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Fed Thoughts: The Gravitational Pull on Monetary Policy

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At its meeting ending November 1, the Federal Open Market Committee (FOMC) kept the funds-rate target range at 5¼ to 5½ percent but left the door open for future firming. At the press conference that followed, Fed Chair Powell leaned back from the threshold. In doing so, the Federal Reserve (Fed) surrendered some of its prior progress in convincing markets that the funds rate will be “high for long,” and market prices put little weight on additional action this year and a lot on a quick policy pivot next year. Incoming economic data have proven the former probably right, but we think the latter is wrong.

We believe the Fed’s problem is that doing nothing is hard work. Unless officials project toughness, investors move on to the next move, which will be easing, but not as soon as they expect.

In what follows, we:

- review the Fed’s misstep in communicating intent;
- explain the bias in investor expectations that the Fed should offset by talking tough;
- identify why we believe inflation inertia along the “last mile” in bringing inflation back to goal requires a firm policy stance through most of 2024; and,
- worry about the risks to the outlook.

The FOMC’s Misstep in Communication

At the conclusion of its October 31-November 1 meeting, the FOMC “decided to maintain the target range for the federal funds rate at 5¼ to 5½ percent” with a bias toward “additional policy firming that may be appropriate to return inflation to 2 percent over time.”¹

In his press conference following the meeting, Chair Powell said all the right words that future firming depended on economic data, financial conditions and events, and that no decision about the outcomes of future meetings had been made. The one exception was that “...the Committee is not thinking about rate cuts right now at all.”² Still, the way he characterized the transmission mechanism seemed to imply firming was at an end. Chair Powell further discussed the following at his press conference:

- More policy restraint was probably in the pipeline, “...the effects have just taken time to get into the economy.”
- While aggregate demand retained momentum, “...the unwinding of the distortions to both supply and demand from the pandemic and the response to the pandemic...can bring down inflation without the need for higher unemployment or slower growth.”
- Disinflation was ongoing, in part because “...wage increases have really come down significantly over the course of the last 18 months to a level where they’re substantially closer to that level that would be consistent with 2 percent inflation over time...”

- And inflation expectations “...are in a good place,” dismissing evidence to the contrary with the assurance that “...there’s no real crack in that armor. You can always find one reading that is a little bit out of whack, but, honestly, the bulk of them are just very clear that the public believes that inflation will come down.”
- As for the uncertainty around the policy outlook, “The risk of doing too much versus the risk of doing too little are getting closer to balance, because policy is I think clearly restrictive at 5¼ to 5½ percent.”

The word count might suggest a balanced approach from the Chair, but, as he is wont to say, you shall know it in its works. In the event, his performance was taken as dovish, and markets rallied strongly. Investors marked down the future path of the policy rate and unwound a significant share of the firming in financial conditions posted in the run-up to the meeting.

The wavering commitment to another quarter-point hike this year in the September outlook probably owed to the hopes of policymakers that the backup in the 10-year yield in advance of the meeting had done some of their work, firming still in the banking pipeline, and, wherever the nominal funds rate is in December, the plan to keep it there through much (probably three-quarters) of next year will send inflation back to goal. Hope is the thing with feathers, not a strategy.

We believe the lesson for the Chair is that his description of policy is a blunt instrument. Investors extrapolated his complacency: Policymakers embracing reasons not to follow cues from macro data now will not do so in the future, and if they are not talking about raising rates, then they must be thinking about cutting them.

What’s Happened Since?

The release of the better-than-expected consumer price index (CPI) reading for October two weeks after the meeting had to cheer Fed officials. The Fed bit players taking the stage when the blackout curtain lifted pointed to that good news, mostly ratifying market beliefs of no further action this year but following Franklin Roosevelt’s admonition that “it is impolite to talk about rope in the house of someone who was hung.” That is, no one was talking about the market doing their work, and they were careful to repeat that nothing had been ruled out. This was caution in policy communication, not in policy implementation.

