



MORNING BRIEFING

March 13, 2019

Disconnecting the Dots

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

(1) Don't miss seeing the data for the dots, warns Powell. (2) Defining "normal," for the balance sheet at least. (3) The new normal fed funds rate remains nebulous. (4) The pause that refreshes (markets). (5) Did the bull make it to 10? (6) The past decade has favored Growth over Value.

Fed I: End of the (Dot) Plot? Don't look too closely at the Fed's dot plot or you might miss the larger monetary policy picture, warned Federal Reserve Chairman Jerome Powell in a 3/8 [speech](#) titled "Monetary Policy: Normalization and the Road Ahead." To make his point, he showed two unusual images: an unrecognizable [close-up](#) of a bouquet of flowers from impressionist painter Georges Seurat's "A Sunday Afternoon on the Island of La Grande Jatte" and a very recognizable [image](#) of the full painting. Monetary impressionists may not be seeing the forest for the trees, to mix up the metaphor.

The Fed began issuing its Summary of Economic Projections (SEP) for the next three years and longer run back in 2007, specifically with the [10/30-10/31/07](#) Federal Open Market Committee (FOMC) meeting materials. Included in the SEP is the "dot plot," which reflects each participant's view of the appropriate federal funds rate trajectory "in the scenario that he or she sees as most likely," according to Powell. The scenarios outline participants' outlooks for the unemployment rate, the pace of real GDP growth, and the inflation rate.

Looking back at Figure 2 in the latest, [12/19 SEP](#), we see the median forecast for the federal funds rate envisioned would rise to 2.90% this year and 3.10% in 2020. The precision of these (median) point estimates in the dot plot is at odds with repeated warnings by Fed officials that the outlook is highly uncertain and that incoming data will dictate the appropriate policy response. Melissa and I take Powell's impressionist interpretation to mean that the Fed hasn't had a clear enough view of what lies ahead to put much faith in the latest dots. Indeed, he seems to be questioning the usefulness of the entire exercise, and may be signaling its demise. Consider the following:

(1) *Collateral confusion*. This is not the first time that a Fed chair has provided Fed watchers with an art class on interpreting the Fed's dot-based pictures of monetary policy. In his speech, Powell reviewed two previous instances. In 2014, the dots caused "collateral confusion," according to the then Fed Chair Janet Yellen, when the markets misread the Fed's intentions. She stated that what matters more than the dots is what is said in the FOMC Statement released after each meeting.

Similarly, former Fed Chairman Ben Bernanke once said that the "dots" are merely inputs to the Fed's policy decision-making; they don't account for "all the risks, the uncertainties, all the things that inform our collective judgement."

(2) *Bullard's missing dot*. Powell didn't specifically mention him, but St. Louis Fed President James Bullard, a current voter on the FOMC, has questioned the usefulness of the dots for some time. Since

2016, Bullard has opted out of providing longer-run projections, the only participant to do so. He explained why in a [paper](#), contending that switches among monetary policy “regimes”—and the possible future macroeconomic outcomes they may lead to—are not forecastable beyond 2.5 years.

(3) *FOMC’s flexible course.* Perhaps Bullard led the FOMC participants in an impromptu discussion about the dots during the January 29-30 meeting? According to the [Minutes](#): “A few participants expressed concerns that in the current environment of increased uncertainty, the policy rate projections prepared as part of the Summary of Economic Projections (SEP) do not accurately convey the Committee’s policy outlook.” It was the first time that the minutes suggested that this subject had been discussed in a FOMC meeting.

These participants were concerned that “the public had misinterpreted the median or central tendency of those projections as representing the consensus view of the Committee or as suggesting that policy was on a preset course.” In other words: The public doesn’t understand impressionistic art, so let’s stop showing it to them!

(4) *A suggestion.* We are not fans of the dot plot. We think that a data-dependent approach is the most sensible way to run monetary policy. Nevertheless, the SEP does provide some useful insights into the heads of the Fed heads.

While the words of Fed officials along with the FOMC Statement and the Minutes help to paint the larger picture of monetary policy, it would also be helpful if the estimated probability of occurrence associated with each of the participants’ projections was indicated within the SEP.

