



MORNING BRIEFING

August 29, 2018

Dancing with the Stars

See the [collection](#) of the individual charts linked below.

(1) The yield curve question gets a brief mention at Jackson Hole. (2) It may not be different this time, but the yield curve has yet to actually invert. (3) What's really different this time is that the federal funds rate is 2%, while the comparable ECB and BOJ rates are slightly negative. (4) The 2-year Treasury is predicting a 2.6% fed funds rate in a year. (5) Italy's new euroskeptic government may frustrate ECB's hopes of normalizing policy. (6) How do you say "bond vigilantes" in Italian? (7) The chairman's first speech: slow and steady. (8) Powell rejects navigating by the stars. (9) Academic portion of Jackson Hole was intellectually interesting, without much practical usefulness.

The Fed I: The Yield Curve Conundrum. Fed Chairman Jerome Powell didn't mention the flattening of the yield curve in his opening remarks at the Kansas City Fed's annual economic symposium, held in Jackson Hole, WY last Thursday through Saturday. He has addressed this recent development before, and seems to lean toward benign neglect on the subject. Not so for others at the conference: James Bullard, president of the St. Louis Fed, said that signals such as a flattening yield curve signal should be taken "seriously," adding that there's no reason to challenge them now. He is not a voter on the FOMC this year, however. Cleveland Fed President Loretta Mester, who is a 2018 voter, said the indicator is "different than it has been in the past." Consider the following:

(1) *It isn't different this time.* A new [Economic Letter](#) published Monday by the Federal Reserve Bank of San Francisco (FRB-SF) warns that the flattening of the yield curve may still be a good recession indicator if it leads to an inversion of the curve ([Fig. 1](#)). In other words, this time is no different than in the past in that respect. However, the article also notes that "it is still a comfortable distance from a yield curve inversion." The yield curve spread is commonly measured as the difference between the 10-year US Treasury bond yield and the federal funds rate. It was still well above zero at 97 bps on Monday, hovering around its lowest readings since March 17, 2008 ([Fig. 2](#)).

Bearishly inclined prognosticators are always looking for trouble, and have found more to worry about in the spread between the 10-year and 2-year Treasury yields. It was down to 18 bps on Monday, the lowest since August 2, 2007 and awfully close to zero. The 2-year yield tends to be identical to the 12-month forward federal funds future, and both currently imply that the Fed is expected to raise the federal funds rate to around 2.60% from the current 1.88% ([Fig. 3](#)).

(2) *It is different this time.* One obvious explanation for the flattening of the yield curve is that the Fed's QE bond-purchasing programs reduced the supply of Treasury bonds. However, the Fed's QE program was terminated during October 2014, and the Fed started reducing its holdings during October 2017 ([Fig. 4](#)).

As Debbie and I have observed in the past, a more likely explanation for why the 10-year US Treasury bond yield has been remarkably subdued just below 3.00% for most of this year is that comparable yields in Germany and Japan remain near zero ([Fig. 5](#)). That's because both the ECB and BOJ

continue to peg their official rates just below zero ([Fig. 6](#)).

The BOJ continues to be frustrated in its quixotic campaign of ultra-easy monetary policy, aiming to boost inflation to 2.0%. During July, the Japanese headline CPI was up only 1.0% y/y, while the core rate came in at a big fat ZERO ([Fig. 7](#)). The ECB has achieved its inflation goal with the CPI up 2.1% y/y during July, but the core rate was still only 1.1% ([Fig. 8](#)).

The ECB has a new problem that may frustrate the bank's desire to follow the Fed's lead in gradually normalizing monetary policy. The Italians elected yet another new government on March 4. This one has a strong anti-EU bias. Yesterday, [TheStreet](#) reported:

"Italy's benchmark borrowing costs hit a four-and-a-half year high Tuesday as investors continued to trim government bond holdings amid concern that the country's populist administration is on a collision course with EU officials in Brussels that echoes the worst of the region's 2012 debt crisis.

"Italy's Deputy Prime Minister Luigi Di Maio told the *Il Fatto Quotidiano* newspaper Tuesday that his government could breach the EU's 3% deficit target next year as it spends billions more than anticipated in order to meet various election commitments. The outlay is also expected to include billions more for improvements in Italy's road and transport infrastructure following the deadly collapse of a busy commuter bridge earlier this month that killed 43 people in the northern city of Genoa."

