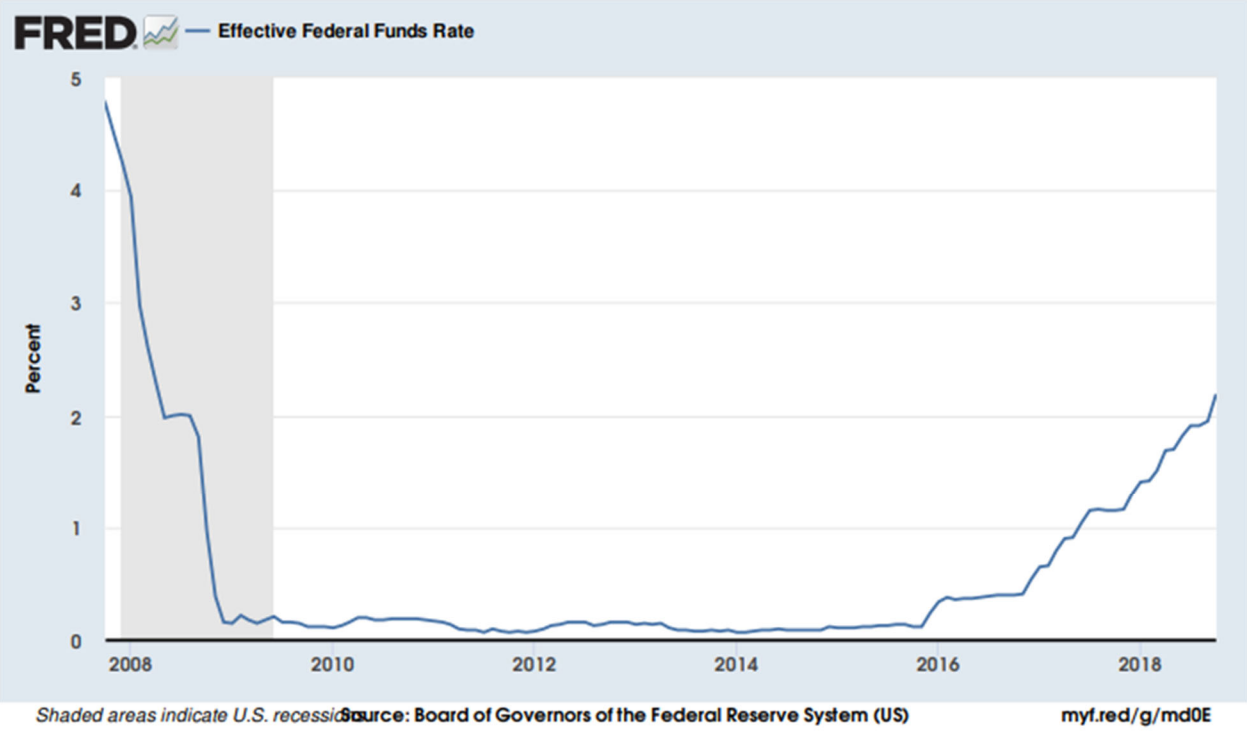
Powell - Jousting at Windmills to Find Neutral

- **Goldilocks economy gone after 9 rate hikes**
- **Recession from flattening yield curve unlikely in coming year**
- **Quantitative easing still effecting monetary policy**
- **Self-correcting mechanisms help market find footing**

The Federal Reserve seems to be in a quest to take the federal funds rate to neutral. In fact since October 3rd when Federal Reserve chairman Jerome Powell said in an interview with Judy Woodruff that "the central bank has a ways to go yet before it gets interest rates to where they are neither restrictive nor accommodative" the stock market has been in a tailspin and has corrected over 10% and over 13% for the tech weighted NASDAQ. If you ask any Fed Governor the question what rate is neutral each one with start the answer with the qualifier "it depends." This article is going to explore what the fed means by neutral and what could be in store for the market should we actually get to neutral.

