September 21, 2017

TIGHTENING or NORMALIZING?

Robert B. Albertson – Principal & Chief Strategist
(212) 466-7946 ralbertson@sandleroneill.com

Weison Ding – Director
(212) 466-8005 wding@sandleroneill.com

*** Semantics Aside, Normalization is More Reflective of Fed Intentions**

*** Odds Favor a Protected Yield Curve**

*** Odds Favor Ignoring Hard, Numeric Inflation Targeting**

The U.S. economy continues its enduring but slow growth despite various summer shocks, and we continue to expect more of the same. Since mid-2015 we have made the distinction that this is an extended cycle of recovery/growth based on labor force demographics. This characterization has increasingly become the consensus and has implications for the Federal Reserve.

The current economic cycle has roughly adhered to a remarkable elongation of 2.5+ times the historical sequence of various macro markers. Interestingly, the onset of rising rates also followed this delay in timing. The first Fed Funds (Policy Rate) hike occurred six-plus years after the last recession compared to an average of slightly more than two years later in previous cycles. Ditto subdued wage inflation.

The Federal Reserve will review ongoing data adjusted for hurricane impacts to the extent possible. Underneath these expected adjustments, directions for the short-term Policy Rate and long term rate influence from shrinking its balance sheet (a gradual withdrawal of Quantitative Easing) remain in some controversy.

Further yield curve flattening has weakened the market for financial stocks. It also suggests an early end to economic growth. As many have noted, every recession follows a period of flattening and its eventual inversion, primarily caused by true Policy Rate tightening to slow growth and contain inflation.

However, the Fed has made it clear that slowing the economy is the last thing it wants to see as it currently conducts monetary policy. Economic growth remains quite sluggish by any historical measure. Therefore this is a very different environment and a vastly different set of circumstances for raising rates. The Fed, it can be said, is NOT tightening. It is NORMALIZING.

This is not a spurious semantic distinction in our view, and is crucially helpful to bear in mind when considering likely Fed actions going forward. Fed doves will certainly refer to any rise in interest rates as tightening but such short hand can still be misleading.

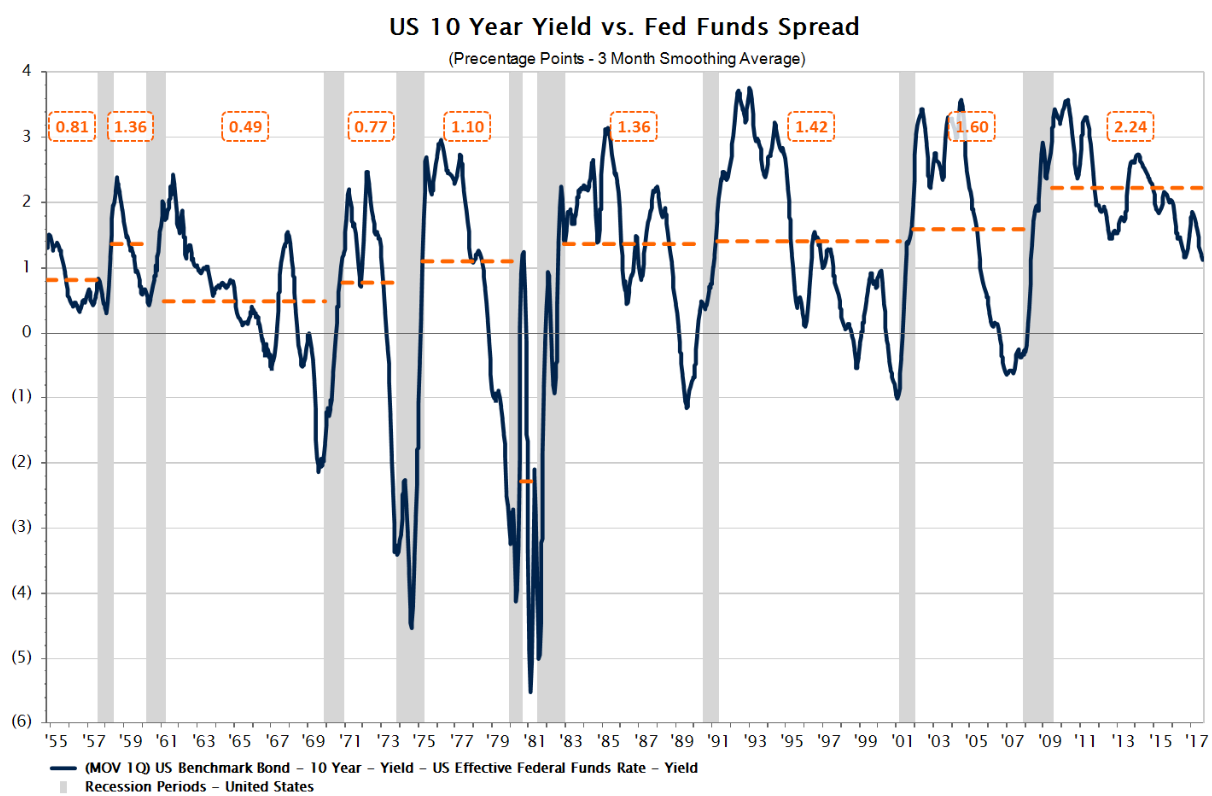
Marching back Quantitative Easing raises another question. Why now or why at all? A popular and cynical explanation is the Fed's theoretical need to shrink its balance sheet so that it can expand it again. The same explanation applies to the Policy Rate to avoid the contingency of a negative rate, but it can be counter argued that the central bank balance sheet is still expandable.