(5) *Spot off.* Barring an unexpected inflation surprise, we are fairly certain that the Fed will continue to be patient and not raise rates until at least the end of the year. One thing we are absolutely sure of: We won’t be gazing at the Fed’s upcoming release of the dot plot for the 3/19-3/20 FOMC [meeting](#) for very long. We’ll take Powell’s advice and view it with a cursory glance and from a few steps back.

In any event, given that the dot plot hasn’t been spot on in a very long time, we won’t be upset if the Fed deletes the dots in the future.

Fed II: Abnormal Normalization. In his 3/8 speech cited above, Powell had the following to say about the normalization of monetary policy: “Delivering on the FOMC’s intention to ultimately normalize policy continues to be a major priority at the Fed. Normalization is far along, and, considering the unprecedented nature of the exercise, it is proceeding smoothly. I am confident that we can effectively manage the remaining stages.” He used the word “normal” or “normalization” 27 times.

Beyond the dots, the most important part of Powell’s speech was that he explained what “normal” means for the balance sheet. It’s not as clear what “normal” means for the federal funds rate. Consider the following:

(1) *“Normal” balance sheet.* For the first time, Powell specified the expected endpoint for the wind-down of the Fed’s balance sheet. Until now, various officials have said that the Fed would likely return the balance sheet to a level higher than it was before the recession, i.e., a new normal (see our [2/25](#) and [2/27](#) and *Morning Briefings*).

Total assets on the Fed’s balance sheet increased \$3.6 trillion from \$0.9 trillion at the start of 2008 to a peak of \$4.5 trillion during February 2016. Since then, assets have fallen by \$0.6 trillion to \$3.9 trillion as of March 6 ([Fig. 1](#)).

Powell said that “something in the ballpark of the 2019:Q4 projected values may be the new normal. The normalized balance sheet may be smaller or larger than that estimate and will grow gradually over time as demand for currency rises with the economy. In all plausible cases, the balance sheet will be considerably larger than before the crisis.”

Showing a [table](#) with the projected value of the Fed’s liabilities (which more or less equals the Fed’s assets, with a small difference for the capital accounts) for the end of 2019, Powell explained that by the time the Fed’s “normalization” is complete, the balance sheet will have grown 10.6ppts as a share of nominal GDP from 5.9% during 2006 to 16.5% during 2019. That is down from 24.8% during 2014. Powell didn’t give the specific dollar amount for the balance-sheet endpoint, but we can infer it from his table.

Powell’s table [sourced](#) nominal GDP from the CBO’s Economic Projections. The CBO estimates that nominal GDP for calendar-year 2019 on average will be about \$21.5 trillion (see CBO’s Table E-1). If the Fed’s balance-sheet normalization ends at 16.5% of the CBO’s 2019 projection, the balance sheet would end around \$3.5 trillion. So there is about \$0.4 trillion remaining to wind down through the end of this year, assuming Q4-2019 as the end date.

Keep in mind, however, that this is based on Powell’s thinking at the moment, which he has said before is subject to change. The official details of the balance-sheet normalization will be announced “reasonably soon,” according to Powell.

(2) *“Normal” federal funds rate?* In September 2014, the Fed outlined its plans for the balance sheet. Over time, the initial guidance has been supplemented with other FOMC communications, including the minutes of the May 2017 meeting. At that time, it was [indicated](#) that the normalization of the balance sheet would commence only after the normalization of the level of the federal funds rate was well under way. We didn’t get much clarity from Powell on what “normal” means for the federal funds rate during last Friday’s speech.

Indeed, the FOMC raised the federal funds rate from the abnormally low “zero lower bound” for the first time on December 16, 2015. Since then, the federal funds target range has been raised nine times to 2.25%-2.50%. We know that the latest median longer-run projection for the federal funds rate in the SEP is 2.8%. But as discussed above, that hasn’t been declared as an absolute for “normal.” In a *60 Minutes* [interview](#) on Sunday, Powell said that “rates are still quite low. But they’re closer to a normal level for a healthy economy.” He didn’t give us much more than that on rates.