In his star turn at a recent International Monetary Fund (IMF) conference, Chair Powell was stern in delivering remarks in a panel discussion,³ similar to his opening statement at the FOMC meeting press conference, that “... if it becomes appropriate to tighten policy further, we will not hesitate to do so. We will continue to move carefully...” The event, however, was a conference honoring Ken Rogoff, filled with members of the official community, and Powell was preaching to the converted but probably not from the heart. Curiously, his remarks failed to mention Rogoff’s most cited paper on monetary policy that introduced the notion of “the conservative central banker” to offset the inflationary bias inherent when policymakers have a dual mandate. Curious because, as shown below, being a conservative central banker is probably the solution to the Fed’s current problem.

A few weeks later, the FOMC minutes from the most recent meeting showed a committee committed to its big strategic decision of holding the policy rate on a restrictive plateau until it sees the results it wants—inflation returning to goal. Whether the policy rate goes up from here is a second-order decision, about which it will proceed

cautiously depending on the data and financial conditions. Tellingly, as Powell foreshadowed in his press conference, no one considered cutting rates any time soon.

- In the words of the Committee, everyone agreed “it would be appropriate for policy to remain at a restrictive stance for some time until inflation is clearly moving down sustainably toward the Committee’s objective.”
- There were multiple references that they “would need to see more data, indicating that inflation pressures were abating to be more confident.” That’s both about economic releases and financial conditions and will be evident when demand growth slows to below that of potential to lessen pressures on resources.

They were cautious about financial conditions, noting the rise in longer-term yields in the run-up to the meeting and that such market developments were an important consideration in monetary policy. There was no mention that the rise in yields “had done some of their work,” which had been prominent in their pre-meeting remarks and likely discussed at the meeting. That’s not a surprise. While the document is supposed to present a fair description of the deliberations at the meeting, it is drafted and edited after the meeting and in light of the market reaction. Arguments made at the meeting with a short shelf life often get short shrift in print in the minutes after the fact.

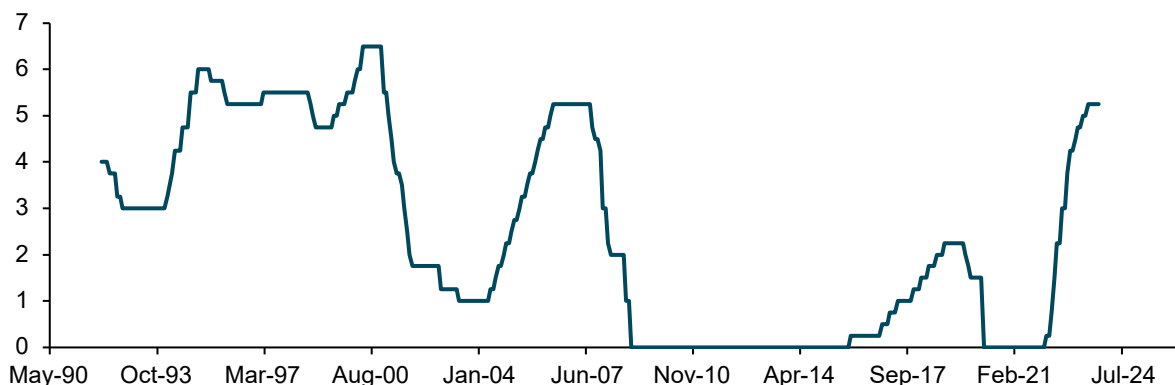
We think that the Fed will keep the policy rate unchanged in December but use its Summary of Economic Projections (SEP) to convey that the marketplace is wrong about a quick policy pivot in 2024. We believe Fed officials will attempt to offset the dovish message from the median dot for 2023 dropping a quarter-point by nudging up the one for 2024, implying higher for longer than investors expect.

Why is Doing Nothing So Hard?

The best guidance in understanding policy setting, whether by the Fed through history or that of other central banks, comes from Isaac Newton. His Second Law holds that a body in motion stays in motion, and a body at rest stays at rest. This explains the persistence of official rates, seen in the chart that follows, in the long upward and downward arcs of the fed funds rate interrupted by similarly long stays at an unchanged level. This persistence is unlike the gyrations in other yields in finance.

Federal Reserve Fed Fund Rate Target

Percent



Source: Federal Reserve, accessed via FRED, 11/30/23.

This predictability doesn't square with intuition if it is costless to change the target rate. At each meeting, it is our belief that a central bank should set the policy rate at the level appropriate with incoming information. Since news is unpredictable, so too should be the policy rate. Potential explanations are plentiful, including, among other possibilities, concerns about financial stability that make changing the policy rate costly, a desire to influence longer-term rates by making the current action a prediction of future ones and inertia in group dynamics. To quote another favorite phrase of Jay Powell, "whatever, it is what it is." And "what it is" is Newtonian in its persistence.

