Weekly Market Flash

Does the Fed Put Still Exist?

November 30, 2018

In the canons of Fed Scripture there was the Greenspan put, which begat the Bernanke put, which begat the Yellen put, and the Governors saw that it was good, and the Governors rested on the seventh day. And then came Jerome Powell, and the put was no more. Or was it?

You've Got a Friend at the Fed

For those not steeped in the arcane speech patterns of those who inhabit and/or observe the goings-on in the Eccles Building, the "Fed put" is the widely-held assumption among investors and traders that whenever risk asset markets get choppy, the Fed will be there to ease the pain with a fresh punch bowl of easy money.

Case in point: in the early months of 2016, just after the Fed had raised rates for the first time since the 2008 recession, global equities took a hit from some negative economic data from China. Now, nobody in the Yellen Fed at the time ever actually came out and said "the S&P 500 fell more than 10 percent, so we're going shelve the rate hikes for a while." But investors could draw their own conclusions – rates did stay on the shelf, not rising again until the end of 2016, a full year after the first increase.

Rise Up

For much of the current recovery cycle the colloquial Fed put was part and parcel of the formal monetary stimulus policy to get the economy back on its feet. Encouraging investors to shift out of low-risk assets like government bonds and into riskier things like equities was a central feature of the system. But those days are over. When stocks lurched into a downturn back in early October it seemed that the market finally got the memo – the FOMC (Federal Open Market Committee, the Fed's monetary policy decision arm) had raised rates again in the September meeting, were on track to do so again in December, and Fed chair Powell was quoted in a speech as saying that current rates were still far away from the neutral interest rate. The economy's doing well, corporate earnings are fine, no need to keep the training wheels on…right? Investors seemed to think otherwise, and Red October was on.

