RJO Previews and Perspectives for Friday, Feb 23

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Powell has a chance to calm market uncertainty about Fed policy at next week's Congressional appearance -- The U.S. stock and bond markets have recently seen volatility tied to higher inflation but also to uncertainty about the new Powell Fed. It may not have been a complete coincidence that the first big day of the downside stock market correction was on Friday, Feb 5, former Fed Chair Yellen's last business day in office. The S&P 500 index then plunged by -4.1% on Fed Chair Powell's first day in office on Monday, Feb 5.

Uncertainty about Fed policy is high, not only because of the new Fed chair, but also because of the hawkish 2018 rotation of four new regional Fed presidents into voting positions and also because the majority of the seats on the Fed's Board of Governors are currently empty.

The Fed's Board of Governors is currently operating with only Fed Chair Powell and Fed Governors Brainard and Quarles, i.e., 3 of the 7 available positions. Vacant positions include the Fed Vice Chair position and three governor seats. President Trump has nominated Marvin Goodfriend as a Fed governor, but he barely survived a partisan 13-12 confirmation vote in the Senate Banking Committee and it is not clear whether he can get enough votes for confirmation in the full Senate.

Meanwhile, the Trump administration has yet to nominate a new Fed Vice Chair. Candidates on the short list reportedly include Cleveland Fed President Loretta Mester, San Francisco Fed President John Williams, Allianz chief economic advisor Mohamed El-Erian, and Pimco's Richard Clarida. Former Fed Governor Lawrence Lindsey recently withdrew from consideration.

Once the markets see a fully-seated Fed Board of Governors and see how the four Fed presidents will vote, then the markets should become a little more comfortable about predicting Fed policy. But in the meantime, the Fed is somewhat of an unknown quantity, particularly since macroeconomic conditions are changing with rising inflation and a stronger economy.

Fed Chair Powell should be able to at least dampen uncertainty a bit simply by clearly stating his policy views when he appears this coming Wednesday before the House Financial Services Committee to deliver the Fed's semi-annual monetary policy report to Congress. As Fed Chair, the markets have so far heard little from Mr. Powell except for his bromide during the stock market plunge on Feb 6 that, "We are in the process of gradually normalizing both interest rate policy and our balance sheet." Mr. Powell did provide a little confidence to alarmed stock investors by adding that "We will remain alert to any developing risks to financial stability."

The market consensus is that Mr. Powell will largely mimic former Fed Chair Yellen's themes and will continue to pursue "gradual" rate hikes. However, the reality is that Mr. Powell faces a more challenging situation than Ms. Yellen did because of expectations for stronger economic growth in 2018 combined with a possible uptick in inflation. Mr. Powell may be forced to sound more hawkish than Ms. Yellen simply to prevent the bond vigilantees from taking over the bond market and driving rates sharply higher on fears that the Fed will fall behind the curve on addressing inflation.

The markets remain unsure about how many rate hikes the Fed will implement in 2018. The markets are now largely convinced that the Fed will make good on its Fed-dot forecasts for three rate hikes with the federal funds futures market indicating market expectations for 2.8 rate hikes by year-end.

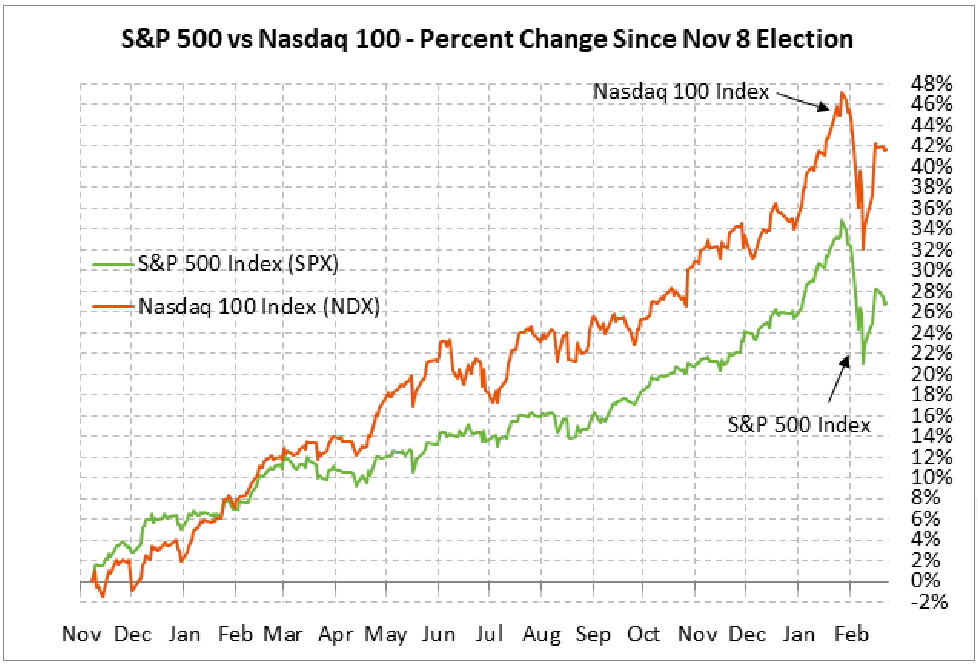
However, there has recently been market commentary on whether the Fed might be pushed into four rate hikes in 2018. If nothing else, four rate hikes would match up with the fact that there are four FOMC meetings in 2018 that feature Powell press conferences (i.e., on March 20-21, June 12-13, Sep 25-26, Dec 18-19).

