ECONOMIC OUTLOOK
REGIONS
September 2016

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Is The FOMC Embracing The "New Normal"?

As a general rule, we've always preferred central bankers to be competent and quiet, in that order. While we still see those as desirable traits, we're just about at the point where we change the order in which we rank those qualities in terms of importance. We're not alone on that front; many analysts and market participants are increasingly frustrated with a seemingly endless flow of public comments from FOMC members regarding the "appropriate" timing and number of hikes in the Fed funds rate.

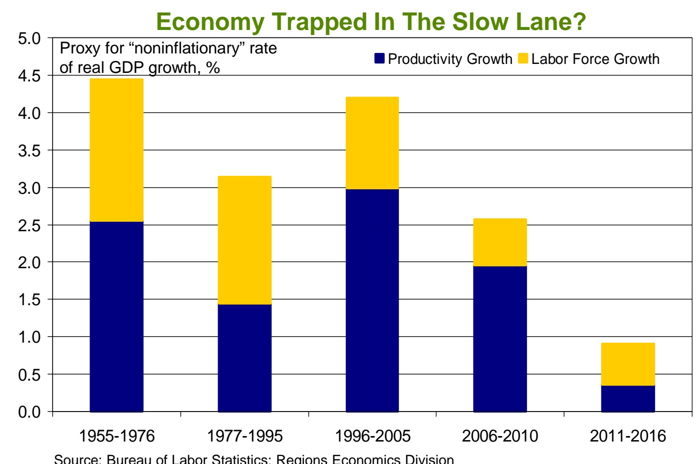
Yes, of course, we get that the "C" in FOMC stands for committee and it is only natural that, as in any committee, individual members of the FOMC will not always share the same views. If that were the extent of it then, okay, we'd all be happy to listen. But, instead of FOMC members debating each other, what we've gotten is in many cases FOMC members debating themselves, out loud and in public. And, sure, it is only natural that over time the views of each individual FOMC member will evolve along with the data that members are purportedly dependent upon. But, really, do we need to hear individual Committee members throwing out a different "appropriate" number of funds rate hikes each time they speak in public, or, even worse, offering that the "appropriate" number of hikes in a given time period could be zero, one, two or three? You know, depending on the data.

Wow, that is so not useful. That all of this talk over the past few years has culminated in a grand total of one hike in the Fed funds target range despite what has been steady, though by no means spectacular, real GDP growth and sustained improvement in labor market conditions makes all of the talk that much more frustrating. We've gotten to the point where it is valid to ask is it really "forward guidance" if no one is listening. Our view, and again we're not alone in this, is that the FOMC has eroded much of what had been a high degree of credibility built up with considerable effort over the course of a number of years.

That credibility is critical in a central bank being able to engage in policy moves without disrupting the financial markets. We're not so sure that's the case at present, though presumably we'll find out at least once by year-end. Our concern is that many market participants have basically tuned out the FOMC and have adopted a "we'll believe it when we see it" mentality. As a result, when the FOMC does follow through with the next rate hike (which we still think will be this December), many market participants will be caught off guard and there could be considerable disruption in the markets. This of course would leave at least some FOMC members scratching their heads wondering why anyone was surprised.

Still, although we find the constant emphasis on "when" and "how many" to be of no use and indeed counterproductive, we've been most interested in what, for at least some FOMC members, has been a new line of discussion of late. Over the past several weeks, St. Louis Fed President Bullard, San Francisco Fed President Williams, New York Fed President Dudley, and Fed Chair Yellen have all, in one manner or another, touched on the notion that things just aren't what they used to be. More specifically, a common theme basically boils down to the premise that the pattern of modest real GDP growth and correspondingly low inflation that has prevailed since the end of the 2007-09 recession is basically as good as it's going to get. If true, this then has stark implications for monetary policy, including the "terminal" value of the Fed funds rate target range, the ability of the FOMC to respond when the economy does slip back into recession, and, yes, even the timing of the next hike in the funds rate target range.