The Federal Reserve currently holds $4.2 trillion in Treasuries and Mortgage-Backed Securities (MBS) on its balance sheet. Combined maturities over one and five years are 87% and 64%, respectively. Virtually all the MBS portfolio is over ten years. Allowing the gradual lack of reinvestment to reduce this by $2.6 trillion over five years would add roughly $45 billion monthly in effective new supply mostly to the long end of the market.

This is important for two reasons. It primarily represents new supply to be re-absorbed in the private marketplace at the longer end of the yield curve and it becomes consequential in size as it will soon equal the level of projected net new auction issuance of Treasuries. The Fed has confirmed it will cap this shrinkage in October through December at an initially slow monthly pace of $6 billion in Treasuries and $5 billion in MBS, rising to $30 billion and $20 billion, respectively.

We think it is reasonable to consider further Policy Rate increases will await evidence that the longer end of the yield curve is rising commensurately, in effect returning to "normal." The Fed implicitly supported this idea when originally indicating that QE removal was interchangeable with Policy Rate hikes, previously stating the latter could wait while the former begins. However, after the latest FOMC meeting a hike in December and three more next year are still implied. Interestingly the European Central Bank is more extreme on this, suggesting virtually no short rate increase until all QE on its $5 trillion balance sheet has been removed.

If we are correct, a normal-sloping yield curve should be in the Fed's interest and goals.



Source: Source Tullett Prebon, FactSet, Sandler O'Neill

Consider the Fed's latest "dot plot" expectations of FOMC members clustering at 2.80% for the Fed Funds rate in the "longer term" and 2.75% by yearend 2019, both marginally below where they were in June. That makes little sense if long rates remain abnormally low. Of course the near "dot plot" array has not been predictive but the "longer term" is a reasonable representation of what the FOMC ultimately expects to be "normal" for short term rates. But that has to have context with probable long rates.

For long rates, the Treasury Borrowing Advisory Committee still has the 10-year stabilizing around 4% in five years, presumably the TBAC's idea of "normal." That is ultimately 120 basis points of positive spread, only slightly above where it is today, yet still below its 160 basis point 30-year average. Removing the volatile swings during recessions this spread had actually been rising.

