The Fed Admits the Markets Were Right

By Matthew C. Klein  March 22, 2019 3:31 p.m. ET

Federal Reserve Chairman Jerome Powell. Photo Illustration by Joel Arbeu; Source Photo by Chip Somodevilla/Getty Images

Last year, Federal Reserve officials raised short-term interest rates faster than they had initially planned because the U.S. economy grew more than they had initially expected. The results of their latest monetary policy meeting, which took place this past week, imply that many of those officials now think they made a mistake.

They could have avoided that mistake if they had heeded the lesson of 2015-16: Pay more attention to the signals coming from financial markets and focus less on data describing events that have already happened.

“Appropriate monetary policy” now means keeping short-term interest rates close to where they are right now through the end of 2021—at least. Before the surprise growth spurt, Fed officials were expecting rates to be as much as half a percentage point higher in the coming years than they do now. Six months ago, Fed officials believed they would have to raise interest rates by a full percentage point between now and the end of 2020. While no one yet anticipates any outright interest rate cuts, the implied trajectory of future increases has completely flattened out.
'Appropriate Monetary Policy' Has Changed
Median estimate of Federal Reserve policy interest rate under preferred conditions.

As William B. English, the Fed’s top staff economist from 2010 to 2015, put it to me, “This is what you should expect when the underlying economy is weaker than you thought.” Fed officials had been overoptimistic until new information compelled them to revise their views. Recent data on everything from retail sales to jobless claims to manufacturing sentiment implies a significant slowdown. The Federal Reserve Bank of New York currently estimates gross domestic product will grow at an annual rate of about 1.4% in the first half of this year, less than half the average rate in 2018. Fed officials still believe they can keep growth and inflation on track, but now think interest rates have to be substantially lower to generate enough spending by households and businesses.

The question is why so many at the Fed were blindsided by a turn of events that was clearly anticipated by the financial markets. Commodities, stocks, exchange rates, credit spreads, and the yield curve were all warning policy makers of the risk of excessive interest-rate increases as early as October, yet those signals were mostly ignored by Fed officials until after their meeting in mid-December. Even the macroeconomic concerns cited by Fed Chairman Jerome Powell at the most recent press conference—weak growth in China and Europe, as well as a faltering U.S. housing market—were all evident months ago.
Central bankers have to set policy based on where the economy will be, not where it has already been. They need to anticipate and offset changes in saving and spending behavior to dampen the swings of the business cycle and keep inflation under control. Yet the Fed’s best forecasts are no better than an average of recent data plus a random guess, while the relationships between the things the central bank can directly affect and the things it is supposed to control—inflation and employment—are volatile and mysterious.

Fortunately, central bankers can supplement their own limited knowledge of the future with real-time surveys of the most sophisticated analysts in the world. All they have to do is look at the prices of financial assets, which are highly sensitive to changing expectations of growth, inflation, and monetary policy.

The value of this information should have been apparent after the Fed’s previous about-face in 2015-16. When the Fed, under Janet Yellen, first began raising rates at the end of 2015, officials were worried that unemployment would fall “too quickly” and lead to “excessive” wage growth. “Recognizing the time it takes for policy actions to affect future economic outcomes,” they wrote in their statement, they decided to begin tightening well before inflation materialized. Moreover, they made it clear they expected to raise the policy interest rate by another percentage point over the course of 2016.

That was wildly overoptimistic. Traders expressed their concerns the Fed would tighten too much by selling risky assets and bidding up the prices of safe U.S. Treasury debt. Traders proved more prescient than the central bankers: Manufacturing production fell, business investment stalled, and even the job market stopped improving. It took months before Fed officials eventually realized they had overestimated the underlying strength of the U.S. economy and adjusted their plans. By that point, growth had slowed to a crawl.
The Fed seems to have repeated its earlier mistake, but as I had suspected back in December, it has also moved more quickly to fix it. Traders seem unsure whether that was enough. Stocks are up, but credit spreads are still elevated, especially for the riskiest borrowers, and commodity prices are still down.

Closing In on Trouble
Difference between the yields on 10-year U.S. Treasury notes and three-month U.S. Treasury bills

![Graph showing the difference between 10-year U.S. Treasury notes and three-month U.S. Treasury bills.]

Note: Data through Thursday, March 21, 2019
Sources: Federal Reserve Board; Barron’s calculations

The biggest concern, however, is the yield curve. Economists at the Federal Reserve Bank of San Francisco have found every single downturn since the 1950s was preceded by a period when short-term interest rates exceeded longer-term interest rates. On Friday, the yield on a three-month Treasury bill rose above the yield on a 10-year Treasury note for the first time since 2007. Only once before, in 1966, has this signal ever warned of a downturn that failed to materialize. Another false positive could be possible, but it is not the likeliest outcome. There is little room for further Fed errors.

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