What is Neutral? The Goldilocks Economy

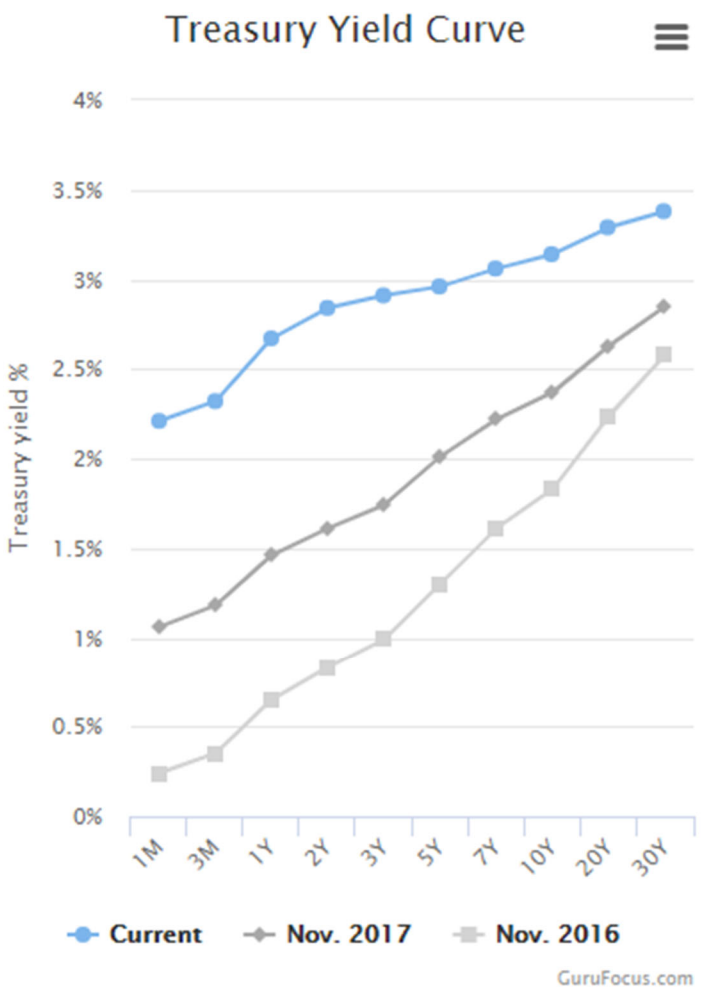
The clues are hidden in the comments by the Federal Reserve Chairman. In the interview with Woodruff, Powell rejected the idea that we needed to keep the policies in place during the financial crisis. Powell said, "the really extremely accommodative low interest rates that we needed when the economy was quite weak, we don't need those anymore. They're not appropriate anymore. Interest rates are still accommodative, but we're gradually moving to a place where they will be neutral," he added. "We may go past neutral, but we're a long way from neutral at this point, probably." By mentioning the fact that the FED may overshoot just demonstrated to the market that he doesn't know where neutral is. Neutral isn't a new concept to the FED it's called the Goldilocks Economy where we are at full employment, we have stable prices, and trending growth. All the mandates of the Fed are met in the Goldilocks Economy.



A look back in history shows us that for 7 years the Fed was at a zero interest policy and since 2016 rates have slowly notched up to 2.17%. In 2016 there was a noticeable upward turn in equities after the initial market selloff "digested" a shift in policy to raising rates. History has a chance of repeating itself but this time we have a new Fed Chair. Is the market going through a phase of indigestion or do we have something fundamentally to worry about?

Recession Worries

When markets go down over 10% it typically signals a contraction in growth and perhaps a bear market. There are signs the economy is slowing but no one knows at what rate. One need only look at the Q3 GDP number of 3.5% vs the 4.2% in Q2 and estimates of mid 2% in the seasonally strong Q4 to see that there is a slowing. Next year is still expected to grow at 2.7% but this doesn't factor in a trade war with China. Tariffs are on the minds of everyone too because they are the weakest sector of our economy. Despite all these data points the bellwether indicator had been an inverted yield curve. It has predicted the last 7 recessions. It is definitely flattening, but it's not inverted. So given all the data it's just too early for pundits to call for a recession.



Overshooting Neutral

How does the Federal Reserve really know what neutral rate is? Most in the market would agree that the Fed really doesn't know and as stated in the thesis it truly does depend on a number of factors. In essence finding neutral goes back to the Goldilocks economy where everything is in perfect balance. For the past 3 years growth started up again, inflation stayed relatively constant, and the job market started making gains. Everything seemed to be in balance and the CBOE volatility index hit a multigenerational low in January 2018 then came a return to volatility with the Dow's worst point drop ever on February 5, 2018 with an intraday low down 1597 points. The drop was precipitated by concerns that inflation was returning and that the Fed would be forced to accelerate interest rate hikes. The inflation boogey man showed his face briefly, but never materialized and the market went on to reach new heights only to drop again in October 2018 on the Fed Chairman's comments. The market is no longer in balance and making its way back, but the answer to the question of what is the neutral rate may have been solved. It is the last rate where the market was in balance and the volatility was low.