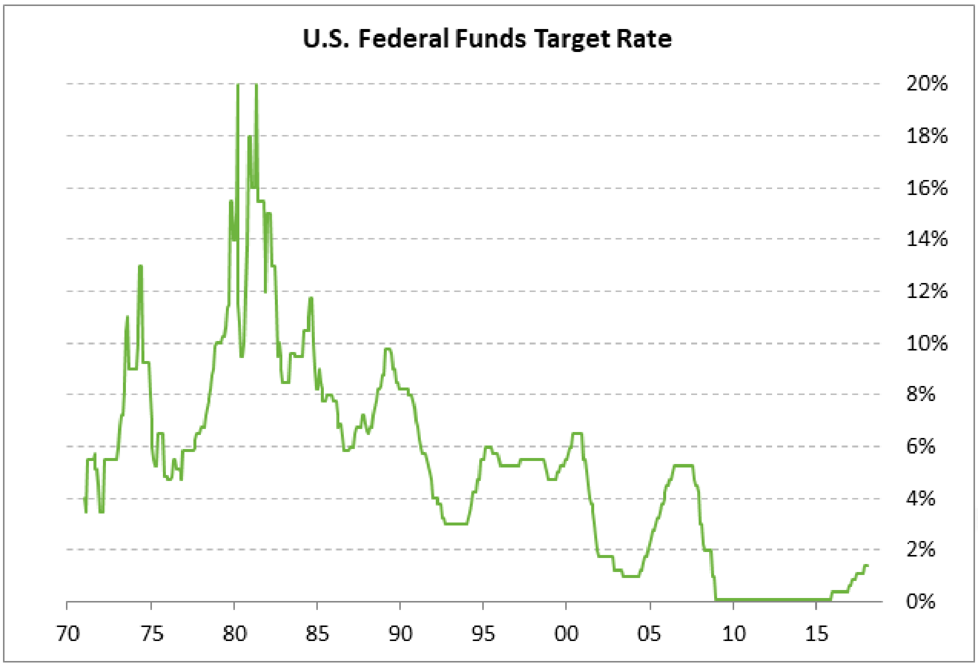
Based on the current macroeconomic outlook, we doubt that the Fed will need to raise rates four times in 2018 and will instead stick to its current forecast of three rate hikes. It has taken a decade for the Fed to nurse the U.S., and indeed global economy, back to health after the Great Recession. We believe that the Fed will stick to gradual rate hikes as long as there is no threatening move in inflation above 2%.