Each FOMC member has their own way of framing their discussion of this issue. For some, it is in terms of the declining value of the natural rate of interest, or the short-term real interest rate that balances monetary policy such that it is neither expansionary nor contractionary (this is often referred to as "r*"). For St. Louis Fed President Bullard, the economy's low growth, low inflation "regime" will prevail for at least the next 2.5 years but when specifically the regime will change is something that cannot be forecasted. Other FOMC members have discussed the need to develop alternative policy tools to compensate for the likelihood that the Fed funds rate (or the target range, the point is the same) will remain so low that it will diminish the FOMC's ability to respond to the next downturn by means of the traditional policy lever, i.e., changes in the funds rate.



No matter the angle at which it is approached, the discussion really boils down to a topic we've frequently spoken to and that we illustrate with the above chart. In it, we show the economy's "speed limit," or, the rate at which the economy can grow without sparking inflation pressures, which can be approximated by taking

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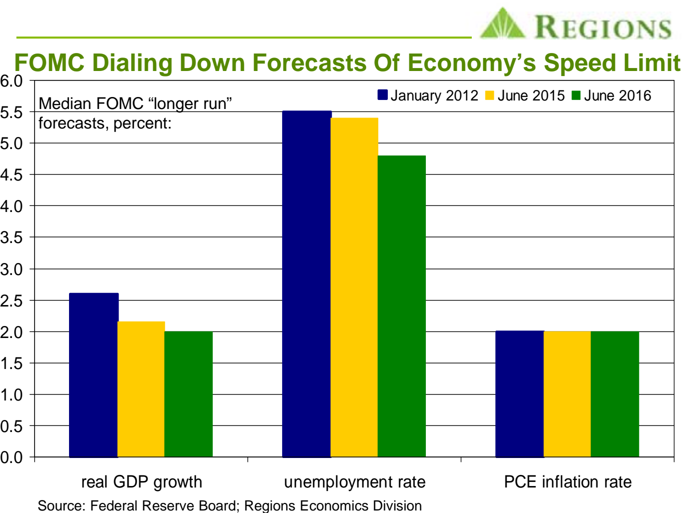
the sum of the rate of growth of the labor force and the rate of labor productivity growth. As seen in the chart, at present the economy's speed limit is distressingly slow, conjuring up images of Etimoni Timuani far more so than images of Usain Bolt. Okay, we'll save you the Google search – Mr. Timuani was the lone Olympian from the tiny island nation of Tuvalu at the Rio games, and posted the slowest time of any competitor in the men's 100 meter preliminary rounds, thus failing to advance to the qualifying heats. To be sure, though, even on the slowest day he's ever had, Mr. Timuani would have no trouble outrunning the U.S. economy.

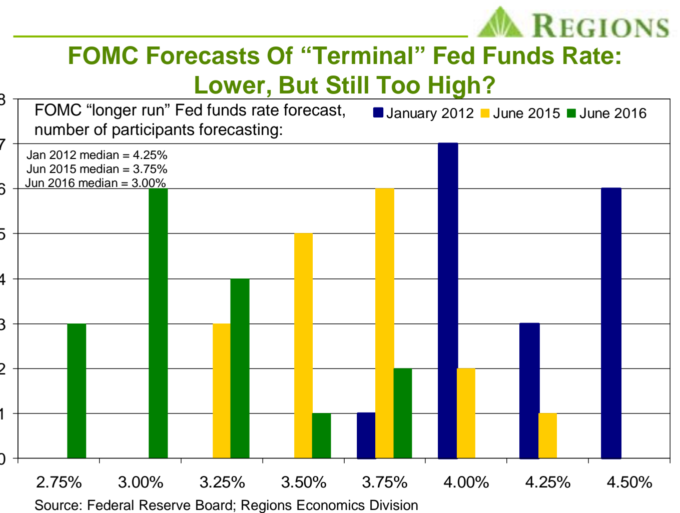
The above chart will of course be familiar to our long-time readers, as we've often shown it in the context of our frequent discussions of the uncomfortable implications of the economy's anemic trend rate of productivity growth. Perhaps a bit too familiar for some, given the "what, again with your little bar chart?" reaction from one of our colleagues each time we offer up this chart. We don't take that as anything against our little bar chart, but instead as mounting frustration with the message contained in the chart. After all, 15 years ago everyone just loved our little bar chart.