Also evident in the exhibit and well-remembered, periods of significant negative spread have always preceded recessions since the 1960s and were always driven by substantial Policy Rate increases ranging from roughly 200 to 950 basis points against stable or rising long rates.

We would argue the latest Fed guidance almost ensures the pattern will be different over the next few years, as there is neither strong economic growth nor any lurking inflationary spiral foreseen. The Fed is potentially waiting for long rates to elevate and make room for further Policy (short) Rate hikes. It seems dubious to us that the Fed Funds rate could even reach its 2.80% dot plot position before the 10-year well-exceeds the TBACs 4% expectation.

If not, this really would be tightening, not normalizing.

The Fed continues to be openly perplexed about the lack of inflation despite steady employment growth and plummeting unemployment. We are more perplexed, in such a slow growth economy, why the Fed has even chosen a hard, round number for its 2% inflation target. Why not 1.8% or 2.1%? Why 2% anyway?

Inflation expectations also influence long rates. So should real growth. In combination they historically gravitate to long rate levels. The 10-year risk free (Treasury) rate has averaged real GDP growth plus inflation less about 25 basis points in the U.S. which suggests a reasonable definition for "normal" or "neutral" in monetary policy. If the market, as the Fed, expects 2% real growth and 2% inflation, the 10 year-rate should be closer to 4.0%, not 2.2%. Admittedly, global political concerns certainly compress long rates in safe-haven currencies.

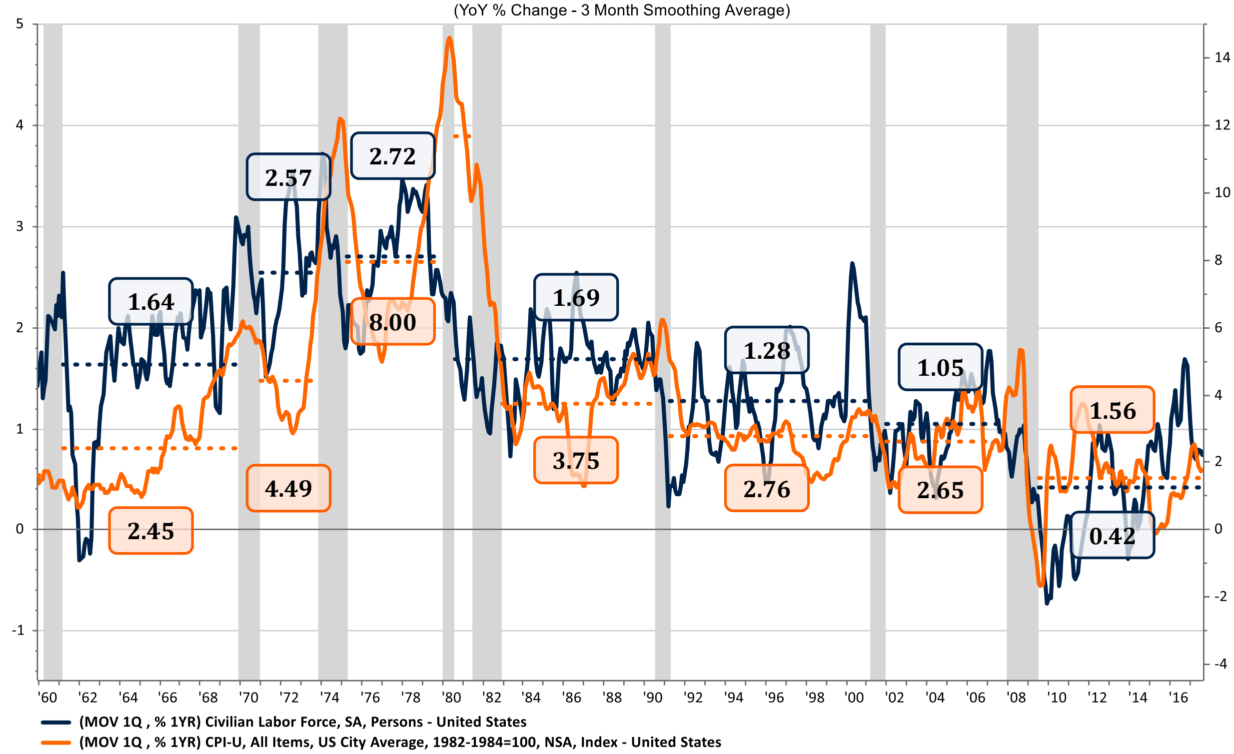
Labor force deceleration also suggests that a 2% inflation target may be too arbitrary and too high. We have repeatedly called attention to this macro metric for over two years. It supersedes our monthly focus away from "jobs Friday" (non-farm payrolls) and more toward smoothed analysis of the labor force itself. We find labor force data more relevant in analyzing both cyclical and secular trends as well as separating the two to reflect broad demographic change.

