# The inevitability of tighter monetary conditions

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This year begins under a fog of uncertainty that rivals any other in my long association with financial markets. No one knows where politics of populism will take us. The comfortable status quo of globalisation and unfettered capital flows has lifted asset prices to new heights and has made fortunes for rentiers over the past several decades - but in doing so, also has worsened the gap between rich and poor. For whatever reasons, widening inequality seems to foster a reversion to populist politics and protectionist policies even though history indicates that neither of these frameworks augments the wealth of nations and, if sustained over time, tend to sap a country's strength and vigor. We now seem to be in the initial throes of optimism about a change in policies, as often occurs in the wake of a US presidential elections. Markets are dismissing what they do not know about the future in the hopes that whatever transpires will remedy the shortcomings of past policies. I often refer to this phase of the business cycle as "la la land" for politicians and investors who think fiscal stimulus is a free lunch and asset prices have no upper bound. In reality, we are setting the stage for an inevitable tightening in monetary conditions. The only questions are how soon, how much and with what consequences. The Federal Reserve will provide some answers in the months ahead.

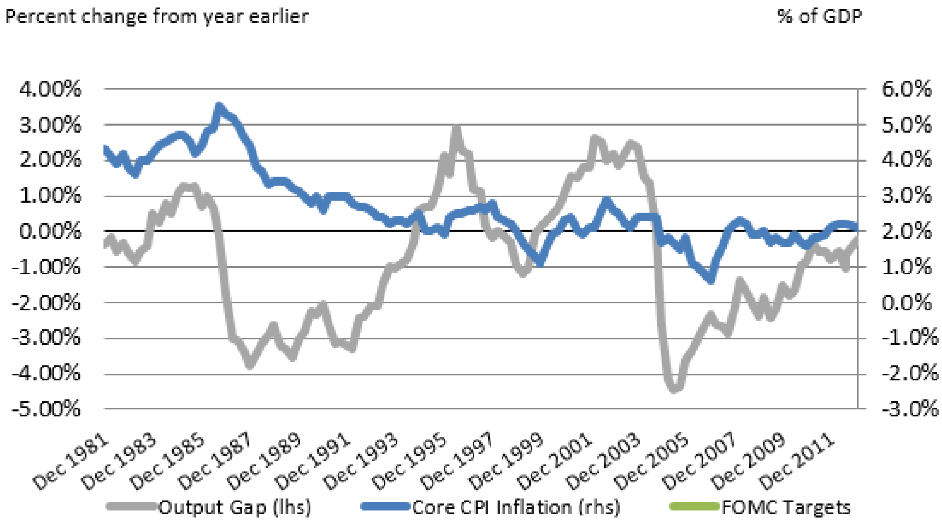
## THE CURRENT SETTING FOR US MONETARY POLICY

Here is the Fed's predicament in a nutshell. With the recent spurt in activity, the US economy now is operating on the cusp of its inflation-stable potential. That does not mean that the economy could not produce more output if companies invested more and idle workers accepted new jobs or worked longer hours. Rather, at this threshold, the Fed now faces an inevitable tradeoff between more growth and more inflation. In the jargon of FOMC members, the Fed has reached its operational targets of 2% inflation and full employment, at which point it must reconsider the wisdom of further monetary stimulus. As long as FOMC members believe the current favorable conditions are sustainable, then they have little choice but to shift policy to a "neutral" stance. Granted, the Fed's view of what constitutes "neutral" has changed dramatically in recent years. Staff research shows that demographic trends have lowered the equilibrium real interest rate 125 basis points since 1980.[1] That implies the new neutral for the fed funds rate now is no more than 50 to 100 basis points, which translates into a nominal funds rate of 2.5% to 3%.

The spectre of the Fed being forced to hike short-term interest rates multiple times in the coming years raises key questions for financial markets ranging from what happens to long-term interest rates, equity valuations and the viability of the current economic expansion that is already the longest in history.

Figure 1 gives a visual image of the current state of the US economy. The grey line measures the so-called Output Gap, the difference (in percentage points on the right-hand scale) between the **level** of actual GDP and its inflation-stable potential. The relationship between growth and inflation is widely misunderstood and often misrepresented. It does not mean that the economy could not produce physically more output, but rather that to do so would raise unit costs. In short, companies would have to invest in new capacity or upgrade old facilities, idle workers would need retraining to qualify for new jobs, or current employees would need to work longer hours at higher pay. By contrast, when actual output is below potential, extra growth tends to be a godsend that might even lower unit costs and inflation. Unfortunately, that potential windfall is lost once the output gap is zero, as it is now.

Figure 1: US Output Gap and Inflation




Sources: US Commerce Dept, Bureau of Labor Statistics and Fenwick Advisers' estimates.

Note, however, that inflation does not immediately surge ahead when actual output rises above its potential. For one thing, cost pressures tend to build gradually and at first, squeeze profit margins before companies raise prices. That takes time. As is visible in Figure 1, inflation increases only after the grey line crosses zero into positive territory (i.e. actual GDP is greater than potential) with a reprieve of about one year.

