A New Maestro?

Observations on an important speech by Fed Chairman Powell

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Yesterday the US Fed Chairman Jerome Powell delivered an important speech at The Economic Club of New York. Powell's speech is significant both for its immediate impact – equity markets rallied sharply as a result – and for what it says about the future framework of US monetary policy under Chairman Powell.

Powell Pauses

The section of Chairman Powell's speech which rightly caught the attention of the markets concerns the immediate outlook for monetary policy:

"*Interest rates are still low by historical standards, and they remain just below the broad range of estimates of the level that would be neutral for the economy that is, neither speeding up nor slowing down growth.*"

The all-important phrase here is *'just below,'* indicating the FOMC is likely to increase interest rates only modestly from here, perhaps just another 25bp hike in December, before shifting to a neutral bias whereby further moves would be determined by incoming economic data.

This is the communication both equity markets and President Trump were looking for, signalling that Chairman Powell does not intend to use monetary policy to purposely engineer an economic slowdown.

Our own assessment agrees with that of the equity markets; Powell's speech has largely removed the main risk that triggered the October-November equity market selloff. We therefore expect the equity markets will continue to recover October's losses.

That said, we believe, Powell's speech signals a new, more sophisticated, approach to central banking and one which, over time, even President Trump may come to appreciate.

Minsky goes mainstream

I have been a central bank watcher for well over two decades and in that time have rarely seen central bankers admit the need to take account of leverage and asset prices as part of their policy making framework. Arguably, this oversight caused the Federal Reserve and almost all central bankers, to overlook the growing financial fragility in the years prior to the Global Financial Crisis. In this speech Powell has firmly rejected that policy paradigm and instead placed debt levels, debt term structures and asset prices firmly on the central banker's watch list. We reach this conclusion because of the following elements of Powell's speech:

"For Economic Club of New York trivia buffs, I will note that the second ever presentation to this club by a Federal Reserve official was about [financial stability]. The date was March 18, 1929. Weeks before, the Fed had issued a public statement of concern over stock market speculation, and had provided guidance frowning on bank funding of such speculation. William Harding, a former Fed Chair and then president of the Federal Reserve Bank of Boston, defended the Fed's actions in his talk. He argued that, while the Fed should not act as the arbiter of correct asset prices, it did have a primary responsibility to protect the banking system's capacity to meet the credit needs of households and businesses. At the meeting, critics argued that public statements about inflated asset prices were "fraught with danger;" that the nation's banks were so well managed that they should not "face public admonition"; and, more generally, that the Fed was "out of its sphere. Of course, Harding spoke just a few months before the 1929 stock market crash, which signaled the onset of the Great Depression."

Here Powell is pointing out that central banks have long been criticised when they worry about asset prices and credit bubbles, but when they fail to do so the consequences are sometimes catastrophic. He then goes on to mention Hyman Minsky, one of the few economists to explain how economic stability eventually leads to excessive leverage, financial instability and thereby economic instability.

"As Hyman Minsky emphasized, along with the many benefits of dynamism comes the reality that the financial system will sometimes evolve toward excess and dangerous imbalances."

Minsky's insight has long been ignored by central bankers, it is a welcome development to see his name in this speech.

Powell then goes on to explain, in some detail, his approach to monitoring early-onset financial instability by setting out four key vulnerabilities to be monitored:

"The first vulnerability is excessive leverage in the financial sector."

"The second vulnerability is funding risk, which arises when banks or nonbank financial entities rely on funding that can be rapidly withdrawn."

"The third vulnerability is excessive debt loads at households and businesses."

"The fourth and final vulnerability arises when asset values rise far above conventional, historically observed valuation benchmarks."

Importantly, on each of these four points, Powell then explains why the Fed does not currently see cause for concern, and

therefore, by implication, does not see the need to curtail the economic expansion:

"In our surveillance, we examine leverage across many types of financial institutions, including banks, insurance companies, hedge funds, and various funding vehicles. Currently, we do not detect a broad-based buildup of abnormal or excessive leverage."

"Today we view funding-risk vulnerabilities as low. Banks hold low levels of liabilities that are able and likely to run, and they hold high levels of liquid assets to fund any outflows that do occur."

"After the contraction, household debt has grown only moderately. The net increase in mortgage debt has been among borrowers with higher credit scores. While heavily indebted households always suffer in a downturn, all of this suggests that household debt would not present a systemic stability threat if the economy sours…the ratio of corporate debt to GDP is about where one might expect after nearly a decade of economic expansion: it is well above its trend, but not yet at the peaks hit in the late 1980s or late 1990s … the upward trend in recent years appears broadly consistent with the growth in business assets relative to GDP."

Finally, and, for our purposes, most importantly on the topic of asset prices and the stock market Powell is explicit:

"We see no major asset class, however, where valuations appear far in excess of standard benchmarks as some did, for example, in the late 1990s dot-com boom or the pre-crisis credit boom. The asset class that gets the most attention day-to-day is, of course, the stock market. Today, equity market prices are broadly consistent with historical benchmarks such as forward price-to-earnings ratios."

Overall, we concur with Powell's assessment of the condition of the US economy. Despite an unusually long post-crisis economic expansion, we do not perceive either a build up of excessive leverage or excessive exuberance in asset prices. It is reassuring to hear that the Fed shares this confidence and, by implication, is happy to set monetary policy at an appropriate level to allow the expansion to continue. In our opinion, investors can and should take comfort from Powell's speech.

With this policy backdrop we see little reason why the current economic expansion cannot continue for the foreseeable future.

That said all investors should take note, Chairman Powell has clearly explained, under his stewardship, the Federal Reserve is unlikely to tolerate excessive credit creation or asset price inflation in the way Alan Greenspan did prior to the Global Financial Crisis.

It is for this reason we view Chairman Powell's speech as a welcome move toward a higher standard of central banking. Over time this should benefit economic growth and therefore investment returns.

Summary

In summary, Chairman Powell has indicated he believes the Federal reserve is close to completing this rate hike cycle and does not see the need to check either the economic expansion or the associated stock market rally at present. ■

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