Anyway, back to the matter at hand. Again, no matter how the discussion is couched, a common theme seems to be more and more FOMC members coming to terms with, and assessing the implications of, the economy being stuck in the slow lane, i.e. persistently slow real GDP growth. To some extent, a number of FOMC officials have held this view for some time now even if it hasn't been a topic of conversation. For instance, four times a year the FOMC releases a set of projections in which each member offers their assessment of the paths of real GDP growth, inflation, and the unemployment rate. In addition to projecting the paths of these variables over the coming few years, Committee members also offer their assessment of the path of the Fed funds rate (or, more precisely, the midpoint of the Fed funds target range) consistent with their economic outlook – the infamous "dot plot."



What tends to get less attention, however, are the projections for the "longer run" value of each of these variables, or, if you like, the "steady state" value that would prevail under the appropriate value of the funds rate and the absence of shocks. In the chart above, we show the longer run forecasts for real GDP growth, the unemployment rate, and the rate of inflation as measured by the Personal Consumption Expenditures (PCE) Deflator at three points in time between January 2012 and June 2016 (the latest set of projections). As seen in the chart, the median estimate of longer run real GDP growth has steadily inched lower and now stands at 2.0 percent. It is interesting to note how the range of estimates offered by individual FOMC members has changed since January 2012. At that point, the range of estimates for longer term real GDP growth was 2.2 to 3.0 percent; as of June 2016 the range was 1.8 percent to 2.4 percent. Note that in conjunction with this month's meeting (September 20-21) the FOMC will release an updated set of projections.

Perhaps an even more striking illustration of how views of the economy's longer run growth path have evolved (or, is "devolved" a more appropriate term?) is the change in the assessment of the longer run value of the Fed funds rate, specifically, the midpoint of the funds rate target range. As seen in the chart below, the median estimate of the "terminal" funds rate has come down considerably over time, which is consistent with a downgrading of the economy's longer run growth prospects. Still, the extent to which this is the case is striking, and, at least to us, conveys far more meaningful information on how FOMC members view the prospects for the economy than any amount of chatter over whether or not we can rule out four funds rate hikes this year, or this century for that matter.



As indicated in the chart, the median longer run value of the Fed funds target range midpoint was 4.25 percent as of the January 2012 projections, but as of the June 2016 projections the median stood at 3.00 percent. Of course, there are those who dismiss the concept of steady state values as nothing more than a theoretical construct with no "real world" implications. Sure, to some extent that's a valid point, or, as we often put it, we'll never really know what equilibrium is because even if the economy ever got there, by time we figured out it had been at equilibrium the economy would be somewhere else.

That does not, however, mean the above chart should be dismissed out of hand. Again, the value of this chart is that it is a meaningful signal of how FOMC members view the longer run prospects for real GDP growth, which in turn has meaningful implications for the course of monetary policy. As such, it would seem this is something that would be discussed more openly rather than something that often gets lost in the details.

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What Does It All Mean?

That of course may be changing, as indicated by public comments by several FOMC members of late which seem to be catching up with the evolution of the FOMC's projections over the past few years. Again, we see this as a good thing, even if the implications are uncomfortable, and we think it would be useful if discussions about the "appropriate" number of Fed funds rate hikes or the timing of those hikes were put in the context of where the funds rate target range is relative to its longer run, or, terminal, value.

For instance, one question we are frequently asked is how the FOMC can "even think of raising interest rates" given how slowly the economy is still growing more than seven years after the end of the 2007-09 recession. This is precisely where the implications of the economy's low speed limit start to become relevant. Though perhaps not as low as implied by our chart above, there is no question the economy's speed limit is lower than has been the case for any prolonged period going back through the life of the data. Thus, even with an average rate of 2.1 percent over the life of the present expansion, real GDP growth has been above that speed limit.

A natural question may be "okay, where's the inflation?" since, at least as we've defined it, a sustained period of the economy growing in excess of its speed limit should be accompanied by accelerating inflation. The buffer, however, comes in the form of excess capacity, or, slack, in the form of idle labor resources and/or idle productive capacity. The reality is that at the end of the 2007-09 recession the economy was awash in idle capacity that has been absorbed at a painfully slow pace, as indicated by the historically low rate of growth during this expansion. A point of contention at present is just how much slack there is left to absorb. This is important because when excess slack has been totally absorbed inflation pressures can be expected to build, even at a persistently slow rate of real GDP growth.

