Fed Thoughts:
Janet Yellen’s Curtain Call?
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Members of two Congressional committees managed to occupy Federal Reserve Chair Janet Yellen for almost six hours of semi-annual hearings last week. To do so, however, they asked the same questions over and over again. Our elected representatives were not trying to find inconsistencies in her answers, as there never are and none of the interlocutors were actually really listening. Rather, politicians were filling the time as long as the klieg lights remained on.

Even a devoted Fed-head has to admit that the drama has leached out of the event over time as the result of actions on both sides of the hearing table.

Monetary policy was always complicated, but never more so now that central bankers describe what they do in academic terms. Put frankly, members of the House and Senate are not well suited to dig into these details. Remember these missed opportunities anytime there is talk of auditing the Fed’s conduct of monetary policy. There is already a Congressional mechanism in place. The semiannual testimonies were designed to assess “...the efforts, activities, objectives and plans of the Board and the Federal Open Market Committee with respect to the conduct of monetary policy” (as specified in Section 2B of the Federal Reserve Act). The problem is that the oversight committees do not press these issues.

On the other side of the table, the prepared testimonies have gotten shorter over time and convey nothing new relative to the preceding post-FOMC-meeting press conferences.

With both the demand and supply of policy content contracted, public interest in the process has shrunk. Consider, for instance, search volume on Google about the testimony, which has bounced along a bottom-dwelling level of boredom for almost a decade.

We still have to listen, of course, and what we heard was a reworking of the June statement and press conference. The US economy should continue to expand at a moderate pace and inflation return to the Fed’s 2 percent goal “with further gradual adjustments in the stance of monetary policy”. That is, they anticipate getting to...

1 https://www.federalreserve.gov/aboutthefed/section2b.htm
2 https://www.federalreserve.gov/newsevents/testimony/yellen20170712a.htm
their goals with some more firmings this year. To be precise—and the message has been repeated enough to be precise—Fed policymakers have two actions penciled in for their two remaining press-conference meetings of 2017. In September, the FOMC will announce the slowing of its portfolio reinvestments, to begin in October and follow a preset sequence of increasing caps in place for three months at a time. In December, the FOMC will deliver its third quarter-point hike of the year. This implies that the sole purpose of the July and October meetings is for someone to utter the phrase that “action should be taken soon” so that it can be dutifully recorded in the minutes, eliminating any chance of market surprise at the next meetings.

Of course, all this guidance comes with the assurance that all decisions are data dependent and made meeting by meeting. But the script for 2017 is mostly already written unless data disappoint in a material fashion, which is not our forecast, only our fear. With this year out of the way, Yellen devoted her testimony to fight the 2018-and-beyond contest. (This, by the way, is a battle she mostly likely will watch on the sidelines when she is replaced next February—a likelihood she was forced to acknowledge a few times over the two days of testimony.) How much will the Fed ultimately have to tighten? Apparently, the Fed chair believes that they are close to, but not yet, done. There is more to do because “...the factors that are currently holding down the neutral rate will diminish somewhat over time” However, there is not much more to do because “...the longer-run neutral level of the federal funds rate is likely to remain below levels that prevailed in previous decades”. It feels like some dots in the Summary of Economic Projections (SEP) will be coming down. As a result, December will be one of those “dovish hikes” in which the Fed takes from markets with one hand—a quarter point rise in the funds rate—and gives with the other—see, there is not much more to do.

In the window of Fed talk, rates rallied some and the probability of action at the December meeting steadied in the fair-coin toss vicinity. Fifty percent seems too slim a probability to put on one more hike this year. The unemployment rate is low and seems likely to go lower if we get, as we expect, real GDP growth averaging a touch over 2 percent over the next 1-1/2 years that outstrips the expansion of potential output. Indeed, as one House representative pointed out, at least one submission in the SEP puts the unemployment rate at 3.8 percent in 2019. That said, the high end of the inflation range for that year is 2.2 percent, not much of an overshoot of the Fed’s goal.