So, chances are good that the Fed will not see the whites of the eyes of more inflation until 2018. The bad news is on the flip side of that coin – namely, inflation is very slow to decelerate after the economy grinds to a halt. Note that the peaks in the grey line mark the end of expansion and the onset of recessions (i.e. actual output growth slows to a crawl and eventually suffers an outright contraction). Yet inflation doesn't slow until after actual output falls below its potential, which typically does not occur until after the economy falls into recession. Even then, disinflation is slow to materialise. Moreover, the more GDP overshoots potential, the greater the delay in getting inflation under control. Once you let the genie out of the bottle, it is very difficult to get it back in without some serious damage to the economy.

Some critics of this framework, including a few FOMC participants, claim that inflation does not response to the output gap as much as it did in the past, despite an impressive track record for this framework that dates back to the 1960s. There is some evidence of diminishing impact with the globalization of production and finance. Indeed, you can see this in Figure 1. The small overage of about 1% in the early 1990s led to 1-1/2 percentage point increase in inflation, whereas since 2000 we have seen output exceed potential by more than 4% causing only a one percentage point increase in inflation. Yet to deny its relevance today is to ignore the corroborating evidence of nascent cost pressure from a host of other data.

The most obvious signs of cost pressures come from the labor market. Wages finally are beginning to increase, even on an inflation-adjusted basis. Recent surveys of payroll employment show average hourly earnings rising 2.9% from a year ago (Figure 2), which is close to what many Fed officials think is sustainable.

Figure 2: US Wages Are on the Rise
Average hourly earnings of all employees: Total Private


Sources: US Bureau of Labor Statistics, fred.stlouisfed.org. Note: Shaded areas indicate U.S. recessions.

Unfortunately, this statistic is deeply flawed by changes in the composition of the job market and the workforce. Most notably, older workers with more experience are paid more than younger workers even in the same jobs, and those higher paid now have been retiring in droves over the past decade, which depresses the average wage as measured by this survey.

The Atlanta Fed attempts to adjust for this demographic distortion by constructing a wage series for prime age workers (the white line in Figure 3). For that group, wages have increased 4.3% over the past year and show a rising trend since 2014, consistent with business's common complaint that they cannot find enough workers with the requisite skills. Note the persistent difference in this wage measure from the average hourly earnings data (the yellow line). More important is the widening gap between prime workers' wage gains and inflation, as measured by the core PCE price index (the green line). However measured, real wages clearly are rising in the US after many years of stagnation.

Figure 3: Wages of Prime Age Workers
Percent change from a year earlier

Sources: Bloomberg and Atlanta Federal Reserve.

Plenty of other data confirm that labor market conditions already are tight even without any added pressure from Trump's proposed immigration restrictions and infrastructure buildup. Figure 4 below shows an inferred measure of labor market strength from the BLS' JOLTS data – the number of workers who quit their jobs compared to those who are involuntarily laid off (the white line) – along with the same wage data as in Figure 3. When jobs are plentiful, workers are much more likely to aspire to a better one and to take action, especially if a new job offers more pay. Conversely, layoffs rise dramatically in recessions and fall as qualified workers become more difficult to recruit. Thus, this ratio is a good tracker of business cycles and even represents a decent lead indicator of both downturns and recoveries. It also is correlated, albeit with a much longer lag, with wage pressures. When faced with the prospect of losing sales for lack of enough workers, employers usually will take the only other effective option – they raise pay. These JOLTS data, which moved sharply higher in 2016 and have reached record levels, indicate that US employers now face that predicament.

Figure 4: Labor Market Conditions Tightened Sharply in 2016


Source: Bloomberg.

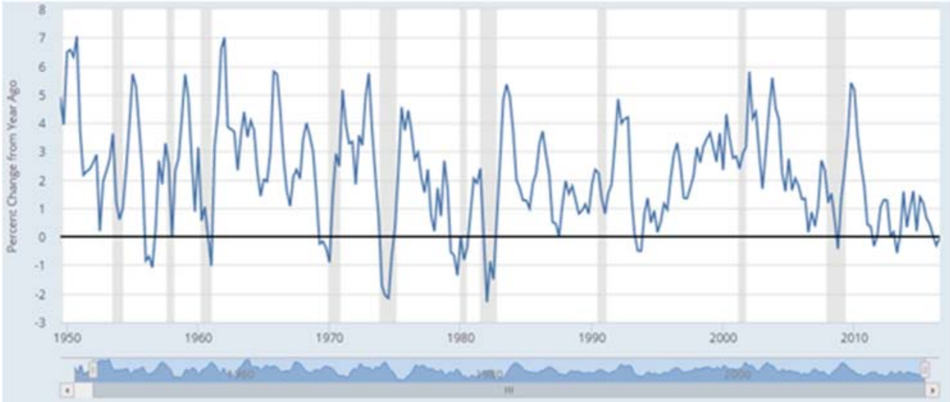
## REAL INCOMES WILL SUSTAIN GROWTH IN DOMESTIC DEMAND

Rising real wages will sustain a virtuous circle for domestic demand probably well into 2018 despite political uncertainty. US households have already deleveraged and fraudulent mortgages have been cleaned up. Apart from the lingering burden of student debt, household balance sheets are in decent shape. Rising incomes will sustain consumption which in turn will beget business investment. Granted, we are not talking about the magnitudes of past booms – the growth rates are almost half of what they were as recently as the 1990s. Then again, America's potential output, which is the appropriate metric for measuring the consequences of growth at full employment, is much lower as well. Even moderate growth of 2.5% in 2017, as I expect, would push the level of real GDP well above potential and set the stage for a more problematic 2018.