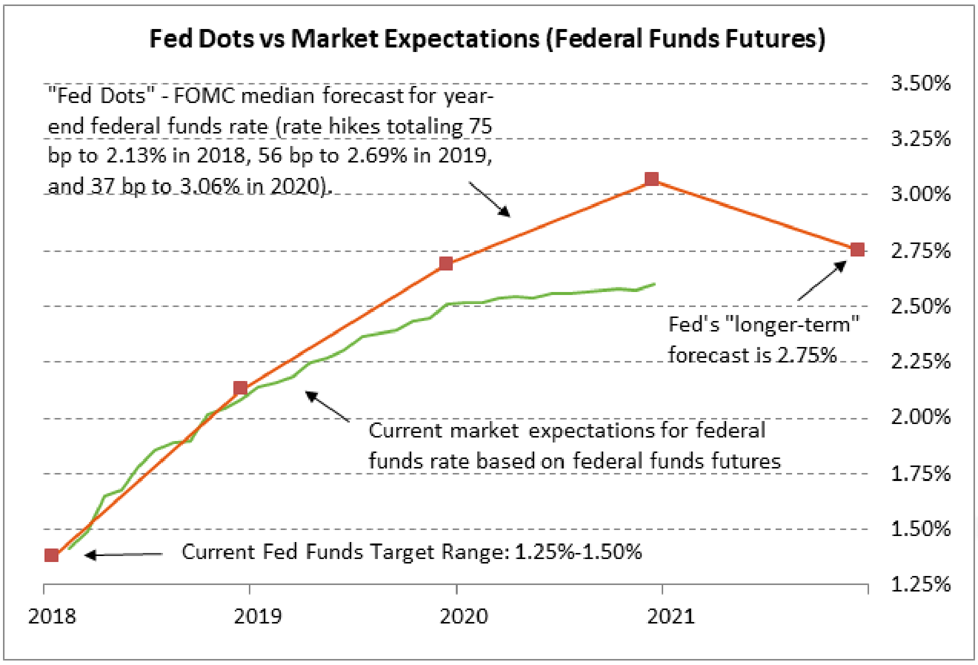
Indeed, the Fed's last rate-hike regime was a complete disaster since it ended with the biggest financial crisis since the Great Depression. The Fed during 2004-06 raised the funds rate by a total of 425 bp, i.e., from 1.00% in May 2004 to the peak of 5.25% in June 2006. The 2004-06 rate hike regime involved seventeen 25 bp rate hikes in the space of just 25 months, which averages out to 1.5 rate hike per month or 8.5 rate hikes per year. The current path of 3 rate hikes per year seems quaint by comparison.

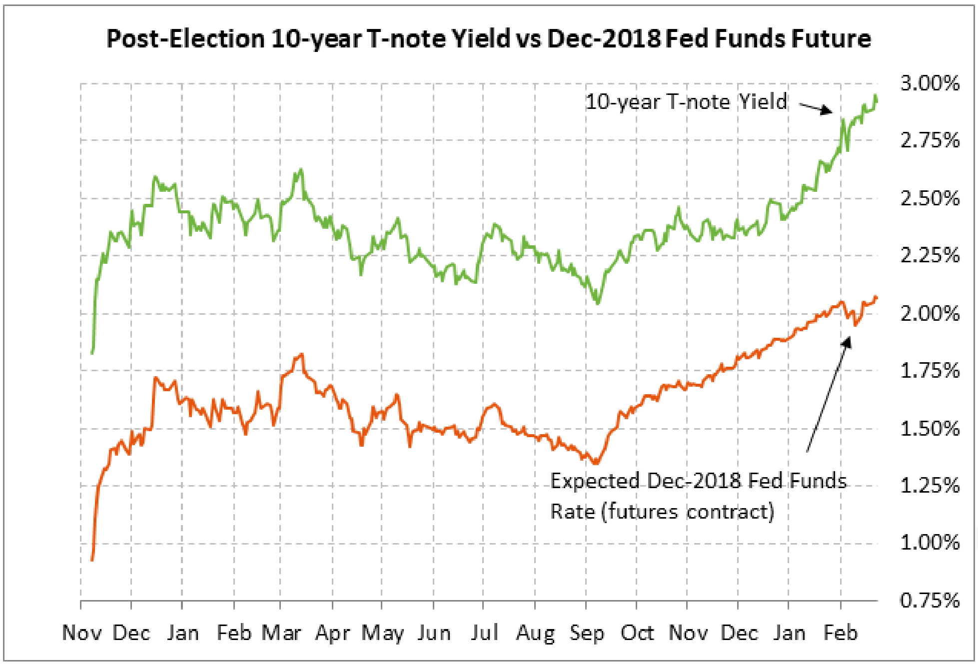
The T-note market will heavily key on Mr. Powell's testimony next Wednesday. A hawkish tone could easily push the 10-year T-note yield above 3.00%, which is only 5 bp away from the current level of 2.95%. However, if Mr. Powell convinces the markets that he is a gradualist and that he is not alarmed by the current inflation outlook, then the T-note yield could move slightly lower.