The uncomfortable reality for our forecast is that over the past few months we have seen a uniform undershoot in inflation. It is instructive to frame the evidence using some of the analytic tools employed across the Federal Reserve System. Some look at the difference in the inflation rates of goods and services in the consumer price basket that are reset frequently (flexible-price components) versus those that are reset less frequently (sticky-price components). Flexible-price goods tend to have higher energy and commodity components while the sticky-price basket mostly includes services.

Sticky-price goods and services move inertially by construction and turn out to be an attractor for flexible-price goods and services. That is, headline inflation tends to rise when sticky prices are rising faster than flexible prices. So, while it is uncomfortable that inflation in both parts has moved lower over the past four months, the wedge remains wide, supporting a forecast that inflation ticks higher.

The FRBNY surveys households regarding their inflation expectations (in a manner staff believes to be better than private alternatives.) Both one- and three-year-ahead inflation expectations are on a distinct downtrend of late. Fed officials, however, point to the fact that both are above the two-percent goal, which should act as a force pulling inflation up over time. One last tried-and-true metric comes from the Treasury market. Breakeven inflation at the ten-year maturity (or the difference between the yields on nominal Treasuries and TIPS) is around 1.75 percent, below the Fed’s goal and lower than they were at the end of 2016. Still, the term structure of inflation expectations points up, consistent with the ultimate achievement of the Fed’s goal, if only in the fullness of time.

Deep down, an unemployment rate below 4.5 percent seems low and should place pressure on costs over time. With the price of oil bouncing along the bottom of its trading range and import prices now adding, rather than subtracting from inflation, a forecast of a modest increase in consumer price inflation over the remainder of this year and an overshoot of the Fed’s goal in 2018 still seems reasonable. But there is ample room for worry, which explains the logic of the sequence of Fed action. The FOMC is reserving the more significant one, the quarter-point hike, for December, allowing evidence to accumulate that inflation has changed direction from the path of the past few months. That said, given that Fed

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1 [https://www.federalreserve.gov/newsevents/testimony/yellen20170712a.htm](https://www.federalreserve.gov/newsevents/testimony/yellen20170712a.htm)

officials are leaning far forward on their guidance, the hurdle to dissuade them is probably high.

We also got guidance on the other action—putting into motion (slow motion, that is) the trimming of the Fed’s $4.5 trillion balance sheet. In response to a question, Chair Yellen answered that announcing the slowing of reinvestments is “...something we should begin to do this year, and to my mind, relatively soon.” Remember here, that after two correct signals this year, “soon” is the code word for the next FOMC meeting. The Fed chair’s words usually can be dissected with a surgical scalpel. The dual formulation most likely means that the Committee has agreed to the general proposition that balance-sheet renormalization starts this year. As to the specifics, if the chair has any say what gets on the FOMC agenda (and that is not really a question), they would announce the plan at the upcoming meeting.

Announcing next week that the program will take effect in October has a few advantages, including that it makes a non-press-conference meeting relevant, gives market participants a long runway, and sets a precedent for the next few years before there has been any meaningful conversation about who the chair will be then. This is not, however, a group tending toward improvisation. In addition, they probably fret that conspiracy-theory-leaning market participants would conclude the September meeting was freed up to slip in another policy action. By default, September is the most likely announcement date.

Some details about the program may be inferred from some of the hearing discussion, although the coming Fed transition lessens the import of longer-run speculations. In response to the same question repeated a few times, Yellen held that balance-sheet adjustment would run its course by 2025. If so, it would seem that the Fed chair had in mind the “smaller liabilities” scenario in the Federal Reserve Bank of New York’s recent update on projections of the portfolio. In that exercise, the balance sheet footprint normalizes at around $2.5 trillion, a sizable runoff but still over 10 percent of nominal GDP. While Yellen asserted that the Fed ultimately would return to a Treasury-only portfolio, MBS and agency holdings would still be substantial in 2025, at around $1 trillion.
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