, the Fed didn't start its rate cut cycle until June 1989, 17 months after the USFIG signal. That was too late to head off recession (shaded area), which began another 13 months later.

The next rate hike cycle in the mid-1990s, shown in the top right-hand chart, is particularly informative. The USFIG's inflation downturn signal arrived in July 1995 (green arrow), and the Fed promptly cut rates the very same month, with zero lag. In this cycle, the Fed pulled off a soft landing, using preemptive policy based on an understanding of the inflation cycle, as we discussed earlier.

Basically, the Fed achieved soft landings when it started rate cut cycles the same month the inflation downturn signals arrived. However, recessions followed when the rate cut cycles began with lags relative to the USFIG downturn signals.

So, what really seems to matter is not when the Fed *stops* rate hikes, but how promptly it starts the rate *cut* cycle following the inflation downturn signal.

In the current cycle, shown in the bottom right chart, the inflation downturn signal arrived last September, seven months ago (green arrow). Of course, the Fed has no intention of starting a rate cut cycle just yet. Therefore, according to this pattern, an element of recession risk is present.

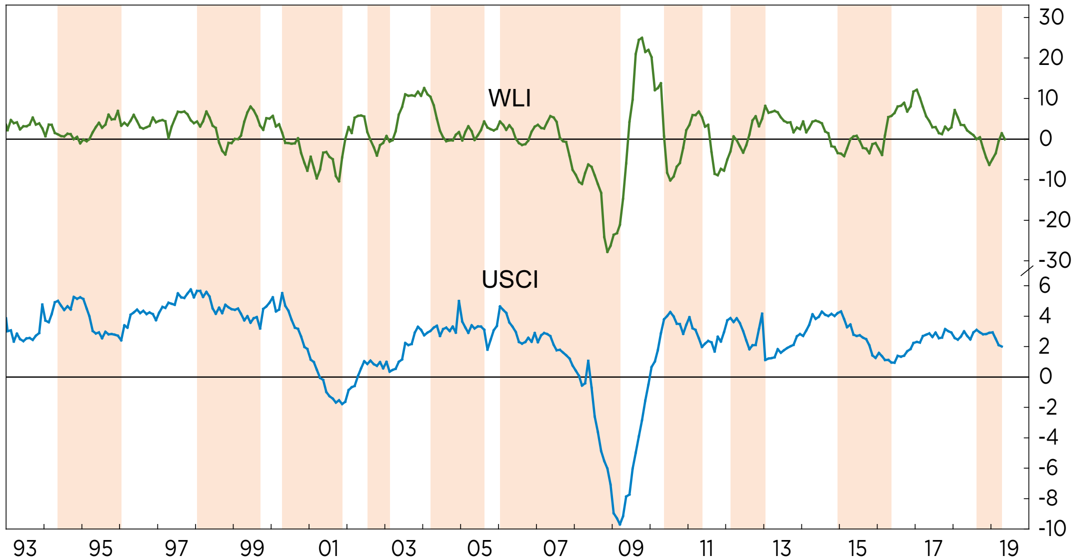
To be clear, as neat as the predictive power of USFIG looks, it isn't sufficient for recession forecasting since its signals haven't been proven to predict all earlier recessions in the U.S., or in other economies we monitor. Similarly, ECRI has long held that an inverted yield curve isn't a dependable recession predictor, especially in the context of QE-related distortions.

The robustness of largely empirical relationships that may have worked over a few cycles in certain times and places – however rationalized – depends on contingent factors that are subject to change when certain broad contours of institutional arrangements are altered. They are, so to speak, rooted in shallow topsoil that may be washed away by shifting economic currents.

Instead, an ECRI recession forecast originates from our objective leading indexes of the business cycle. That's because they have solid foundations, based on durable verities anchored in the deep structure of market economies, and have proven their worth over more than a century of economic cycles in the U.S. and many other market-oriented economies.

Those leading indexes correctly predicted the current cyclical slowdown in economic growth, but what are they telling us now? ▸▸

Indicators of U.S. Growth (%)



Shaded areas represent U.S. growth rate cycle downturns.