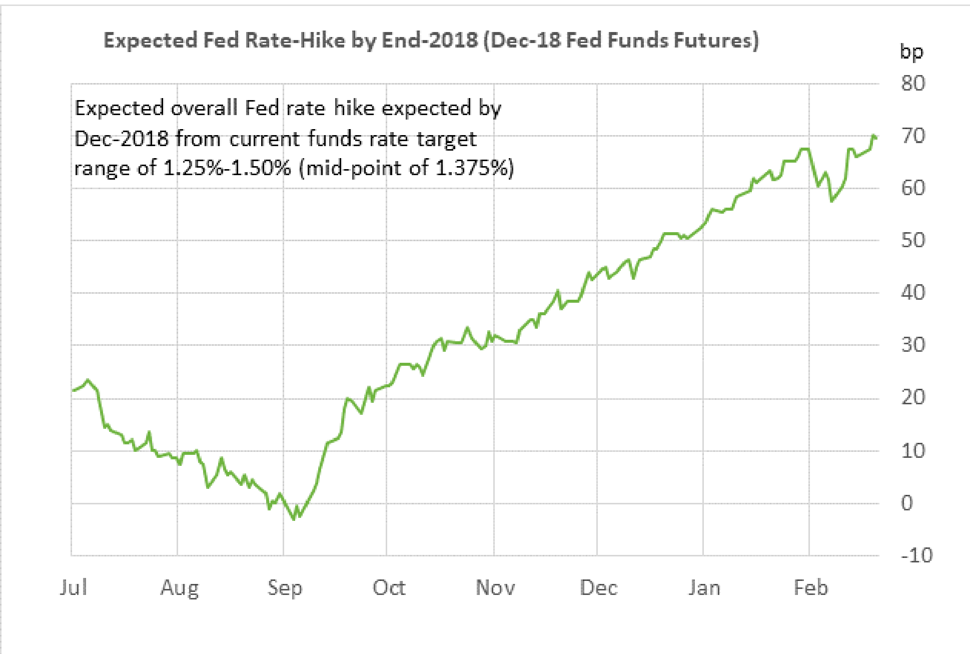
Yet, there is no real doubt that the 10-year T-note yield will eventually move above 3% on a sustained basis. The direction of interest rates is clearly upward as global monetary policy normalizes and the global economy returns to some semblance of normality after a decade of convalescence.


S&P 500 vs Nasdaq 100 - Percent Change Since Nov 8 Election
Nasdaq 100 Index
S&P 500 Index (SPX)
Nasdaq 100 Index (NDX)
S&P 500 Index
48%
46%
44%
42%
40%
38%
36%
34%
32%
30%
28%
26%
24%
22%
20%
18%
16%
14%
12%
10%
8%
6%
4%
2%
0%
-2%
Nov Dec Jan Feb Mar Apr May Jun Jul Aug Sep Oct Nov Dec Jan Feb


U.S. Federal Funds Target Rate
20%
18%
16%
14%
12%
10%
8%
6%
4%
2%
0%
70 75 80 85 90 95 00 05 10 15


Fed Dots vs Market Expectations (Federal Funds Futures)
"Fed Dots" - FOMC median forecast for year-end federal funds rate (rate hikes totaling 75 bp to 2.13% in 2018, 56 bp to 2.69% in 2019, and 37 bp to 3.06% in 2020).
Fed's "longer-term" forecast is 2.75%
Current market expectations for federal funds rate based on federal funds futures
Current Fed Funds Target Range: 1.25%-1.50%
3.50%
3.25%
3.00%
2.75%
2.50%
2.25%
2.00%
1.75%
1.50%
1.25%
2018
2019
2020
2021


Post-Election 10-year T-note Yield vs Dec-2018 Fed Funds Future
10-year T-note Yield
Expected Dec-2018 Fed Funds Rate (futures contract)
3.00%
2.75%
2.50%
2.25%
2.00%
1.75%
1.50%
1.25%
1.00%
0.75%
Nov Dec Jan Feb Mar Apr May Jun Jul Aug Sep Oct Nov Dec Jan Feb


Expected Fed Rate-Hike by End-2018 (Dec-18 Fed Funds Futures)
bp
Expected overall Fed rate hike expected by Dec-2018 from current funds rate target range of 1.25%-1.50% (mid-point of 1.375%)
80
70
60
50
40
30
20
10
0
-10
Jul Aug Sep Oct Nov Dec Jan Feb