As a result, the 10-year Italian government bond yield has soared from this year's low of 1.63% on April 19 to 3.11% on Monday ([Fig. 9](#)). The spread between this yield and the comparable German one has blown out from 116 bps to 289 bps over this same period ([Fig. 10](#)). How do you say "bond vigilantes" in Italian?

The Fed II: Powell's Path. Melissa and I spent the weekend reviewing the speeches, papers, and commentary presented at Jackson Hole. Going into the event, we had a good sense of what topics would be covered, as discussed in our 8/22 [Morning Briefing](#).

Most widely anticipated was Jerome Powell's first Jackson Hole [speech](#) as Fed chairman, given on 8/24 and titled "Monetary Policy in a Changing Economy." We didn't expect the speech to indicate any major change in his policy guidance as we had outlined it based on his 7/17 [Semiannual Monetary Policy Report to the Congress](#). (See the C-SPAN broadcast [here](#), including the Q&A.)

Indeed, Powell's overriding message didn't change much. However, there were a few subtle differences in the subtext. It seems to us that Powell has gradually become more concerned about upside risks to the US economy than the downside ones. He struck a slightly more confident tone, defending his position that gradual interest-rate increases remain appropriate. Speaking to a mostly academic audience, Powell also brought more of the technical reasoning behind his stance on monetary policy to light than before.

Let's compare more closely what Powell has said before to points made in his latest speech:

(1) *Continuing on the slow, but steady path.* Once again, Powell reiterated the Committee's consensus view that the "gradual process of normalization remains appropriate." He said: "As the economy has strengthened, the FOMC has gradually raised the federal funds rate from its crisis-era low near zero toward more normal levels. We are also allowing our securities holdings—assets acquired to support the economy during the deep recession and the long recovery—to decline gradually as these securities are paid off."

(2) *Conservative approach is best in uncertain times.* This time, however, Powell went into more depth about the conservative philosophy behind the gradual approach. Powell explained that it is especially appropriate given the uncertainty around the direction of the US economy, particularly related to longer-term structural forces “beyond the reach of monetary policy.” Powell began and ended his speech with two quotes on uncertainty. He quoted former Fed Chairman Alan Greenspan: “Uncertainty is not just an important feature of the monetary policy landscape; it is the defining characteristic of that landscape.”

Near the end of his speech, Powell referred to the literature on uncertainty, which “started with the work of William Brainard and the well-known Brainard principle, which recommends that when you are uncertain about the effects of your actions, you should move conservatively. In other words, when unsure of the potency of a medicine, start with a somewhat smaller dose.” The word “uncertainty” appeared 15 times in Powell’s speech and footnotes.

Powell explained that there are two exceptions to this rule. One is when “attempting to avoid severely adverse events.” The other is when “inflation expectations threaten to become unanchored.” Neither scenario is probable right now, according to Powell.

(3) *Avoiding two major errors.* On numerous previous occasions, Powell has repeated the mantra that the risks to the outlook are balanced. This time, we noticed that Powell dropped the word “balanced” when discussing the risks. However, he did continue to touch on the risks to the outlook on both sides. He stated: “[T]he two errors that the Committee is always seeking to avoid” are “moving too fast and needlessly shortening the expansion, versus moving too slowly and risking a destabilizing overheating.” He added: “Readers of the minutes of FOMC meetings and other communications will know that our discussions focus keenly on the relative salience of these risks.” Powell sees the “current path of gradually raising interest rates as the FOMC’s approach to taking seriously” both risks.

Previously, Powell has said that the Fed would accept deviations above or below the Fed’s 2.0% inflation objective if these weren’t significant or persistent. This time, we observe that Powell gave slightly more weight to the upside risk to inflation: “While inflation has recently moved up near 2 percent, we have seen no clear sign of an acceleration above 2 percent, and there does not seem to be an elevated risk of overheating.”

(4) *Labor market is strong.* Similarly, Powell previously focused on the improvement in labor force participation, suggesting that there may be room for the labor force to run. While he noted that the Fed continues to monitor lots of different labor force metrics in his Jackson Hole speech, he didn’t specifically mention labor force participation. Rather, Powell said: “The unemployment rate has declined steadily for almost nine years and, at 3.9 percent, is now near a 20-year low. Most people who want jobs can find them.” In context, that statement indicates to us that he thinks the labor market is pretty tight.

(5) *One area of weakness.* Powell’s stance on wages, however, didn’t change much. He said: “[R]eal wages, particularly for medium- and low-income workers, have grown quite slowly in recent decades.” He explained, as he has before, that “if incomes are to rise meaningfully over time,” then the economy must “break out of its low-productivity mode of the past decade or more.” In the past, Powell indicated that education and investment might solve the productivity problem. While he didn’t go there this time, he did note that monetary policy has little control over this issue.