Besides being motivated by muted inflation and global uncertainties, we have a suspicion that the Fed may have “paused” rate increases to allow the financial markets to further digest the balance-sheet wind-down as it proceeds. “Normal” for the federal funds rate might mean something different depending on how the market reacts to the remainder of the balance-sheet normalization.

The Fed is likely trying to avoid a recurrence of the market freak-outs, as occurred last year when Powell suggested that the federal funds rate was far from neutral and when he said that the balance-sheet wind-down was on automatic pilot. Since then, Powell retracted both statements, saying the balance sheet is flexible and the federal funds rate is close to neutral.

During his 3/8 speech, he repeated that the “federal funds rate is now within the broad range of estimates of the neutral rate—the interest rate that tends neither to stimulate nor to restrain the economy. Committee participants generally agree that this policy stance is appropriate to promote our dual mandate of maximum employment and price stability. Future adjustments will depend on what incoming data tell us about the baseline outlook and risks to that outlook.”

Strategy: Slicing & Dicing Growth & Value. The current bull market marked its tenth anniversary on Saturday. Through Monday's close, the S&P 500 was up 311.4% since March 9, 2009 ([Fig. 2](#)). Of course, we won't know for sure whether the bull market is 10 years old until the index makes a new high again. If the S&P 500 falls at least 20% from last year's September 20 high, then that date is when the bull market has ended. Meanwhile, it's up 11.0% ytd in the best start to a year since 1991; it was up 12.9% at this point that year and ended the year 26.3% higher.

I asked Joe to see how the S&P 500 Growth and Value stock indexes have performed during the current bull market. He reports:

(1) The S&P 500 Growth index has easily outpaced S&P 500 Value over the past 10 years, rising 364.1% versus a 258.8% gain for Value ([Fig. 3](#)).

(2) However, the S&P 500 Growth and Value indexes had their bull-market runs interrupted by bear markets last year. How can that be when the S&P 500 didn't go into a bear market? The answer comes down to S&P's index construction methodology. In short, the constituents of the Growth and Value indexes are weighted differently than the S&P 500. At their bear-market lows in December, Growth was down 21.0% from its October 1 peak and Value was down 21.2% from its record high on January 26, 2018.

(3) It has been 409 days since the last record high for the S&P 500 Value index. That compares to 161 days for S&P 500 Growth and 193 days for the S&P 500. All three of these indexes were at record highs on January 26, 2018. Following a short correction, Growth's price index continued rising to record highs until October 1 and the S&P 500 did so until September 20, but Value has been left behind. Value peaked on September 21 just short of its record high by 2.6%, and has lagged in the rally since the market's bottom on December 24.

(4) From the December lows, Growth has risen 19.7% and Value has gained 16.9%, while the S&P 500 is up 18.4%. The S&P 500 and the Growth index are 5.0% and 5.4% below their respective record highs, while Value is down 7.8% from its high after nearly falling back into a correction last week.

CALENDARS

US. Wed: Durable Goods Orders Total, Ex Transportation, and Core Capital Goods -0.8%/0.1%/0.1%, PPI-FD Headline, Core, and Core Less Trade Services 0.2%/0.2%/0.2%, Construction Spending 0.3%, Atlanta Fed Business Inflation Expectations, E-Commerce Retail Sales, EIA Petroleum Status Report. **Thurs:** Jobless Claims 225k, New Home Sales 620k, Import & Export Prices 0.3%/0.2%, EIA Natural Gas Report. (Econoday estimates)

Global. Wed: Eurozone Industrial Production 1.0%/m/m/-2.1%/y/y, Mexico Industrial Production -2.0% y/y. **Thurs:** Germany CPI 0.5%/m/m/1.6%/y/y, China Retail Sales (ytd) 8.1% y/y, China Industrial Production (ytd) 5.5% y/y, China Fixed Assets Ex Rural (ytd) 6.0% y/y. (DailyFX estimates)

STRATEGY INDICATORS

S&P/Russell LargeCaps & SMidCaps ([link](#)): All of these price indexes are up so far in 2019, and only the SmallCaps are still in a correction. Here's how they rank ytd through Monday's close, along with their percentage changes since SMidCap's record highs in late August and LargeCap's on September 20: Russell SmallCap 2000 (14.9% ytd, -11.0% from record high), S&P MidCap 400 (13.4, -8.0), S&P SmallCap 600 (12.3, -13.6), Russell LargeCap 1000 (11.5, -5.0), and S&P LargeCap 500 (11.0, -5.0).

