



MORNING BRIEFING

August 27, 2019

Fed's New Obsession with ELB

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

(1) Is ELB the same as zero, or something south of that? (2) Slippery slope. (3) Should the Fed have done more? (4) Wondering what to do if ELB goes to zero? Ask the ECB and BOJ! (5) Recalling Powell's recent ELB nightmare speech. (6) The Fed has become the world's central bank of last resort. (7) Three reasons why the Fed eased at the end of July. (8) A few by-the-way comments on financial stability. (9) Fed's pirouette puts focus back on ELB. (10) History lesson: QE2 was the alternative to negative rates.

The Fed I: Turning Negative? The [minutes](#) of the 7/30-31 FOMC meeting mentions the acronym "ELB" 15 times, up from none in the June meeting's [minutes](#). That stands for "effective lower bound," which is Fedpeak—presumably for "ZERO" or conceivably for even less. The presumption is that the federal funds rate can't fall below zero. Yet the minutes hinted that Fed officials might be thinking that if they have to lower the federal funds rate to zero, it's a slippery slope from there to considering going negative.

All the ELB references were in a special section at the beginning of the July minutes titled "Review of Monetary Policy Strategy, Tools, and Communication Practices." The Fed initiated this review about a year ago, and we expect ongoing discussion of the ELB and other monetary policy issues in future FOMC meetings.

There were lots of high-fives in the review section, as committee participants congratulated one another for supplementing the ELB with forward guidance and quantitative easing (QE) programs. The conventional response to weak economic activity with low inflation is to lower the federal funds rate. It was dropped to a range of 0.00%-0.25% on 12/16/08 in response to the Great Recession and the Great Financial Crisis. The Fed then resorted to unconventional policies including forward guidance and QE.

The only regret that Fed officials expressed during their discussion of this subject is that they hadn't implemented more unconventional policy measures after they hit the ELB: "In particular, a number of participants commented that, as many of the potential costs of the Committee's asset purchases had failed to materialize, the Federal Reserve might have been able to make use of balance sheet tools even more aggressively over the past decade in providing appropriate levels of accommodation."

Here's what might happen the next time the federal funds rate falls to the ELB, which Fed officials apparently believe is a distinct possibility: "If policymakers are not able to provide sufficient accommodation at the ELB through the use of forward guidance or balance sheet actions, the constraints posed by the ELB could be an impediment to the attainment of the

Federal Reserve's dual-mandate objectives over time and put at risk the anchoring of inflation expectations at the Committee's longer-run inflation objective. Participants looked forward to a detailed discussion over coming meetings of alternative strategies for monetary policy."

The minutes did not mention the possibility of pushing the federal funds rate below the ELB into negative territory, as happened in the Eurozone (on 6/5/2014) and Japan (on 1/29/16) ([Fig. 1](#)). Instead, the remainder of the section reviewing monetary policy focused on communicating the Fed's intention to increase the inflation rate. How or why such an approach would work to boost inflation isn't clear at all.

Powell was even more obsessed with ELB in a 6/4 [speech](#) that mentioned it 26 times, as Melissa and I have observed previously. Powell never defined what he meant by ELB in the speech. He didn't say it means zero. So he didn't explicitly rule out the possibility of negative interest rates. He did seem very concerned that the federal funds rate is too close to the ELB and worried about what the Fed can do when the federal funds rate falls to the ELB:

"The next time policy rates hit the ELB—and there will be a next time—it will not be a surprise. We are now well aware of the challenges the ELB presents, and we have the painful experience of the Global Financial Crisis and its aftermath to guide us. Our obligation to the public we serve is to take those measures now that will put us in the best position to deal with our next encounter with the ELB."

Leaving no doubt about his concern, Powell said: "In short, the proximity of interest rates to the ELB has become the preeminent monetary policy challenge of our time, tainting all manner of issues with ELB risk and imbuing many old challenges with greater significance."