This is precisely why some FOMC members seem intent of raising the Fed funds target range sooner rather than later, with at least some sense of urgency stemming from the long lags with which changes in monetary policy impact the economy. In other words, for those who think we are at or close to full employment, raising the funds rate is a natural response. Our view, however, is that the economy is nowhere as close to full employment as some would put it and as is implied by the "headline" (or, U3) rate of unemployment sitting at 4.9 percent.

With the number of underutilized labor resources, or, the sum of those unemployed, working part-time for economic reasons, and marginally attached to the labor force, by our estimate over two million people above where it would be in a healthy labor market, we think it more than a little premature to be talking about full employment. Moreover, the combined number of people in these three categories has barely budged thus far in 2016, falling by roughly 144,000 after having declined by over two million people per year on average in 2013, 2014, and 2015. That the number of underutilized labor resources has barely budged over the past several months leads some to conclude there has been a structural shift that leaves us with a permanently higher "equilibrium" number of those working part-time for economic reasons. If this is the case, then it follows the economy is approaching full employment, as these underutilized labor resources have little, if any, impact on the pace of wage growth.

The concern of those who argue the economy is at or full employment is that the faster wage growth that will result from tighter labor market conditions will lead to mounting inflation pressures in the broader economy, hence the argument for the FOMC to raise the funds rate sooner rather than later. As we have often noted, however, it is not a given that faster wage growth will be followed by faster inflation in the broader economy, as labor productivity growth acts as a buffer between the two. At present, however, that buffer is virtually nonexistent, as can be seen in our chart of the economy's speed limit on Page 1.

Since 2011, nonfarm labor productivity has grown by an average rate of just 0.36 percent per year (we've used year-to-date growth through Q2 for 2016), the slowest growth sustained over any six-year period on record. Only the 1977-1982 period, at 0.54 percent, even comes close. To the extent the economy is approaching full employment, then, the lack of a buffer between wage pressures and price pressures in the broader economy reinforces the argument of those seeing tighter labor markets as grounds for the FOMC upping the Fed funds rate target range. This is the case despite what has been and will likely remain tepid growth in real GDP, which illustrates one implication of a persistently slow speed limit for the economy. Specifically, the slower speed limit implies the FOMC will have to start raising the Fed funds rate at a lower rate of real GDP growth than has been the case in past cycles.

It is of course true that the rate of productivity growth could accelerate which, by forming a buffer between wage inflation and price inflation, would in turn push the point at which the FOMC would need to start raising the funds rate to fend off inflation further out into the future. The problem, however, is that turns in productivity cycles don't happen overnight, and given what has been persistent underinvestment on the part of businesses over the course of the current expansion, it is hard to see a meaningful and sustained increase in labor productivity growth on the horizon. As a side note, the operative word here is "sustained" – the data on productivity are inherently volatile from quarter to quarter and, no, what is shaping up to be productivity growth on the order of 2.0 percent for Q3 will, sadly, not herald a new "productivity miracle."

This points to an interesting argument inherent in the St. Louis Fed's new regime based approach to determining the appropriate value of the Fed funds target range. In the Bank's view, the low productivity regime that has prevailed since at least 2011 is very persistent over time and, while it could give way to a regime in which productivity growth is faster, this is not something that can be accurately forecasted. As such, the assumption is the current anemic trend rate of productivity growth will be with us for some time to come. That said, it should be noted that even in the current low productivity growth regime, the St. Louis Fed's approach does not see inflation accelerating meaningfully, so that only one more hike in the Fed funds rate target range is appropriate unless and until the economy is operating in a new regime.

That we are stuck in a persistently slow productivity growth regime is an argument we've been making for some time, though not couching the discussion in terms of "regimes." We're not sold, however, on the notion that "one more and done" is the proper

policy stance but are sympathetic to the notion that a meaningful and sustained acceleration in inflation may be some time in coming. Either way, though, for as long as the economy does remain trapped in a low productivity growth regime, that gets us back to the point that such a regime implies a much lower terminal funds rate than has been the case in past cycles.