## UNINTENDED CONSEQUENCES: COST PRESSURES

While rising real wages are desirable on many counts, this trend comes at an inopportune time when businesses are doing a poor job of improving productivity, which is the lifeblood for profitability and future gains in real wages. Trend productivity growth has trended lower since the turn of the century and has averaged less than 1% per annum this decade. That is a very small offset to real wage gains, reminiscent of the 1970s and 1980s, when excess demand morphed into cost-push pressures as the dominant theme for inflation. We are not near that tipping point yet – and I doubt the Fed is willing to revisit that ugly era. However, these macro data suggest what happens when an economy pushes too hard at full employment – growth alone does not lift aggregate productivity but it can drive equity valuations to new heights.

Figure 5: Dismal Productivity Growth
Non-farm Business Sector: Real Output Per Hour of All Persons




Sources: US Bureau of Labor Statistics, fred.stlouisfed.org. Note: Shaded areas indicate U.S. recessions.

## THE FED'S RESPONSE

To investors, this scenario seems like nirvana. For the Fed, it poses tough and inevitable choices, all of which will lead to tighter monetary conditions, sooner or later. If the Fed wants to mitigate market backlash, sooner will work better than later. The main policy options are:
1) restore the fed funds rate to at least the "new neutral" and perhaps higher; and,
2) run off its oversized $4 trillion balance sheet of (mostly) debt securities.

Everyone has expected the former – to the surprise of most observers, discussion of the second option has already begun. Note that I did not include the option of actually selling assets in the market. That will never happen and there is no reason the Fed would need to do so.

Let's weigh the consequences of using just the funds rate, which is widely considered to be the more potent tool.

One obvious outcome would be the full and quite immediate pass through of the new "risk free" rate into short-term market rates, notably high yield bonds whose average duration tends to be around three years or so. High yield investors would suffer losses but might choose to ride it out if current yields provided enough cover.

Two complications will arise.

First, the Fed may be forced to go well beyond what now is perceived to be a new neutral rate of 2.5% or so, especially if Congress implements Trump's aggressive infrastructure and tax agendas. Credit duration (i.e. yield spreads on weaker credits) are very likely to widen because higher refinancing costs will put the most indebted companies at much higher risk.

The second worry is that the Fed will move too slowly or, less likely, will move too fast in normalising the funds rate. A slow trajectory seems less painful, but in truth that has become a dangerous game now that the economy has reached full employment. The key to a smooth transition is to stay ahead of the curve. Monetary policy works with long and variable lags and, if the Fed is late to the game, it will lose its ability to contain inflation and hence its influence on long-term interest rates. The Fed must raise the funds rate at least to 1.25% and preferably to 1.5% by the end of 2017 to maintain its credibility with markets, in my opinion. Anything less will risk falling behind the curve.

A third issue that seems to weigh on some FOMC members is the implication for the US dollar of relying solely on the funds rate to tighten conditions. Implicit is the thought that a runoff in the Fed's portfolio is a milder vehicle with less impact on the exchange rate. To me, this argument is overrated. For one thing, we are talking about small interest rate differentials even by year-end. Carry traders will need to use a lot of leverage to make much money off them. Second, the dollar's rise over the past three months probably reflects a divergence in G7 policies. Third, to the surprise of many observers, both the ECB and BOJ are running out of bonds to buy, albeit for very different reasons, and the UK is not collapsing under the weight of Brexit. Policies will not look so "divergent" as the year progresses.

The second option seems simple enough. The Fed can simply taper its reinvestment of interest on the portfolio and/or cease to replace the principal on maturing bonds. These two actions alone would reduce the Fed's portfolio about $600 billion over the next few years. Chair Yellen has yet to discuss this option in detail and does not appear to favor this step until at least 2018. Other FOMC members are openly presenting their views on an earlier start. More open debate is inevitable. Having listened to one member's presentation on the issue, however, my sense is that the Fed still has a lot of details to work out.

Execution is everything on this issue and precise communication to markets will make the difference between a smooth runoff and another misguided "taper tantrum" in which hedge fund traders rush to the exit. This subject deserves deeper consideration in another commentary.

## ENDNOTES

1. See Etienne Gagnon, Benjamin K Johannsen and David Lopez-Salido, "Understanding the New Normal: The Role of Demographics", Finance and Economics Discussion Series, Federal Reserve Board, 3 October 2016 (https://www.federalreserve.gov/econresdata/feds/2016/files/2016080pap.pdf)

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