The Markets Self-Correcting Mechanisms

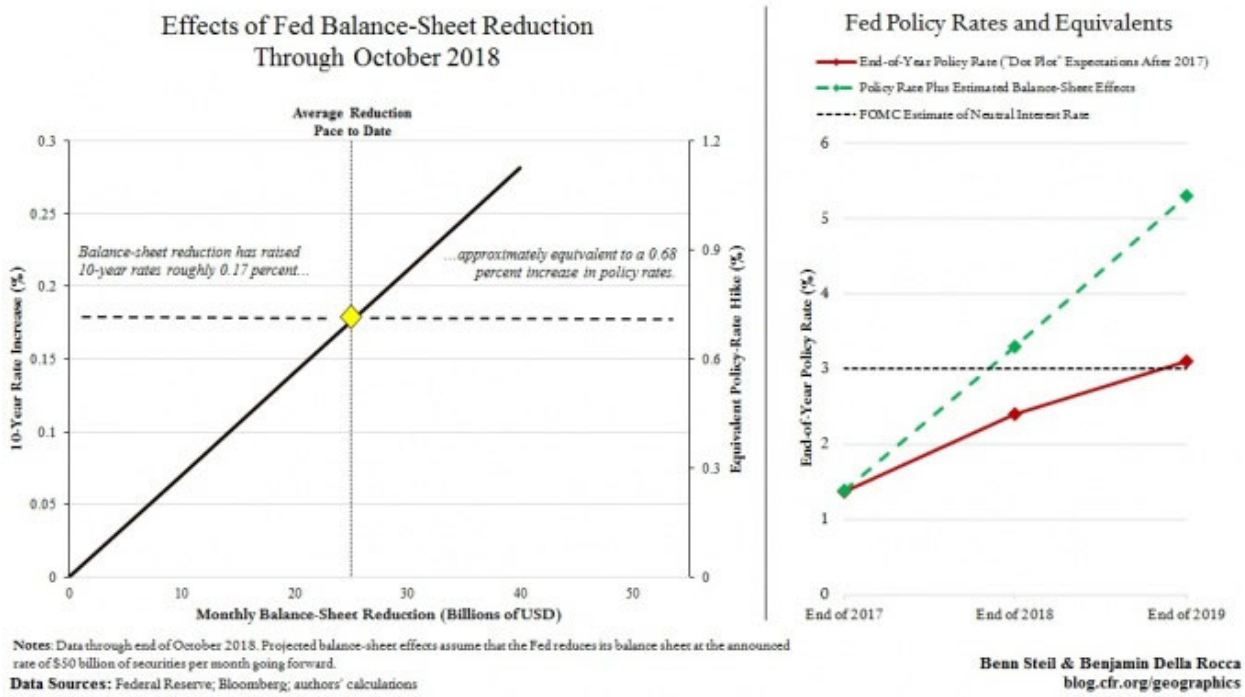
There are many markets that are self-correcting. Since Powell's October 5th speech West Texas Intermediate (WTI) Crude has dropped from $75 to $50. This is a big boom for consumers akin to a tax cut. This will also help out with shipping costs during the very busy holiday season which is good news for retailers. The bond market has a built in self-correcting mechanism. When growth gets too fast rates go up and the economy slows down and rates drop. The Federal Reserve Chairman can also jawbone rates without having to do anything to the actual Fed Funds rate.

Quantitative Easing

The fed had increased their balance sheet from 1-5 trillion to help the economy recover from the great recession of 2008-2009. Quantitative easing rounds 1-4 had taken the funds rate from 5.25 in September 2007 to zero in December 2008.

The recent quantitative tightening has taken the fed funds rate from zero to 2.25%. New fed chairman Powell said in October that he is just beginning to take the funds rate to neutral. The problem with this statement is that the markets can't handle anymore tightening's or the proposed 2-3 fed fund increases in 2019. This highly inflexible fed speak began a sharp stock market correction, which has removed over 2.5 trillion in capital market value from the economy.