This is the point many FOMC members seem to be gravitating to, even if from a number of different directions, and is the most significant message embedded in our chart showing the FOMC forecasts of the terminal Fed funds rate. To the extent this is the case, there are a number of implications. One that has gotten considerable attention from FOMC members is the extent to which the FOMC may need to develop new tools for its toolkit in order to effectively respond to the next recession. Dr. Yellen touched on this point in her speech at the recent Jackson Hole conference, though seeming fairly confident the FOMC's existing tools will be adequate. Other FOMC members, and many private sector analysts for that matter, seem at least a bit less confident.

Simply put, if indeed the terminal funds rate will be significantly lower in the current cycle than has been the case in the past, the implication is that the FOMC has less latitude to cut short-term interest rates when the economy does slip into the next recession. With the traditional interest rate lever offering less relief, the FOMC must have alternative policy tools to fill the void.

One suggestion that has been made is the FOMC should be willing to tolerate a higher rate of inflation than the current target rate of 2.0 percent. The premise being that a higher "steady state" rate of inflation in turn mandates a higher steady state funds rate, so that when the next recession comes the FOMC has more latitude to cut the funds rate to help combat the recession. This is, in our view, a very curious argument, for a number of reasons.

Okay, call us crazy, but the notion of central bankers – from any central bank – openly embracing more inflation, as though they can conjure up just the right rate and keep it from going higher makes us more than a little nervous. And, oh, by the way, inflation has been below the 2.0 percent target rate for over four years now, raising the obvious question of how a higher target will be hit when a lower target has proven so elusive for so long. And, even if there were a way to engineer a faster rate of inflation (umm, are those helicopters laden with cash we hear revving up off in the distance?) there are the not so small matters of the impact of higher inflation and higher interest rates on the economy. You know, matters such as the adverse impacts of higher borrowing costs and the adverse effects on asset prices of willingly debasing your own currency.

Still, this is precisely the type of discussion we think market participants should be hearing more of from the FOMC. Specifically, where do FOMC members see the terminal funds rate and why do they see that as being the appropriate rate. And, what are the implications for market interest rates and the FOMC's ability to counter the next downturn that everyone knows is coming even if no one knows when it will arrive. To us, there would be far more value in this information than is currently conveyed to market participants by dots on a plot and today's pronouncement of the "appropriate" number of funds rate hikes that may or may not be the same as yesterday's or tomorrow's number.

Indeed, even some FOMC members seem dissatisfied with the current state of "forward guidance." There has been considerable discussion of whether or not the "dot plot" serves any useful purpose, though we are somewhat bemused by the reason many FOMC members typically offer for doubting the value of the dots. The common complaint is that market participants misinterpret the meaning of the dots, taking the projections of the path of the funds rate as a set in stone forecast. We're not quite sure this is really the problem. We have never, nor do we know anyone who has ever, interpreted the dot plot as anything other than a projection of what the appropriate path of the funds rate would be were the economy to evolve as FOMC members see it evolving. Clearly, if perceptions about the economy's path change, then the funds rate implied by the dot plot will change.

We'd argue that rather than being unable to correctly interpret the dot plot, market participants have a much harder time trying to decipher what specifically "data dependent" means and how each piece of data fits into the bigger picture and what it takes to change the outlook for individual FOMC members in a manner that would alter the "appropriate" path of the funds rate. Indeed, another common theme heard from FOMC members is there is a difference between being "data dependent" and being "data point dependent." Again, nothing earth shattering here, as while some data releases are seen as more important, such as the monthly employment reports, we don't know of anyone who went into this brave new world of forward guidance thinking any one single data point could change the FOMC's outlook.

The problem, however, is that there have been times at which that has seemed to be the case. And this gets us back to where we started. One factor that has contributed to the confusion is the constant talk about conditions warranting ___ rate hikes (fill in the number) by the end of ___ (fill in the year). Another problem with the current manner of forward guidance is that market participants tend to extrapolate the "next" funds rate hike into an entire series of funds rate hikes, which in turn has tended to cause volatility in asset prices and the value of the U.S. dollar.

If there was a better sense of where the FOMC saw the terminal value of the funds rate, a higher probability of the "next" rate hike would perhaps not spark as much volatility in the financial markets. And, yes, it is true that as is the case with the "appropriate" number of funds rate hikes and their timing, the FOMC's view of the terminal funds rate would also be subject to change. But, those changes figure to come far less often than do changes in the view of the appropriate path of the funds rate. After all, the economy's speed limit is something that does not change quickly, nor does it change without there being tangible evidence of that change along the way. In terms of forward guidance, we think it reasonable to argue that less would be more. Hopefully, one day that premise will be put to the test.

