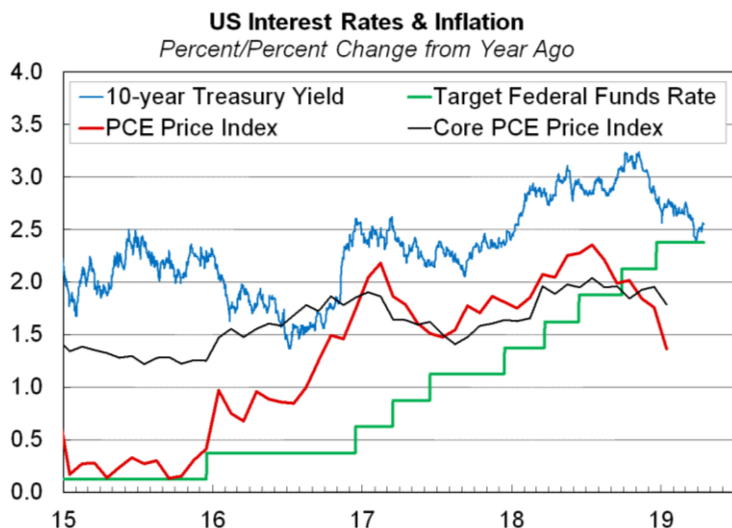
Current Economic Conditions

Robert C. Fry, Jr., Ph.D. April 19, 2019

FED'S DECEMBER RATE HIKE MORE EARLY THAN WRONG

In an op-ed in the March 14 issue of *The Wall Street Journal*, Stephen Moore and Louis Woodhill argued that the Federal Reserve had erred in raising short-term interest rates in September and December of last year and that "these hikes caused a severe dollar shortage, a fall in commodity prices, and a rapid slowing of growth – accompanied by wild swings in the stock market." While President Trump liked the column and soon tapped Moore for an open seat on the Board of Governors of the Federal Reserve System, an objective look at the data available to the Fed before the two rate hikes suggests that the Fed did make a mistake in December, but that it's hard to fault the Fed for its decision in September. And while the December rate hike was a mistake, the resilience of the U.S. economy suggests that the Fed is unlikely to reverse the rate hike. It's more likely that the economy grows into the December rate hike and that, contrary to what futures markets indicate, the next move in short-term interest rates is likely to be up.

When the Fed met in September, inflation, as measured by July's year-over-year percent change in the Personal Consumption Expenditures Price Index, was at 2.3% – above the Fed's 2% target – **and rising**. Since then, data revisions have raised that inflation rate to 2.4%. Real Gross Domestic Product had grown at a 4.2% annualized rate in the prior quarter, well above even the most optimistic estimates of potential growth. The S&P500 stock price index was within 1% of its all-time high. The yield on 10-year Treasury notes was 3.10%, more than 1.2 percentage points above the Fed's federal funds rate target, meaning that a quarter-point hike in the funds rate wouldn't come close to inverting the yield curve. Given the data the Fed had to work with, there are few central bankers in the world who wouldn't have raised interest rates.



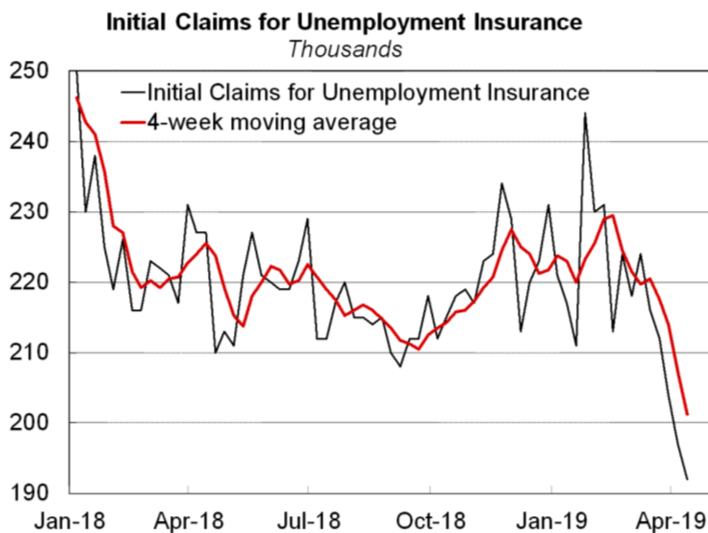
By the December Fed meeting, economic and financial conditions had changed significantly. GDP growth was reported at a still-robust 3.5% in the third quarter (since revised down to 3.4%) but was clearly slowing. Inflation had reversed course and was down to the Fed's 2% target **and falling**. The "core" inflation rate, which excludes food and energy prices, was at 1.8%, below the Fed's target and down from 2.0% three months earlier. The S&P500 was down 12.7% from where it stood before the September meeting. Perhaps most importantly, the 10-year bond yield had fallen to 2.82%. When the bond yield falls after a hike in short-term rates, that's a signal that either growth is slowing, or inflation is easing. Either way, it's a signal for the Fed to stop raising rates. The Fed failed to heed that signal.

