Market Insight:
Patience and Pre-Conditions

Beata Caranci, SVP & Chief Economist | 416-982-8067
James Orlando, CFA, Senior Economist | 416-413-3180

February 6, 2019

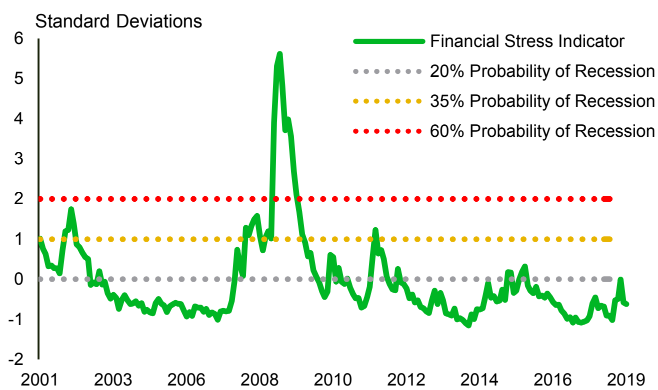
Highlights

- The Federal Reserve has rightfully pressed the pause button on future rate hikes until the data confirm greater economic momentum.
- This leaves a higher burden of proof on the data, suggesting specific pre-conditions need to be met before the central bank steps back in with another upward policy rate adjustment. These include relatively stable financial conditions, a bounceback in global growth, and stronger evidence of intensifying domestic inflationary pressures.
- It will take time for these factors to materialize. It's important to emphasize that the data now needs to make a compelling case, since the central bank has moved into the lower bound of estimates of neutral interest rates. We have long argued that 2019 will be the peak in the interest rate cycle, and the case is probably more compelling today than it was in 2018.

On January 30th, financial markets let out a huge sigh of relief when the Federal Reserve signaled a shift in its monetary stance. It was only a short period prior (in October) when the Fed Chair stated "we're a long way from neutral" interest rates. In December, a formal FOMC communication reinforced the tightening cycle by noting "further gradual increases" were still warranted. But, just six weeks later, the January FOMC statement changed course by citing "the Committee will be patient" . In effect, a tightening bias quickly became redefined as a neutral stance. Were the earlier statements a miscalculation on the Fed's part? Not really. The sands shifted under their feet in that short period, and the Fed can be credited with demonstrating the flexibility required to be responsive and true to the data. To explain, we'll first need to take a small step back in time.

At the end of the summer in 2018, U.S. economic growth was pushing well above 3% and equity markets were hitting new highs. Then the world changed. Data started revealing that trade tensions and slowing growth in China and Europe were chipping away at sentiment, manufacturing and export activity. Corporations started reporting weaker earnings guidance and equities the world over fell precipitously. This is where recession talk began to heat up, and surveys began revealing higher odds being assigned by market participants. Then along came the New Year and with it, renewed optimism. This optimism was partly rooted in central bank speeches displaying candor in the need to reevaluate the risks to the economic outlook and the emphasis that monetary tightening was not on a preset course. That rhetoric has now been followed by action.

Chart 1: Financial Market Stress Easing



Source: TD Economics

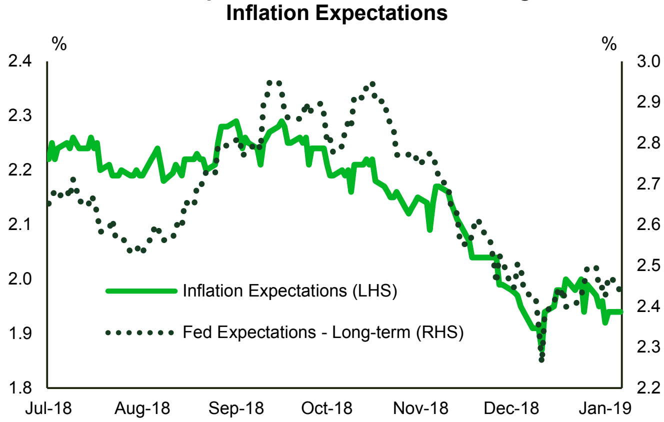
The Fed has hit pause, but for how long?

The Fed's patient mood seems to be more rooted in the deterioration in the global outlook and the resulting fragility of financial market sentiment, rather than domestic conditions. An intensifying downdraft within China and Europe placed economic data surprises pretty much on one side: negative. Importantly, this started to reveal an increased risk of a synchronized global downturn. Although the U.S. data have not been out of step with our expectations in any meaningful way, an easing trend is unfolding against this global backdrop and amidst tighter financial conditions. Added to this is the reality that there has been little improvement in event risks related to trade tensions, Brexit, and other geopolitical tensions.