LargeCap's forward EPS had been the most below its record high since June 2016, while MidCap and SmallCap have not been this far below since February 2016 and November 2010, respectively. The yearly change in forward earnings soared to cyclical highs during 2018 due to the boost from the Tax Cuts and Jobs Act (TCJA), but is tumbling now as y/y comparisons become more difficult. In the latest week, the rate of change in LargeCap's forward earnings fell to a 26-month low of 6.6% y/y from 6.8%. That's down from 23.2% in mid-September, which was the highest since January 2011 and compares to a six-year low of -1.8% in October 2015. MidCap's y/y change was down to a 25-month low of 7.3% from 7.9%, which compares to 24.1% in mid-September (the highest since April 2011) and a six-year low of -1.3% in December 2015. SmallCap's dropped to a 17-month low of 8.6% from 10.1%, which is down from an eight-year high of 35.3% in early October and compares to a six-year low of 0.3% in December 2015. Analysts had been expecting double-digit percentage earnings growth in 2019, but those forecasts have been dropping since October. Here are the latest consensus earnings growth rates for 2018, 2019, and 2020: LargeCap (22.5%, 3.9%, 12.0%), MidCap (22.5, 3.7, 12.5), and SmallCap (21.4, 7.6, 17.1).

S&P 500 Growth vs Value ([link](#)): The S&P 500 Growth index is up 11.7% ytd through Monday's close, slightly ahead of the 10.2% gain for its Value counterpart. Growth has risen 19.7% since the bottom on December 24, ahead of the 16.9% gain for Value. Both of these indexes are out of a correction now: Growth is now 5.4% below its October 1 record high, while Value is 7.8% below its record high on January 26, 2018. Since the election in late 2016, Growth's 40.7% gain is more than double the 18.4% increase logged by Value. Looking at the fundamentals, Growth is expected to deliver higher revenue growth (STRG) and earnings growth (STEG) than Value over the next 12 months. Specifically, 7.9% STRG and 7.7% STEG are projected for Growth, respectively, versus 4.1% and 4.5% for Value. Prior to the selloff in February 2018, Growth's P/E of 21.8 on January 26, 2018 was its highest since May 2002, while Value's 16.6 on January 3, 2018 was its highest since April 2002. Through Monday, Growth's P/E was back up to 20.6 from its 50-month low of 15.9 on December 24, and Value's 13.3 was up from a six-year low of 11.5 on January 3. Regarding NERI, Growth's was negative in February for a third month after 19 straight positive readings, as it fell to a 25-month low of -4.4% from -3.5%; that compares to a record high of 22.3% in March 2018 and a five-year low of -16.2% in April 2015. Value's NERI was negative in February for a fourth month and at a 34-month low as it fell to -9.8% from -6.8%; that compares to a record high of 21.2% in March 2018 and five-year low of -20.3% in April 2015. The TCJA sharply boosted the consensus forward earnings estimates and the forward profit margin for both Growth and Value, but Growth's margin is falling now. Growth's forward profit margin of 15.9% is up from 14.4% prior to the TCJA's passage, but down from its record high of 16.7% during mid-September. Value's forward profit margin of 10.2% is down from a record high of 10.5% in December, but up from 9.1% prior to the TCJA.

