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BOND MARKET PERSPECTIVES

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POWELL SAYS FED ON TRACK…FOR NOW

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KEY TAKEAWAYS

In testimony to Congress, Fed Chair Powell largely stuck to the script, saying little to alter the Fed's perceived course.

Powell said the economy is strong and that gradual rate hikes remain the likely path forward, but also noted that the Fed was data-dependent and flexible to change that path.

Post-testimony, President Trump inserted himself into the debate by questioning the Fed's plans to continue hiking rates.

Federal Reserve (Fed) Chair Jay Powell's recent comments to Congress, and the subsequent market reaction, offered some insight into the future of monetary policy in the United States. In his semiannual testimony to the Senate Banking Committee, Powell said little that was surprising, but the comments nonetheless help investors in their efforts to understand monetary policy going forward, and how that policy could shape market behavior.

ON TRACK…"FOR NOW"

Broadly, Powell indicated that the Fed remains on course to gradually raise interest rates and that the economy is strong and growing at a solid pace. He also eased some investor concerns by reiterating that the Fed's stated path is not set in stone, and its members can reassess and change course should data emerge indicating there is a better path forward. The two most important words of Powell's testimony may have been "for now." Powell said the Fed "believes that—for now—the best way forward is to keep gradually raising the federal funds rate." Investors saw the "for now" as critical, especially in the face of rising trade tensions. If data start to deteriorate due to trade skirmishes, tariffs, or an all-out trade war, the Fed can (and likely will) adopt a slower path of rate hikes, put them on hold entirely, or even become more accommodative if need be.

Powell clearly understands the Fed's predicament. "We are aware that, on the one hand, raising interest rates too slowly may lead to high inflation or financial market excesses," he said. "On the other hand, if we raise rates too rapidly, the economy could weaken and inflation could run persistently below our objective." Given this predicament, Powell also gave interesting testimony regarding his views on inflation, which dominates much of the debate about the appropriate pace of Fed rate hikes. When asked whether he was more concerned about inflation being too high or too low in the near term, Powell said he was more

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concerned about low inflation. Market sentiment may back up this assertion as well, with the market breakeven one-year inflation rate rolling over recently, relative to longer-term breakeven inflation rates [Figure 1]. Though Fed rate hike expectations did not change as a result of the statement, it goes without saying that less inflation pressure would prompt the Fed to hike less, not more, all else being equal.

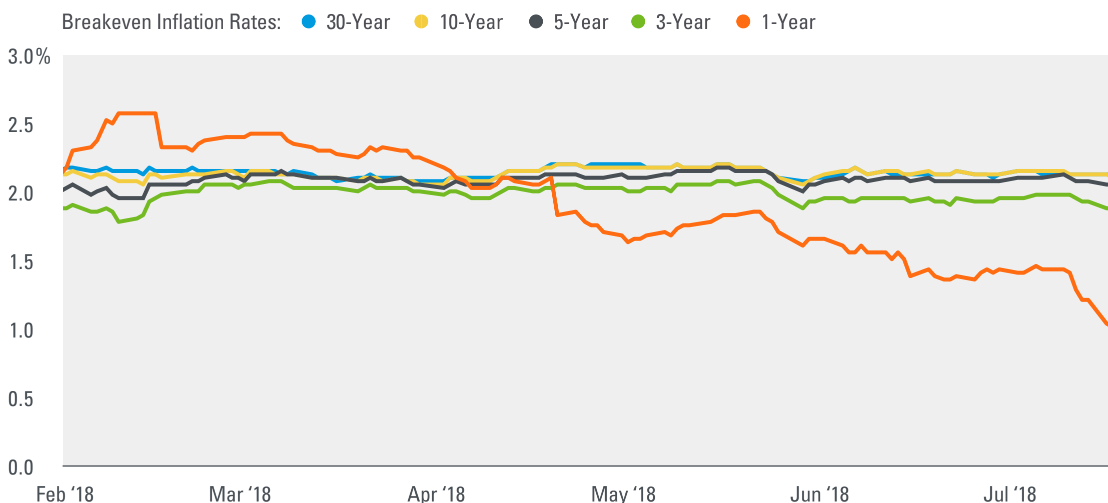
HOW DID MARKETS REACT?

Market reaction was extremely muted, evidence that Powell's words were very carefully chosen and that the Fed has been delivering a mostly consistent message under his leadership. Longer-term rates have increased in the week or so after Powell's testimony, but not necessarily because of it. Rumors around the Bank of Japan (BOJ), a central bank that has been seen as accommodative for years and will likely to continue to be, conspired to pressure rates higher as well. The BOJ is said to be holding active discussions about how to make its monetary easing policies more sustainable, i.e., cheaper to implement. If Japan were to alter or abandon its policy of targeting a 0% yield on the 10-year Japanese government bond, it could untether rates globally, pushing rates higher across the developed world. The BOJ's next decision will come on July 31, and investors will be keen to look for not only any change to policy (though no actual change is yet expected) but any change to nuance or language surrounding the policy.

POLITICAL PRESSURE

Asked many times to chime in regarding policy matters, Powell took care to reiterate that the Fed is concerned with stable prices and full employment, evidence that he's trying to avoid weighing in on political matters and wants to maintain the Fed's independence. He did make general statements about trade policy, saying that countries with lower barriers to trade generally have better economic outcomes. His diplomatic approach did not prevent politics from finding him, however. President Trump took the Fed to task on Twitter, arguing that rate hikes were destructive to the economic expansion that was boosted by the recent tax cuts. Trump also suggested that a stronger U.S. dollar is harmful for domestic growth

1 NEAR-TERM INFLATION MEASURES WANE WHILE LONGER-TERM HOLD STEADY



Source: LPL Research, Bloomberg 07/23/18

prospects. By doing so, Trump broke with decades of tradition, as presidents have generally avoided weighing in on Fed actions and policies, instead allowing the Fed to pursue its dual mandate by operating outside of any political pressure.

Neither Powell nor other Fed members have responded to the president, but the pressure could have unintended consequences. If the Fed is truly on the fence regarding one or two more hikes in 2018, they may opt for two in an effort to show they are not at the mercy of political pressure. There may be some data to back this up, as Fed rate hike expectations for 2018 and 2019 have actually increased since President Trump's Fed tweets.

CONCLUSION

In his semiannual Senate Banking Committee testimony, Powell reiterated the Fed's current views on the economy and intent to continue its gradual rate hike path, at least for now. Neither Powell's prepared remarks nor the subsequent Q&A rocked the boat, evidenced by extremely muted market reaction during the two-day testimony. Despite some political pressure post-meeting from President Trump, Powell did well to explain the Fed's view that the economy is on solid footing, and that it remains on a data-dependent path to tighten monetary policy going forward. ■

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