The Fed II: The World's Central Bank of Last Resort? The latest minutes provided more detail than usual explaining the decision to lower the federal funds rate range from 2.25%-2.50% to 2.00%-2.25% ([Fig. 2](#)). There were three main reasons:

(1) *Trade-related pressures*. In the US, capital-spending growth has been weakening and manufacturing activity has slowed significantly. Overseas, "uncertainties surrounding international trade" have been weighing on global economic growth. The word "trade" was mentioned 32 times in the minutes (compared to 19 times in the previous minutes). The phrase "trade tensions" was mentioned eight times (versus seven times in the previous minutes).

(2) *Uncertain world*. Lowering the federal funds rate was justified "from a risk-management perspective." The minutes mentioned the word "uncertainties" 14 times (versus 16 times in the previous minutes). The source of these uncertainties is deemed to be mostly in the global economy.

Ominously, a number of participants warned that "policy authorities in many foreign countries had only limited policy space to support aggregate demand should the downside risks to global economic growth be realized." Wow! Does that mean that the Fed is the central bank of last resort for the entire world?

(3) *Anemic inflation*. “A number of participants” are worried that actual and expected inflation rates are too low. Over the past 12 months through June, the headline and core PCED inflation rates were 1.4% and 1.6% ([Fig. 3](#)). They noted that wage inflation remains subdued despite the low unemployment rate, suggesting that “the longer run normal level of the unemployment rate is appreciably lower than often assumed.” Most participants agreed that long-term inflation expectations are below the Fed’s 2.0% target and would stay there unless actual inflation moved higher.

By the way, since the Fed first officially targeted inflation at 2.0% during January 2012, the PCED headline inflation rate has been tracking a 1.3% trendline rather than a 2.0% one ([Fig. 4](#)). In the monetary policy review section of the latest minutes mentioned above, there was a discussion of alternative strategies for boosting inflation, including convincing the markets that the Fed would “make up” the shortfall of below-target inflation readings by allowing inflation to run above 2.0% for a while.

A couple of other reasons got only glancing mention: Concern about the inversion of the yield curve was mentioned just once. Also mentioned was that “the longer-horizon real forward rate implied by TIPS had also declined, suggesting that the longer-run normal level of the real federal funds rate implicit in market prices was lower.”

The Fed III: Financial Stability Is an Issue. There was some discussion about financial stability at the latest FOMC meeting, more so than at June’s meeting. The points were a rehash of the ones reviewed in the Fed’s May 2019 *Financial Stability Report (FSR)* as follow:

(1) *Corporate debt and leveraged lending* reflect “high levels of corporate indebtedness” ([Fig. 5](#), [Fig. 6](#), [Fig. 7](#), and [Fig. 8](#)). May’s *FSR* observed: “[T]he distribution of ratings among nonfinancial investment-grade corporate bonds has deteriorated. The share of bonds rated at the lowest investment-grade level (for example, an S&P rating of triple-B) has reached near-record levels. As of the first quarter of 2019, a little more than 50 percent of investment-grade bonds outstanding were rated triple-B, amounting to about \$1.9 trillion.”

And here was the alarming news about leveraged loans: “The risks associated with leveraged loans have also intensified, as a greater proportion are to borrowers with lower credit ratings and already high levels of debt. In addition, loan agreements contain fewer financial maintenance covenants, which effectively reduce the incentive to monitor obligors and the ability to influence their behavior. The Moody’s Loan Covenant Quality Indicator suggests that the overall strictness of loan covenants is near its weakest level since the index began in 2012, and the fraction of so-called cov-lite leveraged loans (leveraged loans with no financial maintenance covenants) has risen substantially since the crisis.”

The good news is that the junk bond default rate remained very low during the first half of 2019. The renewed decline in bond yields at that time certainly helped to ease financial conditions in the corporate debt markets.

(2) *Private credit markets* aren’t regulated and should be monitored, according to the minutes. There wasn’t much said about this issue in May’s *FSR*, suggesting that private credit markets

need much more monitoring!

(3) *Valuations* in both the stock and bond markets are near all-time highs. The same can be said about commercial real estate valuations. May's *FSR* expressed some concern about elevated asset valuations reflecting higher risk tolerance by investors. Credit-quality yield spreads became very narrow as investors reached for yield in the corporate bond market, buying bonds with lower credit ratings to get more yield. The forward P/E of the S&P 500 was above its historical mean, though still well below the bubble of the late 1990s.