This chart shows the monthly growth rates of our USCI at the bottom, and Weekly Leading Index (WLI) on top.

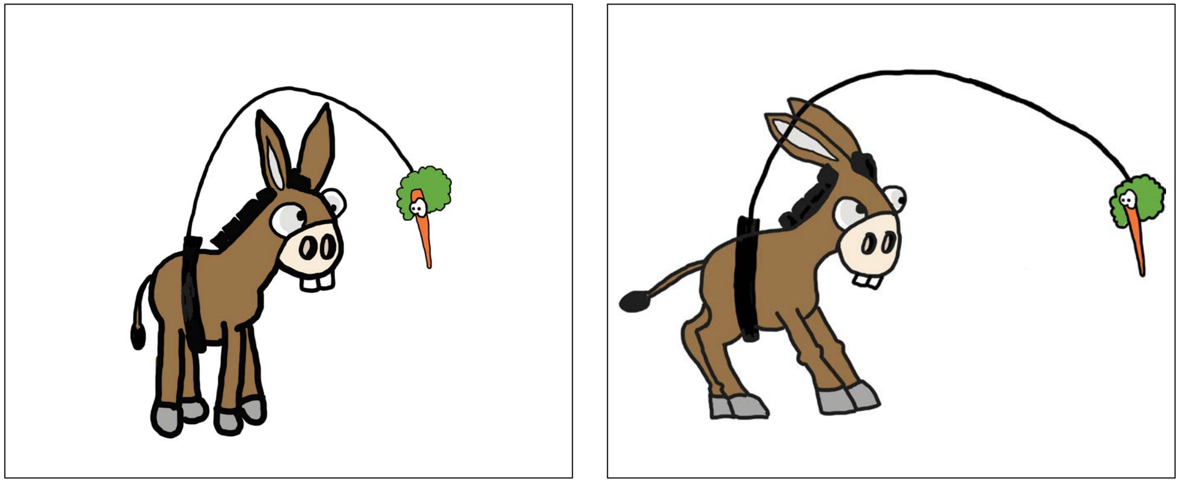
The USCI growth rate is in a cyclical downturn, and has dropped to a 2⅓-year low, following the earlier downturn in WLI growth.

WLI growth has ticked up from a seven-year low to around a ten-month high, suggesting that the outlook may be stabilizing.

However, we're not out of the woods yet for a couple of reasons. First, this uptick is not yet pronounced, pervasive and persistent enough to qualify as a cyclical upturn. Second, the growth rates of our other U.S. leading indexes aren't in cyclical upturns either, so it's too soon to objectively sound the all-clear signal.

Whether or not a recession arrives this year, the Fed is very concerned about its lack of firepower when one does.

But its listening tour is focused on tweaking longer-term inflation expectations, in the hope of gaining more firepower – it isn't even thinking about inflation cycles. ▸▸



This brings us back to the carrot-on-a-stick approach, based on their view that inflation should follow the inflation target.

The latest indication is that the Fed will let the inflation target periodically exceed 2% to make up for times when it's below 2%.

So the idea is to put the carrot even *farther away* from the mule, in hopes of spurring it forward.

We would submit that if inflation expectations haven't been pulled toward the 2% target for years and years, there's no good reason a higher target – in effect, moving the carrot farther away from the mule – will make any difference. ▸▸

In Conclusion

- If our leading indexes turn back down, there may be a recession later this year.
- If they enter a fresh cyclical upturn, along with the FIG, the Fed will find it hard to hold off on further rate hikes.
- In both scenarios, the inability to execute preemptive rate-hike and rate-cut cycles is the real danger.

As we sit here today there are two scenarios of concern. One, which is straightforward, is that if our leading indexes give up the ghost, there may be a recession later this year.

The other is more nuanced. If our leading indexes firm up for the time being, as they did in the late 1980s, and the USFIG enters a fresh cyclical upturn, it's going to be hard for the Fed to hold off on further rate hikes when inflation starts to rise.

In both scenarios, the inability to execute preemptive rate-hike and rate-cut cycles is the real danger.

This is because, as I've laid out, they simply don't know how to foresee a cyclical downturn in inflation, which is important for engineering a soft landing. ■