The Second Law, however, is an abstraction describing an idealized environment in which a single force may be exerted on a single object. There's no friction from the atmosphere, pull from gravity, or push from tailwinds. It's incredibly important in physics, but it's not all you need to know to get from point A to point B.

Monetary policy doesn't operate in an idealized environment, either. We believe many people prefer lower interest rates.

- Central bankers tasked with a dual objective are tempted toward accommodation to generate surprise inflation that keeps the unemployment rate low. (Because they can't predictably surprise, above-goal is the outcome.)
- Politicians likely prefer a lower rate because they believe it supports more jobs for their constituents and lowers the cost to service the government debt.
- Investors love a low policy rate to prop up the values of long-lived assets and love even more cutting the rate for the capital gains produced.
- Media attention is sparked by the possibility of change, not stasis.

Together, this gravitational pull on a central bank favoring lower interest rates imparts an asymmetry between cutting and raising the policy rate and an impediment to keeping it unchanged. To cut rates requires just going with the flow, to convince investors that rates will not naturally fall, the Fed should exert the force of hawkishness. To raise rates, it must be even more hawkish. This is evident in a finer examination of the chart on the previous page.

- The policy rate goes down quickly as gravity makes it easy to ease.
- Policy firming spells take more time because the central bank must be more convinced to act and more forceful in acting to offset the prevailing gravitational force.
- The period before firming is longer than before easing, as the Fed must work up the courage to be unpopular.

Doing nothing with the policy rate takes work because the Fed must project hawkishness, including talking up rate hikes, to offset the downward bias of investors. This can be hard to pull off because when done clumsily sounds false and silence isn't an option.

Circling back to the press conference: Supporting a high-for-long strategy, we believe the Chair left only the one-sided option of hikes, not cuts, on the table. However, he stressed why rates could remain unchanged relative to why they may go up. Investors felt the tug of monetary policy gravity as a one-sided option with rates unchanged until they're cut. We also get back to the IMF conference. If the environment imparts a bias toward lower rates and inflation, then appoint a conservative central banker who naturally pulls the other way. We believe an incentive-conflicted society should protect itself from itself.

For the immediate future, we believe Fed officials, whether they feel it or not, should walk the walk and talk the talk of conservative central bankers. If not, investors will get even further head of themselves in anticipating policy easing.

Why Does Inflation Remain a Problem?

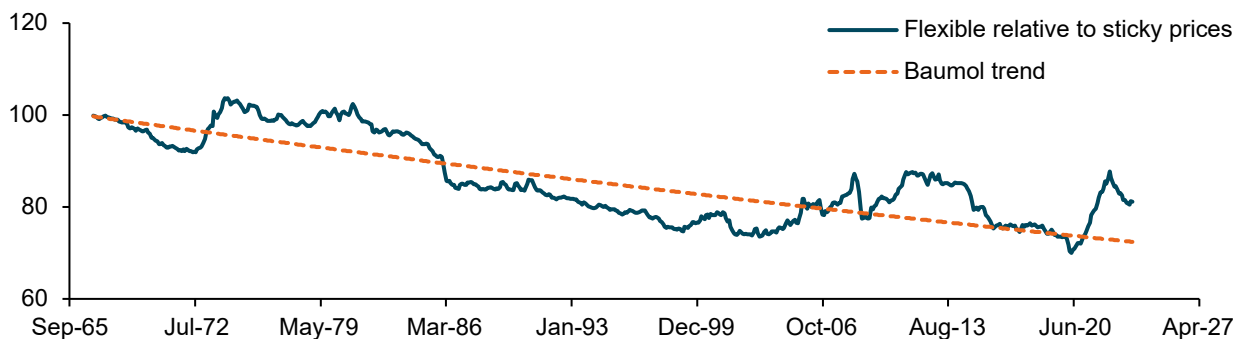
No doubt, the better-than-expected report on consumer prices showed that the Fed has made considerable progress in returning inflation to goal. However, 3¼ percent annual inflation is still north of that goal and it is our belief that the public remains troubled about the economy. Inflation is inertial, making the last mile in its reduction hard and keeping the public anxious, and we feel **the place to look is price levels, not the rate of change**.