May's *FSR* noted that in a recession there would be widespread downgrades of near-junk bonds to junk bonds. Institutional investors who are restricted from holding noninvestment-grade bonds would be forced to sell into an illiquid market at distressed prices. The situation would be exacerbated if corporate bond mutual funds were forced to sell their holdings as a result of panic redemptions by individual investors. The resulting credit crunch for corporate borrowers would then exacerbate the recession.

Our good friend Mike O'Rourke, the chief market strategist of Jones Trading, opined that the Fed's section reviewing its monetary framework was a bit "alarming." As noted above, Fed officials bragged that their unconventional policies didn't have "adverse implications for financial stability" and suggested that maybe next time they should be even more aggressive with their ultra-easy policies. Mike observed: "It appears as though the way the FOMC defines 'success' is by not imploding the financial system with its policies."

Needless to say, Fed officials have yet to review why their attempts to normalize monetary policy failed so badly. They were on that course through the end of last year, but reversed course back to easing this year. They are mostly blaming uncertainties about trade. So now instead of talking about whether the federal funds rate should be at 3.00% or a bit higher, as they did last year, Fed officials are stressing out about the dreaded ELB. That's quite a reversal.

The Fed IV: History Lesson. Former Fed Chair Ben Bernanke first suggested the need for more quantitative easing (i.e., QE2) in his Jackson Hole [speech](#) on 8/27/10. He viewed that as an alternative to dropping the ELB below zero. William Dudley, the president of the Federal Reserve Bank of New York, gave a [speech](#) on 10/1/10 favoring another round of QE, offering specific numbers: "[S]ome simple calculations based on recent experience suggest that \$500 billion of purchases would provide about as much stimulus as a reduction in the federal funds rate of between half a point and three quarters of a point." His basic argument was that despite the downside of additional QE, it was the only tool the Fed had left to meet its congressional mandate to lower the unemployment rate.

At the time, I argued that if the Fed's econometric model was calling for a negative official policy rate, then either there was something wrong with the model or the Fed was trying to fix economic problems that could not be fixed with monetary policy. In my opinion, when the federal funds rate was lowered to zero, Fed officials should have said that that was all they could do. While I expected and endorsed QE1, I am not convinced that QE2 and then QE3 were necessary.

CALENDARS

US. Tues: Consumer Confidence 129, Richmond Fed Manufacturing Index -4, S&P Case-Shiller Home Price Index 3.3% y/y. **Wed:** MBA Mortgage Applications, DOE Crude Oil Inventories. (DailyFX estimates)

Global. Tues: Germany GDP -0.1%q/q/0.4%y/y. **Wed:** None. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings ([link](#)): Forward earnings rose simultaneously for all three indexes for a second straight week, and remain in the uptrends that began during March. LargeCap's has risen during 23 of the past 28 weeks, MidCap's 16 of the past 24 weeks, and SmallCap's 13 of the past 22 weeks. LargeCap's is back up to a record high, while MidCap's and SmallCap's improved to 1.2% and 6.0% below their mid-October highs. At their bottoms earlier in 2019, LargeCap's forward EPS had been the most below its record high since June 2016, and MidCap's was the lowest since May 2015. SmallCap's had not been this far below since October 2010. The yearly change in forward earnings soared to cyclical highs during 2018 due to the boost from the Tax Cuts and Jobs Act but began to tumble in October as y/y comparisons became more difficult. In the latest week, the rate of change in LargeCap's forward earnings edged up to 2.4% y/y from a 34-month low of 2.3%. That's down from 23.2% in mid-September, which was the highest since January 2011. MidCap's y/y change fell to a 40-month low of 0.6% from 1.4%, which compares to 24.1% in mid-September (the highest since April 2011). SmallCap's -3.5% y/y change is up from -4.2%, which was the lowest since December 2009. That compares to an eight-year high of 35.3% in early October. Analysts had been expecting double-digit percentage earnings growth for 2019 last October, but those forecasts are down substantially since then. Here are the latest consensus earnings growth rates for 2018, 2019, and 2020: LargeCap (22.7%, 1.8%, 11.3%), MidCap (22.7, -1.1, 13.7), and SmallCap (22.4, -0.1, 18.0).