Moore and Woodhill (and presumably President Trump) would argue that the deterioration in economic and financial conditions between meetings was due to the September rate hike, but judging from moves in the stock market, Fed Chairman Powell's statements about future rate hikes and shrinkage of the Fed's balance sheet probably did more damage than the rate hike itself. And Fed actions weren't the

only reason for declining stock prices and slowing economic activity. Tariffs (and the threat of higher tariffs) have delayed business investment. Slow growth abroad has reduced the foreign earnings of U.S. companies. The federal government partially shut down for more than a month. Extremely cold weather – the Polar Vortex – shut down economic activity in the Midwest in late January and early February.

The combined result was weak growth from December through February. The weakness showed up primarily in a huge decline in retail sales and consumer spending in December (and another decline in February), declines in industrial production in U.S. manufacturing in January and February, and weak growth in payroll employment in February. In response to the weakness (and the markets' reaction), the Fed has totally changed its "forward guidance." Instead of calling for 2-3 rate hikes in 2019, the median forecast of the members of the Federal Open Market Committee is for no rate hikes, with shrinkage of the Fed's balance sheet now expected to cease by year-end. This reversal has caused long-term interest rates to fall sharply. Yields on 10-year Treasury notes fell to 2.39% on March 27, down from 3.24% on November 8. (They've since risen to 2.56%.) The average rate on 30-year mortgages fell from 4.94% to 4.08%. Baa corporate bond yields have fallen from almost 5.3% last November to about 4.7% today.

Because of either the decline in long-term interest rates or the underlying strength of the U.S. economy, the worst fears of those who thought the Fed shouldn't have raised rates in September and/or December have not been realized. Economic data for March and early April have surprised to the positive side. Initial claims for unemployment insurance, the best weekly measure of economic activity, fell from 244,000 – a 13-month high – in the week ending January 26 to 192,000 – **a 50-year low** – in the week ending April 13. Retail sales, which fell 1.6% in December, rose 1.6% in March. Light vehicle sales, which fell below a 17 million seasonally adjusted annual rate in January and February after four strong months, rose to a 17.5 million rate in March. The Institute for Supply Management's Manufacturing Index rose after three weak months. Nonfarm payrolls grew by 196,000, in line with growth over the prior two years and well above the number needed to absorb growth in the working-age population. As incoming data have improved, the Federal Reserve Bank of Atlanta's GDPNow estimate of first-quarter GDP has risen from 0.3% on March 4 to 2.8% now.



In response to the change in Fed policy and the associated decline in bond yields and mortgage rates, the S&P500 has rebounded to within 1% of its all-time high, and home sales have rebounded strongly after a year-long decline. New home sales surged in February to an 11-month high; existing home sales rose to a 12-month high. Weekly data on mortgage applications suggests that home sales continued to increase in March and April. Building permits for single-family homes, the most important number in the monthly housing report, fell to a 30-month low in March, but must soon turn up if sales continue to rise.

Stock prices, housing market activity, the Institute for Supply Management's new orders index, and Baa bond yields are leading indicators of overall economic activity, and together they paint a much brighter picture for future economic growth than they did just two months ago. Growth might remain at or below trend in the second quarter, due to residual damage from trade policy uncertainty and the fourth-quarter decline in stock prices (and a cut in aircraft production at Boeing), but growth could be significantly stronger in the second half of the year, especially if a trade agreement is reached between the United States and China. If this acceleration occurs, market expectations that the Fed's next move will be to cut interest rates will be proven wrong, and the December rate hike will start to look more early than wrong. With inflation still easing – a global phenomenon – the Fed's next move won't be soon, but it will be up, not down.

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