The 30 percent of the commodity basket that the Federal Reserve Bank of Atlanta identifies as having flexible prices are primarily goods (with prices that are changed rapidly in response to market forces), and the 70 percent with sticky prices are primarily services (with prices subject to formal and informal contracts that are reset infrequently).

- Productivity tends to grow much faster in the goods relative to the service sector. As such, the relative price of goods to services tends to decline over time, the “Baumol disease,”⁴ as reflected in the secular downtrend of flexible to sticky prices.

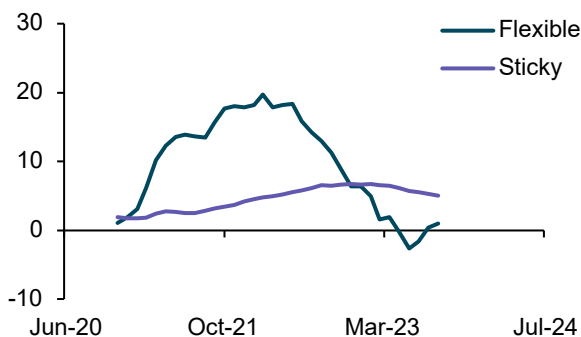
Flexible Relative to Sticky Prices

Index, 1/1967 = 100



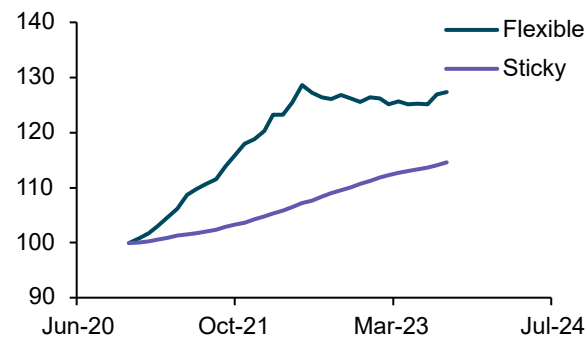
Flexible and Sticky Prices

Twelve-month Change, Percent



Flexible and Sticky Prices

Levels, 12/2019 = 100



Source: Federal Reserve Bank of Atlanta and Firm analysis, accessed 11/8/23.

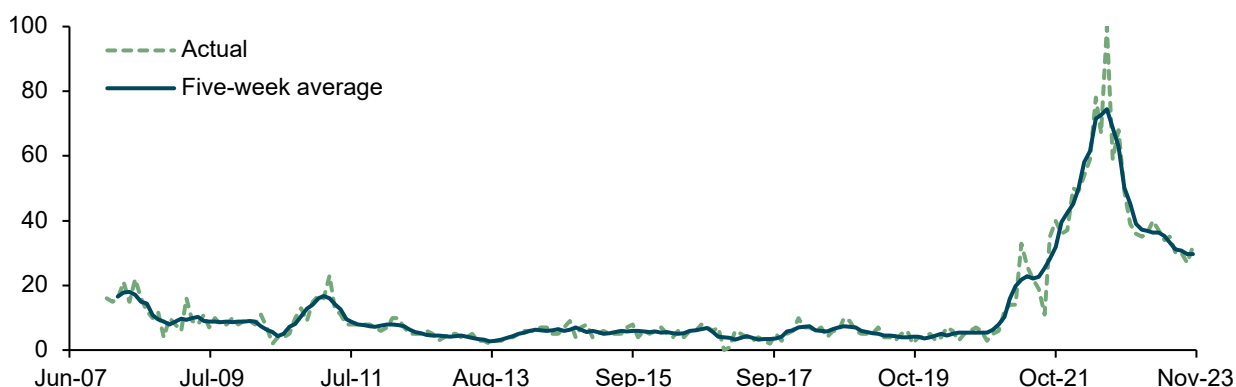
Higher flexible-price inflation from 2020 to 2022 pushed flexible relative to sticky prices well above the secular trend.

- Some combination of declines in the former and increases in the latter are needed to realign those relative prices. Mostly thus far, it has been a faster increase in sticky prices.
- This isn't about current pressures in the labor market or expectations of future inflation. This is catch-up to what has already happened.
- To return to the prior trend, sticky prices must rise 11 percent as of October if flexible prices were unchanged.