(6) *Staying in his lane.* Powell hasn’t said much on fiscal or trade policy in the past, preferring to “stay in his lane.” Previously, he has said that the outcome of the recent tax changes and trade spats are difficult to predict. However, he has previously indicated that the recent tax cuts will likely be simulative; meanwhile, protectionist trade policies may not be so good for the economy.

Powell continued to say very little on either matter. He opened by saying: “As always, there are risk factors abroad and at home that, in time, could demand a different policy response, but today I will step back from these.” We translate this to mean that Powell doesn’t feel the need to change his course of action based on these outside forces right now. He did say that with “fiscal stimulus arriving, there is good reason to expect” that “strong performance will continue.”

By the way, once again, two additional important developments that Powell did not address are the yield curve, as discussed above, and the turmoil in a few emerging market economies.

The Fed III: Stargazing with Jay. During his tenure as a Fed governor, Powell seems to have become increasingly disenchanted with the ability of economic models to guide monetary policy “because the economy has been changing in ways that are difficult to detect and measure in real time.” One finding from recent Fed research that Powell highlighted during his Jackson Hole speech was that “no single, simple approach to monetary policy is likely to be appropriate across a broad range of plausible scenarios.”

Powell explained that, according to conventional thinking, “policymakers should navigate by” the following stars: u^* (the natural rate of unemployment), r^* (the neutral real rate of interest), and Π^* (the inflation objective). For example, “the famous Taylor rule calls for setting the federal funds rate based on where inflation and unemployment stand in relation to the stars.” That is, interest rates should be set higher when inflation and unemployment are above and below their natural rates, respectively, and vice versa.

“Guiding policy by the stars in practice, however, has been quite challenging of late because our best assessments of the location of the stars have been changing significantly,” he said. Returning to the “nautical metaphor,” he said that “the FOMC has been navigating between the shoals of overheating and premature tightening with only a hazy view of what seem to be shifting navigational guides.”

In addition to the Taylor rule, Powell suggested that the Phillips curve (which posits an inverse relationship between inflation and unemployment) has flattened and that Okun’s law (the “well-known relationship between output and unemployment”) has broken down.

The Fed IV: Jackson Hole Teach-In. Leading up to Jackson Hole, Melissa and I reviewed the symposium’s key topic: market concentration—that is, the rise of so-called “superstar” firms that are dominating certain industries, which may or may not be leading to a reduction in competition. The topic is relevant for monetary policy because such market dynamics influence US macroeconomic variables including productivity, growth and inflation.

Reviewing relevant Fed research ahead of Jackson Hole, we wrote that there are two important questions to consider: First, have markets become more concentrated because of uncompetitive practices or have firms just become more efficient? Second, what are the economic ramifications of the increased market concentration? Studies conflict on the answers to both questions. We believe there’s a bit of truth in the various viewpoints, with their applicability differing by industry and company. (For more, see our *8/22 Morning Briefing* linked above.)

We don’t have much more to add to our previous conclusion after reviewing all the symposium documents posted to the Kansas City Fed’s [website](#). Nevertheless, the latest research is at the top of the minds of central bankers who attended Jackson Hole. So, let’s quickly review the bottom line of three of the relevant academic papers presented and their implications for monetary policy:

(1) *“Increasing Differences between firms: Market Power and the Macro-Economy.”* In his 7/29 [paper](#), John Van Reenen of MIT’s Department of Economics and Sloan School of Management concluded that superstars in many industries have become “winner take most/all” because of efficiencies gained from technology and globalization rather than overly relaxed regulations or anti-competitive practices.

Implication for monetary policy: “[I]f the trends of increased concentration and [prices] reflect technological and globalization changes ... we may expect to eventually observe higher productivity, lower prices and higher real wages.”

(2) *“Understanding Weak Capital Investment: the Role of Market Concentration and Intangibles.”* In their 8/10 [paper](#), Nicolas Crouzet of Northwestern University and Janice Eberly of Northwestern University and the National Bureau of Economic Research (NBER) determined that the rise in intangible capital explains the fall in physical capital investment since 2000. Also, intangibles are associated with two of the drivers of rising market concentration: market power and productivity gains.

Implications for monetary policy: “[I]ntangible capital is less interest-sensitive and less collateralizable than physical capital, potentially weakening traditional transmission mechanisms.”