When combined with muted inflationary pressures, the Fed is under no pressing need to raise rates and, in fact, is showing some comfort at holding closer to the lower level of their neutral estimate (2.50-3.50%), at least until there's stronger data to suggest otherwise. As Powell has noted, "you can't directly observe the neutral rate … we have to put aside our own priors of what that rate might be and let the data speak to us". This leaves a higher burden of proof on the data, causing us to map out some possible pre-conditions that need to occur before the Fed would consider moving interest rates further into the estimated neutral range.

First, it almost goes without saying that financial markets need to be reasonably stable. We say "reasonably stable" because central banks guard against being responsive to the inherent volatility of risk-appetite. However, they generally take market volatility into consideration when outsized moves augment the impact-risks to the broader economy via wealth, confidence and spending behaviors. After a wild December, the appetite for risk-assets has bounced off the floor, allowing our Financial Stress Indicator (Chart 1) to return to levels consistent with an average degree of stress. This index now signals less than a 20% probability of recession in the next 12 months. With equities rallying, bond yields holding steady, and credit spreads narrowing, we don't need much more reassurance from financial markets that cooler heads prevail. However, sustainability is key on this front alongside what we believe to be a second precondition: stabilization in global conditions.

Chart 2: Expectations for the Fed Declining with Inflation Expectations



Source: Bloomberg LP, Federal Reserve Board, TD Economics

The Fed will want to see a period of stable-to-stronger global economic momentum, particularly given broadly weaker growth that set in towards the end of 2018. Most economists anticipated cloudy skies for the UK amidst Brexit limbo-land, but were caught off-guard by disappointments within mainland Europe, including France, Germany, and Italy. Although this deterioration partly reflects one-off factors, more worrisome is the prospect that underlying growth has weakened as a consequence of the slowdown in Chinese demand, and may also reflect the impact of elevated trade and global economic uncertainty. In addition, Europe has a much smaller growth-cushion to absorb negative shocks and is already at a low monetary setting.

Although global events historically do not generally move the Fed's hand due to the economy's low export dependency, revenues of many U.S. firms depend now more than ever on foreign demand. As such, the U.S. is no longer an island and financial market stability is increasingly intertwined with global developments. In addition, the Federal Reserve has previously shown patience in the face of global uncertainty, as recently as 2016, when the rate hike cycle was placed on a one-year hold while the Fed assessed the knock-on impact of China's slowing economy.

However, the most important precondition on the interest cycle is a return to above-trend domestic economic growth in Q2 and beyond. This would mark a proof-point that global conditions have not washed upon domestic shores. But, this alone may not be sufficient to satisfy the Federal Reserve. Ultimately, the burden of proof will fall to whether a persistence of economic growth is pushing up inflationary pressures and market expectations. The importance of this needs to be underscored. Chart 2 shows the pull-down forces that have been hitting U.S. Treasury yields in recent weeks. There has been an utter collapse in market expectations for both inflation and the Fed policy path. We've been here before with expectations moving lower on the policy path, but the collapse in inflation is overdone relative to the state of the economy. This measure has a high correlation to oil price movements, but even absent that, it's clear that financial markets have shifted to an "I'll believe it when I see it" mind set. Strengthening in inflation and, importantly, inflation expectations will be a *necessary condition* for any further rate hikes. This may require the Fed to stretch its patience to allow for an inflation "overshoot" in order for the data to build the credibility needed to sustain higher market expectations.

All this to say that we find ourselves reinforcing the thesis presented at the start of the year that history may indeed characterize this time period as make-or-break for this economic cycle. It will likely take a number of months before the ducks fall into line either supporting or refuting any further rate movements from the Fed. At best we can argue that the balance of risks are between zero and one increase for 2019 as a whole.

Bottom Line

If there is one main takeaway, it's that the Federal Reserve has shifted into a wait-and-see mode now that its policy rate is narrowing in on the lower bound estimates of the neutral range. This resets the bar for further rate hikes at a higher threshold, leaving less scope for higher rates in 2019 than in prior years. With global economic momentum disappointing, it is still uncertain whether a fulsome recovery will take hold to sustain financial market stability. Even once this occurs, the domestic data needs to find a stronger footing (which we think it will) and inflation expectations need to reflect that outcome. It could take a number of months before all these ducks fall into line to either support or refute any further rate movements from the Federal Reserve. Until then, patience will be the catchword of 2019.

Disclaimer