This is why we believe that the public is still concerned about inflation despite the Fed's progress in reducing it thus far. Volcker and Greenspan presciently defined price stability as a "state of mind" when "households and firms do not waste effort worrying about changeable prices." Inflation concerns have fallen, as evident, say, in Google news searches on "inflation," but they are still materially higher than pre-2020. That's because the public sees that relative price levels differ from the norm, and they are discomforted.

Google News Searches on "Inflation"

Index, Peak Interest = 100



Source: Google Trends, accessed 11/13/23.

It will take some time for those concerns to recede even after (or if ever) inflation falls back into the 1-to-3-percent zone of price stability emphasized by Volcker and Greenspan. During that time, the funds rate, in our view, will have to remain on its restrictive plateau.

What are the Risks to the Outlook?

The last mile to price stability is hard because inflation is stubborn as relative prices slowly return to their pre-pandemic alignment. Officials may find it difficult not to pivot if the economy contracts and financial strains worsen, especially as internal division and outside pressure mount. If so, the result will be poor economic performance and inflation running somewhat above goal for some time.

Economists can't predict recessions, but they historically can identify when an economy is more vulnerable to one, as it is now.

- Restrictive monetary policy makes an economy more susceptible to adverse shocks, the risk of those abound, and buffers are thinner.
- The Fed doesn't have the market's back, firming at a record pace even as it was predicting recession and during a bank run. Why, if the outlook is not as dire, will it give up its fight against inflation?

Don't forget about Quantitative Tightening (QT). In the first year of the QT program, the Treasury offset any net Fed balance-sheet effect on the public by running down its general account given the constraint of the debt ceiling, and other assets expanded because of emergency loans to stem bank runs. The assets the Fed supplied to the private sector went up, not down.

- **Since June, when the debt ceiling was suspended, QT began in earnest** as the Treasury account returned to its level at the onset of QT, rebounding \$750 billion.
- The combination of a decline in liabilities of the Fed and the shift in their composition to the government reduced what is available to the private sector \$1.25 trillion in five months.

Standard macro models do not include a role for monetary quantities, but there have been notable episodes when large changes seemed to matter (the Great Depression and the 1970s inflation). Such a sharp reduction in the assets from the Fed made available to the public may matter again.

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Vincent is the firm's Chief Economist and Macro Strategist. In this role, he is responsible for developing views on the global economy and making relative value recommendations across global bond markets, currencies and sectors.

Previously, Vincent served as the Chief US Economist and a managing director at Morgan Stanley. For the prior four years, he was a resident scholar at the American Enterprise Institute (AEI). Vincent also worked in several roles at the Federal Reserve over 24 years, including Director of the Division of Monetary Affairs and Secretary and Economist of the Federal Open Market Committee (FOMC). His responsibilities at the Federal Reserve included directing research and analysis of monetary policy strategies and the conduct of policy through open market operations, discount window lending and reserve requirements. Prior to these roles, he was the principal liaison with the domestic desk at the Federal Reserve Bank of New York and was responsible for preparing a document outlining policy alternatives for each FOMC meeting. He was Deputy Director in the Division of International Finance and Associate Economist of the FOMC and spent five years at the Federal Reserve Bank of New York in both the domestic and international research departments.

His academic publications primarily concern the conduct of policy and issues related to the monetary transmission mechanism as well as an analysis of alternative auction techniques and Treasury debt management. After an undergraduate training at Fordham University, he received graduate degrees in economics at Columbia University.

Endnotes

¹ Federal Reserve FOMC Statement, November 1, 2023, <https://www.federalreserve.gov/newsevents/pressreleases/monetary20231101a.htm>

² Federal Reserve October 31-November 1, 2023, FOMC Meeting, <https://www.federalreserve.gov/monetarypolicy/fomcpresconf20231101.htm>

³ Opening Remarks, Fed Chair Jerome H. Powell, November 9, 2023, <https://www.federalreserve.gov/newsevents/speech/powell20231109a.htm>

⁴ "Baumol disease," or "Baumol effect," is the phenomenon economist William Baumol describes as the rise of wages in jobs that have experienced little or no increase in labor productivity in response to rising wages in other jobs that have experienced higher productivity growth.

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