(3) *“More Amazon Effects: Online Competition and Pricing Behaviors.”* In his 8/10 [paper](#), Alberto Cavallo of Harvard Business School and NBER found that because of Amazon and its influence on increases in online competition, prices change more frequently and uniformly across locations than they did a decade ago.

Implications for monetary policy: “[R]etail prices are becoming less ‘insulated’ from” nationwide shocks.”

Our takeaway: Powell’s introductory remarks were the high point of the conference.

CALENDARS

US. Wed: GDP & PCE 4.0%/3.9%, GDP Price Deflator 3.0%, Corporate Profits, Pending Home Sales 0.0%, EIA Petroleum Status Report. **Thurs:** Personal Income & Spending 0.3%/0.4%, Headline & Core PCED 2.3%/2.0% Y/Y, Jobless Claims 214k, EIA Natural Gas Report. (Econoday estimates)

Global. Wed: Germany Gfk Consumer Confidence 10.6, France GDP 0.2%q/q/1.7%y/y, Japan Consumer Confidence 43.3, Japan Retail Trade -0.3%m/m/1.2%y/y, Mexican Central Bank Inflation Report. **Thurs:** Eurozone Economic Confidence 111.9, Germany Unemployment Change & Unemployment Rate -8k/5.2%, Germany CPI 0.1%m/m/2.0%y/y, Canada GDP (annualized) 3.1% q/q, Japan Jobless Rate 2.4%, Japan Industrial Production 0.2%m/m/2.6%y/y, Japan CPI Total, Core, and Core-Core 1.0%/0.8%/0.5% y/y. (DailyFX estimates)

US ECONOMIC INDICATORS

Consumer Confidence ([link](#)): Consumers haven’t been this confident since October 2000! Consumer confidence beat all expectations, jumping 5.5 points to 133.4 last month. “Consumers’ assessment of current business and labor market conditions improved further. Expectations, which had declined in June and July, bounced back in August and continue to suggest solid economic growth for the remainder of 2018,” said Lynn Franco, director of economic indicators at The Conference Board, noting that this level of sentiment should “support healthy consumer spending in the near-term.” The August survey showed consumers’ buying plans improved across several categories, contrasting with recent months, in which consumers’ plans to make major purchases—such as a car, home, or washing machine—had fallen. August’s present situation component climbed for the fourth month, from 157.5 in

April to 172.2 last month, its highest reading since December 2000. Meanwhile, the expectations component rebounded to a six-month high of 107.6 after sliding the prior two months from 107.2 to 102.4. The current jobs outlook continued to remain very favorable last month: Jobs plentiful (to 42.7% from 42.8%) was little changed around July's cyclical high, while jobs hard to get (12.7 from 14.8) dropped to its lowest percentage since March 2001. The six-month jobs outlook was mixed, with the percentage reporting more jobs (21.7 from 22.6) slipping a bit and those expecting fewer jobs (14.1 from 15.2) also declining. The spread between the two remained favorable, at 7.6ppts, holding among one of the highest percentages during the past couple of years.

Regional M-PMIs ([link](#)): Five Fed districts have now reported on manufacturing activity for August—New York, Philadelphia, Dallas, Richmond, and Kansas City—and show growth remains strong. We average the composite, orders, and employment measures as data become available. The composite index (to 21.3 from 24.7) eased, but was not far from June's record high of 26.0 as three regions posted solid performances. New York's (25.6 from 22.6) measure rose to within 2.5 points of last October's 37-month high of 28.1, Richmond's (24.0 from 20.0) matched its high for this year, while Dallas' (30.9 from 32.3) was not far from its near 14-year high of 38.4 recorded in February. Meanwhile, Philadelphia's (11.9 from 25.7) gauge sank to a 21-month low, while Kansas City's (14.0 from 23.0) fell to an eight-month low. The new orders measure (17.0 from 23.2) showed growth eased to a five-month low, as Philly (9.9 from 31.4) and Kansas City (9.0 from 21.0) billings slowed dramatically during the month; orders growth in the Richmond (25.0 from 22.0) region was the strongest in nine months, while orders in the New York (17.1 from 18.2) and Dallas (23.9 from 23.3) regions virtually matched July's robust pace. The employment measure (19.1 from 22.2) also eased this month, as manufacturers in the Philly (14.3 from 16.8), New York (13.1 from 17.2), and Kansas City (14.0 from 26.0) regions showed slower, but still healthy, jobs growth, while Richmond (25.0 from 22.0) factories hired at the best pace on record and Dallas' (unchanged 28.9) matched their best hiring pace in 13 years.

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