US ECONOMIC INDICATORS

NFIB Small Business Optimism Index ([link](#)): The Small Business Optimism Index (SBOI) stopped falling in February, after a five-month slide. "Small business owners are thankful to have the government shutdown in the rear view mirror but need more certainty about the future," said NFIB President and CEO Juanita D. Duggan. "Small businesses put their money where their expectations are as we've seen when they get tax and regulatory relief. The best thing Washington can do for the small business half of the economy is to continue the policies—tax cuts and deregulation—that leave them with more resources to invest and find qualified workers." The SBOI ticked up 0.5 point to 101.7 last month after falling from a record high of 108.8 in August to 101.2 in January—which was the lowest since November 2016. Five of the 10 components rose, two fell, while sales expectations (16%), plans to increase inventories (1), and expected credit conditions (-5) were unchanged at January percentages. Meanwhile, small business owners who expect better business conditions increased 5ppts to 11%, followed by 2-ppt increases in current job openings (to 37%), plans to make capital

outlays (27), and now is a good time to expand (22); current inventory ticked up 0.1ppt to -2%. Earnings trends sank 4ppts to a 14-month low of -9%—as a million laid-off workers and others affected by the shutdown cut back on spending; hiring plans ticked down 2ppts to 16%, 10ppts below August's record high of 26%.

CPI ([link](#)): February's core CPI rate held above the Fed's target rate of 2.0% y/y for the 12th straight month, though remained below July's peak rate for the seventh month. Core prices rose 2.1% y/y in February after three months at 2.2%; it was once again below July's 2.4% rate—which was the fastest pace since September 2008. Here's a ranking of the core goods rates, lowest to highest: medical care commodities (-1.1% y/y), apparel (-0.8), new vehicles (0.3), alcoholic beverages (1.8), used cars & trucks (1.1), tobacco & smoking products (3.7)—with only the last one surpassing the total core rate of 2.1%. Here's the same exercise for the core services rates: airfares (-2.3), physicians' services (0.7), hospital services (2.0), motor vehicle insurance (2.0), motor vehicle maintenance & repair (2.8), owners' equivalent rent (3.3), and rent of primary residence (3.5). Only the rate for motor vehicle maintenance & repair is on an accelerating trend, while two components—hospital services and motor vehicle insurance—are on sharp decelerating trends. Core prices in February ticked up only 0.1%, after gains of 0.2% in each of the prior five months, with the three-month rate easing to 2.1% (saar)—the lowest since October's 15-month low of 1.7%, and down from January's 2.6%—which was the highest since March 2018. The headline CPI rate slowed to 1.5% y/y, the lowest since September 2016 and more than a percentage point below its recent high of 2.9% posted in both June and July, which was the highest since February 2012.

GLOBAL ECONOMIC INDICATORS

UK GDP ([link](#)): Economic growth in the UK accelerated in January, though the three-month rate held at December's seven-month low. Monthly real GDP growth, which tends to be volatile, rebounded 0.5% in January after contracting 0.4% in December. In January, three of the major industry groups, production (to 0.6% from -0.5%)—which includes manufacturing (0.8 from -0.7)—services (0.3 to -0.2), and construction (2.8 from -2.8) all rebounded from December declines, while growth in agriculture sank for the first time, by 1.3%, in five months. On a rolling three-month basis, which is the ONS's preferred barometer for economic growth, real GDP advanced 0.2% for the second month in January, slowing steadily from August's 0.8%—which was the strongest since early 2017. The head of economics at the British Chambers of Commerce said: "The data for the longer three-month period recorded an economy that was continuing to slow under the weight of uncertainty over Brexit and weakening global trading conditions." Service industries, which account for about 80% of the private sector economy, continued to drive gains, climbing 0.5%—the 32nd straight three-month gain. Meanwhile, production and construction industries contracted 0.8% and 0.6%, respectively, over the span; it was the third consecutive decline for the former, the second for the latter.

UK Industrial Production ([link](#)): January industrial production rose for the first time in six months, boosted by a strong rebound in manufacturing output. Headline production recovered 0.6% after a five-month slide of 1.7%, while manufacturing output jumped 0.8% after a six-month decline of 1.9%. Both headline (-0.9% y/y) and manufacturing (-1.1) production are below year-ago levels. Looking at the main industrial groupings, here's a tally for January and y/y: Capital goods (0.1m/m & -4.8%y/y) accounted for much of the decline the past 12 months, with energy (0.2 & -1.0) and intermediate goods (1.0 & -0.6) also a drag. Meanwhile, both consumer nondurable (1.9 & 3.4) and consumer durable (0.9 & 1.9) are above year-ago levels.

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