Is “Patient” Enough to Offset Bull Flattening?

• Muted inflation has allowed the Fed to remain “patient”. Fed maintains that rates could rise or fall with equal likelihood

• Yet significant long-end (bull) flattening means that unless rate cuts become more likely, curves will not re-steepen any time soon

• The market needs more than patience at the moment. See chart book attached

The Fed’s playbook since the beginning of the year can basically be summarized as follows: with inflation pressures (on both goods and wages) muted it can remain “patient” against a backdrop of increasing global threats to the economic outlook. As the year unfolds, the Fed has consistently counseled that “rates are just as likely to go up as down.” That’s the very definition of neutral.

A month or so ago, this posture had been seen as an overt “dovish pivot” from where rates had been expected to go when viewed from a late 2018 vantage point. Market behavior in recent weeks however, suggests that “patient” is no longer sufficient.

With yield curves flattening – and in some segments inverting – as long ends tumble (both in lower inflation expectations as well as real rates), the only prospect for re-steepening requires rate cuts to drive the short end lower and (perhaps) reignite inflation and real growth expectations. In short, “patient” is no longer enough.

The first few slides of the attached deck focus on inflation in the US – from a variety of measures. Our own internal calculations show neither goods prices nor wages are in
danger of breaking out.

Goods inflation, even taking into account the effect of tariffs, remains muted thanks to USD strength, while inflationary expectations – both from the TIPS market as well as mutual fund flows – are steady or even declining, and real wage gains are still below the productivity growth rate and certainly sustainable.

The slow recovery of the labor force participation rate had obscured the Phillips curve relationship between employment and inflation, but this is now starting to assert itself as labor slack gets used up.

While the inflation outlook still merits patience, it appears that the market expects (and even requires) more. Front end money market volatility tends to pick up with equity volatility and is currently rising.

DEC19 futures – which had been converging to the median policy rate foreseen in the March 20 Summary of Economic Projections (“the dots”) – have become dislodged from where the Fed had last forecasted year-end 2019 rates. This is setting up a crucial June 19 FOMC.

Noise in favor of a rate hike will be rising to a din over the next few weeks, but a long roster of Fed speakers in recent days have brushed off any suggestion that a cut is currently on the agenda.

Will the dots for 2019 move lower when they’re published on that date? Will signaling potentially lower rates by year-end actually be enough for markets hungry for a cut?

The long end of the US curve has fallen primarily from lower real rates and inflation expectations, both coinciding with a negative growth outlook. For curves to re-steepen, either the long end needs to rebound (a resolution of the trade spat would help here), or the short end has to go lower and this will not happen with merely a “patient” stance from the Fed. Rate cuts would need to become a realistic probability. Absent that, the bull flattener remains the troubling base case.

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