S&P 500/400/600 Valuation ([link](#)): Valuations edged down across the board last week to 12-week lows for these three S&P market-cap indexes. LargeCap's forward P/E fell 0.2pt w/w to 16.1 and is down 1.1pt from a 17-month high of 17.2 at the end of July. That compares to a five-year low of 13.9 during December and a 16-year high of 18.6 during January 2018—and of course is well below the tech-bubble record high of 25.7 in July 1999. Last week's level remains above the post-Lehman-meltdown P/E of 9.3 in October 2008. MidCap's forward P/E dropped 0.3pt to 14.9, down from a 12-week high of 16.0 at the end of July. That's also down from a seven-month high of 16.3 in early April, but up from 13.0 during December, which was the lowest reading since November 2011. MidCap's P/E is down from a 15-year high of 19.2 in February 2017 and the record high of 20.6 in January 2002. However, MidCap's P/E has been at or below LargeCap's P/E for most of the time since August 2017—the first time that alignment has prevailed since 2009. SmallCap's P/E dropped 0.5pt w/w to 15.5, which compares to an 11-week high of 16.7 at the end of July. That's still well above its seven-year low of 13.6 during December and compares to its 15-year high of 20.5 in December 2016, when Energy's earnings were depressed. SmallCap's P/E was below LargeCap's P/E for an

11th straight week, after being below for much of December for the first time since 2003.

S&P 500 Q2 Earnings Season Monitor ([link](#)): With the Q2 earnings season over 96% complete for the S&P 500 companies, the results compared to the same point during Q1 show that revenues are beating by a greater amount; a higher percentage of companies is reporting positive earnings surprises; the earnings surprise is a tad smaller; and y/y earnings growth is only 1.5ppts lower despite Boeing's dismal Q2 results. Of the 482 S&P 500 companies that have reported through midday Monday, 74% exceeded industry analysts' earnings estimates. Collectively, these reporters have averaged a y/y earnings gain of 1.6% and exceeded forecasts by an impressive 6.0%. Ex-Boeing, Q2's y/y earnings growth improves 1.6ppts to 3.2%. On the revenue side, 57% of companies beat their Q2 sales estimates so far, with results coming in an impressive 1.2% above forecast and 3.8% higher than a year earlier. Q2 earnings growth results are positive y/y for 65% of companies, versus a lower 64% at the same point in Q1, and Q2 revenues have risen y/y for 67% versus a slightly higher 68% during Q1. Looking at earnings during the same point in the Q1-2019 reporting period, a higher percentage of companies (76%) in the S&P 500 had beaten consensus earnings estimates by a higher 6.5%, and earnings were up a higher 3.1% y/y. With respect to revenues at this point in the Q1 season, a similar 57% had exceeded revenue forecasts by a sharply lower 0.2%, and sales rose a higher 4.9% y/y. Compared to 2018's stellar results, these readings for Q2 indicate a continuation of a marked slowdown in revenue and earnings growth and a slight deterioration in profit margins. But that should come as no surprise to investors. Q1-2019 had marked the 11th straight quarter of positive y/y earnings growth and the 12th of positive revenue growth. However, earnings growth trailed revenue growth during Q1-2019 for the first time since Q2-2016. That has happened just five times in the 42 quarters since the bull market started in Q1-2009. With the earnings season nearly complete, it looks like Q2-2019 will make the sixth.