A Barron's article on November 24, 2018 mentioned a blog posting by Benn Steil and Benjamin Della that said "the Fed appears to be underestimating the impact of its balance-sheet reduction." They reference former fed chair Ben Bernanke and his blog posting that showed yields on the 10-yr Treasuries at the end of 2017 would have been 85 basis points higher than where rates concluded 2017 at 2.3%. Steil and Della's analysis concluded that this reduction in the balance sheet has lifted the yield on the benchmark 10-year Treasury by 17 basis points. Based on historical relationships, this would translate into a 68-basis-point boost in the fed- funds rate. If the Fed continues to reduce its holdings by $50 billion a month, as it has been doing, they estimate that monetary conditions would tighten by the equivalent of 220 basis points by the end of 2019. Their conclusion: "Monetary policy will start to contract economic growth early next year.



The Fed's Powell had a meeting at The New York Economic Club on November 28, 2018 that calmed the markets Wednesday as the chairman hinted that rates were just below neutral. Then Trumps dinner with Xi Jinping at the G20 summit in Argentina also reduced market tensions. After the dinner Trump hinted there could be a good outcome to end the US-China trade war. The fruits of this meeting resulted in a 90 day suspension of any new tariffs so the both sides could get a trade deal in place. This apparent "Truce" in the trade war led to a huge market rally on December 3rd.

Powell's Press Conference and William's Interview – Dovish Outlook Connecting the Dots

After the Fed announced a .25% increase in the Federal Funds Powell had a news conference where he seemed resolute that there would be 2 more rate hikes and that they were at the lower range of neutral. Then comments by Powell that the Federal Reserve wasn't going to reduce the rate of its balance sheet normalization sent the market into an abrupt reversal and tailspin. He was very hawkish with his messaging and chose his words carefully making sure that the Fed would not succumb to any political pressure to stop increasing rates. The Federal Reserve should have started discussing flexibility in policy much earlier before politicians blasted them, but now they are forced to be tough to show their autonomy and demonstrate that they cannot be influenced by politics. Now that the grandstanding is over they are seeking alternative methods to ease the market concerns that they weren't listening.

On December 21, 2018 in an overt act of jawboning, Steve Liesman of CNBC had a chance to interview New York Federal Reserve Governor John Williams. The immediate reaction was a market move higher as the fed governor pointed out the little nuances in fed speak that appeared to be quote dovish. The Federal Reserve changed their language from "expects" that some further gradual rate increases to "judges" that some further gradual rate increases in the target range for the federal funds rate. He pointed out that was an opinion and nothing that was set in stone. Williams also pointed out that everything was on the table and that included the balance sheet normalization. He debunked the idea that the Fed was on autopilot restoring the balance sheet.

Investment Summary

Either Trump or Powell or a combination of both could be responsible for this financial Armageddon investors are experiencing right now, but neither of the actors wants to back down for fear of losing their constituency. Trump signaled to the markets that all was well with his meeting with Xi Jinping and the market rallied. Then Powell came out and said that they were close to neutral, the market rallied some more. All of these gains were given back when Wall Street Journal reported flippant remarks by Trump "I am a tariff man" coupled with his teams "tough stand in their 90-day trade negotiations with China." The market is reacting to an inversion of rates that currently does not truly exist. It is for this reason that any correction in the market should be transient yet painful. Investors need to look at the 3 month and the 10 year to gauge whether there has been an inversion not the 3 and the 5 year. The blip in the 2 and 3 year rates is just market noise that was exacerbated by the algorithms and news media spreading fears of recession. Assuming that rates do in fact invert it means that a recession is one to two years out and the market shouldn't be discounting it now.

Two days after the rate hike Williams gave an interview with CNBC and pointed out the verbiage that the market should be looking at. He said "the Federal Reserve is not tone deaf" and listening to all markets. When the Fed governors have to dissect and interpret small changes in language like this it indicates there is no cohesive message. Absent a message, it's clear to market participants the Federal Reserve doesn't really know where neutral is. Recent volatility suggests they overshot it in a big way and are trying to make their way back. This mixed Fed message is making its way into the market via lower stock prices. S&P companies have lost over $2.5 trillion in market cap this December. To give perspective this is the worst monthly performance since the Great Depression. The Dow Jones Industrial Average had 6 greater than 400 point losses this month alone. If you are invested in the market you can't help but to wonder when this will end. If your answer is not soon enough then the capitulation hasn't happened. In my opinion the capitulation will happen next week if it hasn't happened already as the market forces the Fed to cry uncle in the form of another dovish interview with a reserve governor. The next potential catalyst is set for January 3, 2019 with the release of the December meeting minutes. The key takeaway is that neutral is a state of stability and for the Federal Reserve to say we are nearing neutral is almost comical.