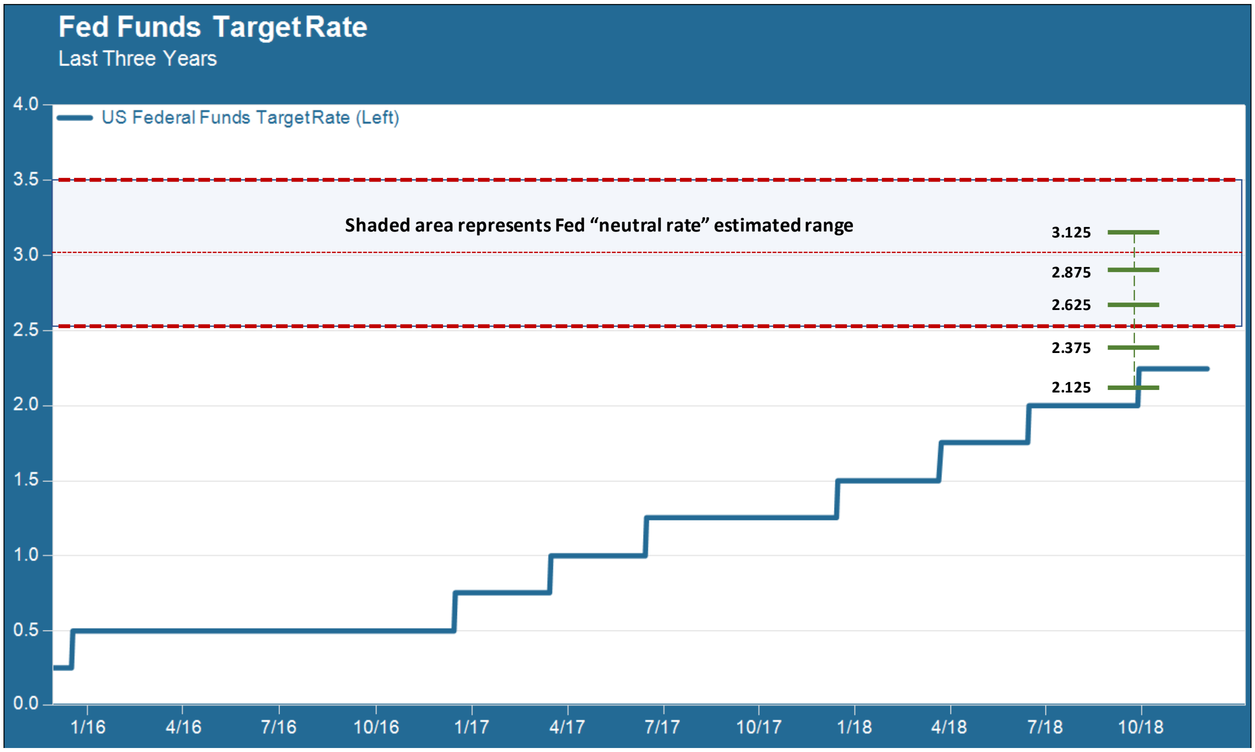
A Lighter Shade of Neutral

Let's go back to that Powell comment about the neutral rate, because it figures very much into what the market has been up to this week. First of all, what exactly is the "neutral" rate of interest? Glad you asked, because even the cerebral Fed folk themselves can't give you a clear answer. It's supposed to be whatever rate of interest is neither stimulative (too low) nor restrictive (too high). The various members of the FOMC have their own ideas, which fall out into a range of about 2.5 to 3.5 percent based on the most recent "dot plot" assumptions the Fed releases periodically after the FOMC meets.

On Wednesday this week, Powell once again referenced the neutral rate. This time, though, rather than saying that rates were currently "far away" from neutral, he said they were "just below" the range of neutral rate estimates. The market went into a tizzy again, but this time in a good way with major indexes jumping more than 2 percent. And so the excited chatter resumed…is that a Powell put we see out there? We may well be wrong about this, but we tend to think not.

Do the Math

Currently, the Fed funds rate is in a target range of 2.0 to 2.25 percent, which puts rates…well, just like Powell said, "just below" the range of neutral rate estimates. The chart below illustrates this.



Source: MVF Research, FactSet

But why did investors obsess over those two words "just below?" Here's how the math works. The midpoint of the current Fed funds range is 2.125 percent (i.e., halfway between the floor of 2 percent and ceiling of 2.25 percent). The FOMC generally likes to see the effective rate (i.e. the actual market rate banks charge each other for overnight loans) somewhere close to the midpoint.

So, to get that midpoint rate above the 2.5 percent lower boundary of the neutral rate range would require two additional rate hikes (presumably one later this month and one sometime next year). To get to the midpoint of the neutral range, a more likely outcome, would require three or four additional rate hikes to get to 2.875 percent or 3.125 percent (i.e., either side of the 3.0 percent midpoint neutral rate).

Three or four additional increases…wait, isn't that what the Fed has already signaled it plans to do? Why, yes! One in December and then two or three in 2019 is the default assumption coming out of FOMC press releases and commentary since at least the middle of this year. So why all the fuss? Parsing what exactly Powell meant by "far away" or "just below" or any other combination of two words would seem silly, if the math seems obviously the same as it has been for months already.

Trumpty Dumpty

One reason given for all the investor excitement was that Powell's comments on Wednesday came right on the heels of another blast of word salad from the nation's chief Twitterer complaining about the Fed and higher interest rates. Was the Fed chief bending the knee to Trump like so many other seemingly reasonable people have in the past two years? Is the Fed put back in the policy bowl because Trump wants low interest rates?

While one can never say never in this day and age, we see very little likelihood that the head of the Federal Reserve, charged among other things with maintaining the independence of the central bank, would immerse himself into the middle any political imbroglio. The timing may have seemed strange, but there just is no factual basis in which to read any kind of political message from Powell's speech. He did say that there is no "preset" path for rates – which is what the Fed always says. Data about the health of the global economy will inform the pace of interest rate policy. If growth appears to be slowing or going into reverse then there will likely be fewer rate hikes, while if the pace continues to hum along at current levels there is no reason to assume anything other than the four rate hikes already baked into policy expectations.

We'll get a preview of whether our analysis is correct or not in just a few short weeks when the FOMC meets for the last time this year. There are just a handful of macro data points coming out between now and then, and barring a very unexpected surprise either from the labor market or consumer price readouts, we don't see anything to suggest the December Fed funds increase won't happen. Hopefully Mr. Market will be able to figure this out in a relatively drama-free fashion.

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