US ECONOMIC INDICATORS

Durable Goods Orders & Shipments ([link](#)): Core capital goods orders in July climbed to within a fraction of a new record high, while core capital goods shipments posted the biggest monthly decline since October 2016—courtesy of US-China trade relations. Nondefense capital goods orders ex aircraft (a proxy for future business investment) increased for the sixth time this year, up 0.4% in July and 2.5% ytd, while core shipments (used in calculating GDP) fell 0.7% last month and was only slightly positive ytd, at 0.9%. Core capital goods orders expanded a sluggish 1.3% during the three months through July, based on the three-month average, after contracting 1.3% in June. Core shipments rose only 0.8% (saar) over the comparable period, slowing steadily from March's 3.9%. Overall durable goods orders climbed 3.9% during the two months ending July, rebounding from a 5.1% loss the prior two months ending May—driven by wide swings in volatile aircraft orders. Excluding transportation, billings are up 0.6% during the four months through July, remaining stalled around cyclical highs.

Regional M-PMIs ([link](#)): The four Fed districts that have reported on manufacturing activity for August so far—Philadelphia, New York, Kansas City, and Dallas—show activity is expanding at a sluggish pace, with growth in the four available regions mixed. The composite (to 4.6 from 4.7) index revealed manufacturing activity matched July's sluggish pace, which was an

improvement from June's (-5.1) dip into contractionary territory. Philadelphia's composite (16.8 from 21.8) index showed activity remained at a healthy, though slower, rate, while New York's (4.8 from 4.3) continued at July's pace, after contracting at its fastest pace since October 2016 in June. In the meantime, Dallas' (2.7 from -6.3) manufacturing sector swang from contraction to expansion, while Kansas City's (-6 from -1) posted its first back-to-back decline in three years and its biggest decline since March 2016. New orders (6.5 from 5.2) growth this month is once again lackluster, expanding at roughly half the pace of April, as Kansas City's (-16 from -2) billings fell deeper into negative territory. Meanwhile, orders in the other three regions all accelerated: Philadelphia (25.8 from 18.9) billings were the strongest since May 2018, while Dallas' (9.3 to 5.5) improved for the third straight month, and New York's (6.7 from -1.5) resumed rising again. Employment (0.1 from 7.6) isn't growing for the first time since November 2016. Manufacturers in both the Philadelphia (3.6 from 30.0) and Dallas (5.5 from 16.0) regions hired at a considerably slower pace than last month, while New York (-1.6 from -9.6) and Kansas City (-7.0 from -6.0) factories continued to cut payrolls.

GLOBAL ECONOMIC INDICATORS

Germany Ifo Business Climate Index ([link](#)): "Worry lines among German business leaders are getting deeper and deeper," according to Ifo—with its business climate index plunging to a seven-year low. Sentiment sank for the 10th time in 11 months, from 104.0 last September to 94.3 this August—its lowest reading since November 2012. Both the expectations (91.3 from 92.1) and current situation (to 97.3 from 99.6) components continued to deteriorate this month, tumbling to their lowest readings since June 2009 and November 2014, respectively. Manufacturers remain the most pessimistic, with their sentiment sliding from a record high of 34.2 in November 2017 to -6.1 this month. "The last time that industrial companies demonstrated such pessimism was in the crisis year of 2009," noted Ifo's President Clemens Fuest. He added that "not a single ray of light was to be seen in any of Germany's key industries." Sentiment in the service sector (to 13.0 from 18.0) sank to its lowest reading since May 2010; it was at 33.8 less than a year ago. Meanwhile, the business climate index for trade dropped to -2.4 this month—the lowest since October 2014, and down sharply from its recent peak of 19.4 at the start of 2018. Sentiment in the construction industry deteriorated slightly this month from 23.1 to 21.4—below its recent peak of 32.1 last October.

Contact us by [email](#) or call 480-664-1333.

Ed Yardeni, President & Chief Investment Strategist, 516-972-7683
Debbie Johnson, Chief Economist, 480-664-1333
Joe Abbott, Chief Quantitative Strategist, 732-497-5306
Melissa Tagg, Director of Research Projects & Operations, 516-782-9967
Mali Quintana, Senior Economist, 480-664-1333
Jackie Doherty, Contributing Editor, 917-328-6848
Valerie de la Rue, Director of Institutional Sales, 516-277-2432
Mary Fanslau, Manager of Client Services, 480-664-1333
Sandy Cohan, Senior Editor, 570-775-6823

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