This approach has gained broader acceptance along with sheer population growth as primary factors defining economic growth rates. It has been responsible for our ongoing conclusion that the current U.S. economic cycle differs from earlier cycles in its slow motion endurance.

The exhibit below may not show tight, short-term correlation in any obvious way but it does reveal a relationship in turning points and proportional amplitude trends between the labor force and inflation over the last seven cycles. It further shows that labor force trends lead inflation trends. Both have been in stair-step trend decline for several decades. We contend equilibrium inflation is now probably lower than the Fed's projections and ongoing target.

Labor Force and Consumer Price Index

(YoY % Change - 3 Month Smoothing Average)



Source: U.S. Department of Labor, Sandler O'Neill

Looking at the averages between recessions it is important to recognize the cycle-to-date has not completed. While labor force growth has indeed been very weak at barely 4/10s of one percent, we would assume it averages higher as the cycle extends. The year-to-date labor force growth has averaged 0.75% which, if used proportionally to history, would certainly lean toward an inflation expectation averaging less than 2%. The Fed describes the 2017 inflation shortfall as a "mystery." If it remains mysterious, odds favor a lowering of the inflation target.

Coming full circle, since our uniquely slow motion economic cycle mirrors the labor force, we view any narrow numerical inflation target as misdirected, completely agreeing with former Wells Fargo's CEO Richard Kovacevich and former FDIC Chair William Issacs in their recent WSJ op-ed.

The Fed has only marginally lowered both its inflation projection and long term Fed Funds target, but if long rates don't react to QE withdrawal, perhaps by early next year, we think the normalization timeline will become extended rather than flirting with any abnormal or disruptive yield curve compression.

* * *

This report has been prepared and issued by the Investment Strategy Group of Sandler O'Neill + Partners, L.P., a registered broker-dealer and a member of the Financial Industry Regulatory Authority, Inc. The information contained in this report (except information regarding Sandler O'Neill and its affiliates) was obtained from various sources that we believe to be reliable, but we do not guarantee its accuracy or completeness. Additional information is available upon request. The information and opinions contained in this report speak only as of the date of this report and are subject to change without notice.

This report has been prepared and circulated for general information only and presents the authors' views of general market and economic conditions and specific industries and/or sectors. This report is not intended to and does not provide a recommendation with respect to any security. This report does not take into account the financial position or particular needs or investment objectives of any individual or entity. The investment strategies, if any, discussed in this report may not be suitable for all investors. Investors must make their own determinations of the appropriateness of an investment strategy and an investment in any particular securities based upon the legal, tax and accounting considerations applicable to such investors and their own investment objective. Investors are cautioned that statements regarding future prospects may not be realized and that past performance is not necessarily indicative of future performance.

This report does not constitute an offer, or a solicitation of an offer, to buy or sell any securities or other financial instruments, including any securities mentioned in this report. Nothing in this report constitutes or should be construed to be accounting, tax, investment or legal advice.

Neither this report, nor any portion thereof, may be reproduced or redistributed by any person for any purpose without the written consent of Sandler O'Neill.

© 2017 Sandler O'Neill + Partners, L.P. All rights reserved.