Finally, as noted above, the September 20-21 FOMC meeting will bring the release of the latest batch of FOMC projections. Our main interest will be the projections of the longer run value of the Fed funds rate. We expect the median Fed funds rate target range midpoint will remain at 3.00 percent, but also expect there to be a greater concentration on that value, with some of the higher projections being marked down. This would be consistent with the notion of more FOMC members accepting a lower speed limit.

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Q1 '16 (a)	Q2 '16 (a)	Q3 '16 (f)	Q4 '16 (f)	Q1 '17 (f)	Q2 '17 (f)	Q3 '17 (f)	Q4 '17 (f)		2014 (a)	2015 (a)	2016 (f)	2017 (f)
0.8	1.1	3.1	2.4	2.1	1.8	2.0	1.8	Real GDP[1]	2.4	2.6	1.5	2.1
1.6	4.4	2.6	2.9	2.6	2.2	2.2	2.1	Real Personal Consumption[1]	2.9	3.2	2.7	2.6
								Business Fixed Investment:				
-4.5	1.1	0.4	1.7	2.4	2.1	2.2	2.1	Equipment, Software, & IP[1]	4.8	4.0	0.2	1.8
0.1	-8.4	0.3	3.8	2.9	3.3	2.7	3.0	Structures[1]	10.3	-4.4	-5.0	2.1
7.8	-7.7	6.0	-0.5	4.9	4.9	7.5	8.3	Residential Fixed Investment[1]	3.5	11.7	5.6	3.7
1.6	-1.5	1.4	1.2	1.1	1.0	0.9	0.9	Government Expenditures[1]	-0.9	1.8	1.0	0.9
-566.2	-562.0	-570.1	-586.3	-598.9	-610.1	-620.8	-629.4	Net Exports[2]	-425.7	-540.0	-571.2	-614.8
1.151	1.156	1.174	1.137	1.148	1.166	1.197	1.229	Housing Starts, millions of units[3]	1.001	1.108	1.155	1.185
17.2	17.1	17.2	16.9	16.6	16.3	16.2	16.0	Vehicle Sales, millions of units[3]	16.4	17.4	17.1	16.3
4.9	4.9	4.9	4.8	4.7	4.7	4.7	4.6	Unemployment Rate, %[4]	6.2	5.3	4.9	4.7
1.9	1.8	1.7	1.5	1.4	1.4	1.3	1.2	Non-Farm Employment[5]	1.9	2.1	1.7	1.3
1.2	1.2	1.1	1.3	1.6	1.5	1.7	1.7	GDP Price Index[5]	1.8	1.1	1.2	1.6
0.9	1.0	1.0	1.4	1.8	1.8	1.9	1.9	PCE Deflator[5]	1.5	0.3	1.1	1.8
1.1	1.1	1.2	1.5	2.1	1.9	2.0	1.9	Consumer Price Index[5]	1.6	0.1	1.2	2.0
1.6	1.6	1.6	1.7	1.7	1.7	1.9	2.0	Core PCE Deflator[5]	1.6	1.4	1.6	1.8
2.3	2.2	2.2	2.1	1.8	1.7	1.8	1.8	Core Consumer Price Index[5]	1.7	1.8	2.2	1.8
0.38	0.38	0.38	0.42	0.63	0.66	0.88	0.88	Fed Funds Target Rate, %[4]	0.13	0.14	0.39	0.76
1.92	1.75	1.55	1.60	1.65	1.75	1.85	1.90	10-Year Treasury Note Yield, %[4]	2.54	2.14	1.71	1.79
3.76	3.60	3.40	3.42	3.45	3.53	3.61	3.65	30-Year Fixed Mortgage, %[4]	4.18	3.85	3.55	3.56
-3.0	-2.8	-2.9	-2.9	-3.0	-3.0	-3.1	-3.3	Current Account, % of GDP	-2.3	-2.7	-2.9	-3.2

a = actual; f = forecast; p = preliminary

Notes:
1 - annualized percentage change
2 - chained 2009 $ billions
3 - annualized rate
4 - quarterly average
5 - year-over-year percentage change

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