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Fed threatens asset price crisis

Financial markets have bullied the Federal Reserve into changing course, raising the prospect of a future asset price collapse.

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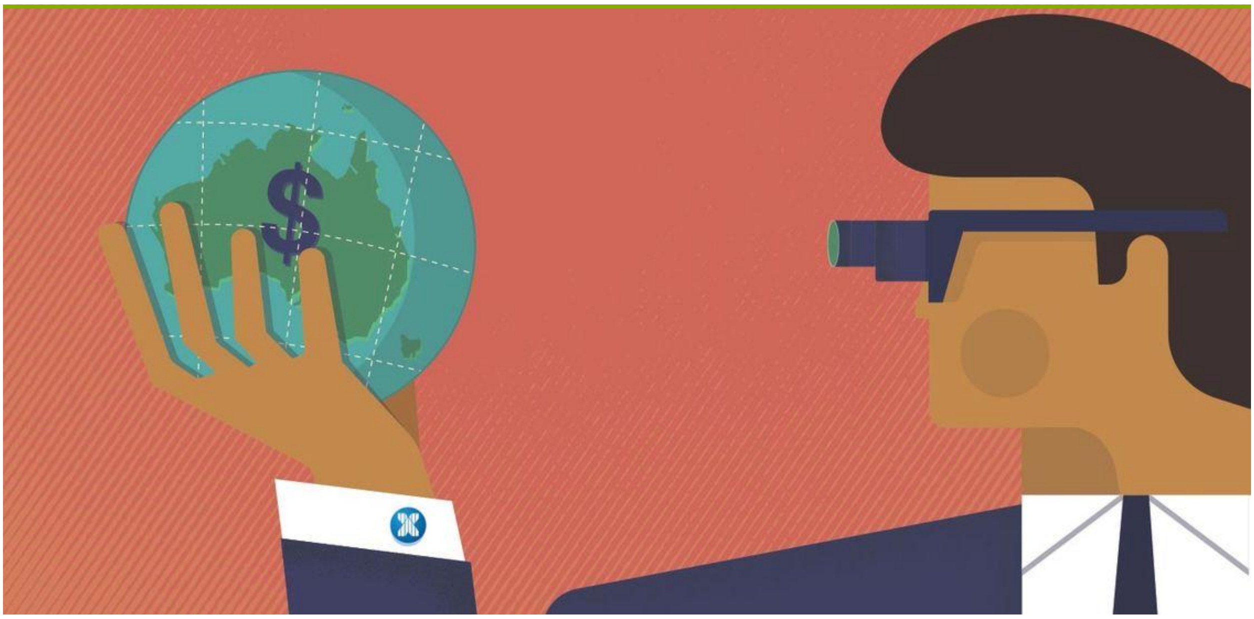

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As recently as May, just a few weeks ago, the chairman of the US Federal Reserve Jerome Powell was adamant that "the committee is comfortable with our current policy stance".

The US economic data were flowing favourably. Employment was increasing by more than the number of new labour market entrants. Inflation was edging up without any threat to the central bank's price stability mandate.

In December, against a similar backdrop, all but two of 17 Fed governors had been expecting up to three 0.25% Federal Funds rate rises during 2019 and all but one thought there could be up to five rises over 2019-2020.

Now, with little discernible change in the flow of US data, a majority of governors expect falls of up to 0.50% over the coming 18 months. Short-term market sentiment has driven an unprecedentedly stunning policy backflip.

Market talk of synchronised global growth during much of 2018 had lent support to tighter monetary conditions even as growth was already edging lower. As I pointed out in an April 19, 2018, 'From the Capital' column, generally upbeat assessments of the world economy at the time relied heavily on what happened in late 2017 rather than on what lay ahead.

The picture has been clouded somewhat by the fiscal stimulus imparted by tax cuts in the US but all major areas of the world economy - the US, Europe and China - have been battling to sustain growth. Late 2017 growth, as I reiterated in my May 17 column, was as good as it was going to get for the foreseeable future.

OECD leading economic indicators fell every month in 2018. OECD GDP went from being higher than trend to below trend. And, in another early sign of fading momentum, nonferrous metal prices had peaked in early 2018. Meanwhile, the 12-month rate of growth in OECD money supply fell from 9% to 5%.

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Policy was in a strange place. Central bank caution after the 2008-2009 financial crisis meant efforts to normalise policy had run well beyond the recovery phase of the real economy. Monetary tightening was underway and slated to continue even as the momentum of global activity was sliding.

Some blame the growth slowdown on US attempts to grab a larger share of world trade but a deceleration in the pace of economic expansion was well underway before the prospect of a long trade dispute.

Even while economic conditions were swinging adversely, US equity prices topped their previous record levels. Late in 2018, as the boost from US tax cuts was wearing thin and equity analysts were searching for sources of future earnings growth to validate market valuations, investor nervousness was beginning to show.

While the Fed's dual employment and price stability mandate says nothing explicitly about asset prices, the potentially destabilising 20% S&P 500 sell-off following the October 2018 Fed Funds rise was an undisguised warning. Markets would put the Fed‘s employment and inflation mandates at risk unless the governors did what was needed to let asset prices run.

Having assuaged financial markets with a rapid change in its policy bias, the Fed became vulnerable to future efforts to extort policies in the best interests of asset owners. By this month, the Fed was meekly acquiescing to their demands.

Weakening asset values can damage confidence and curtail spending by business and households. But ample examples can be cited of financial markets taking the real economy on a wild ride when asset prices race ahead of the future production.

Realignment of disparities between financial markets and the real economy usually occur with a crash in asset prices rather than an accelerated expansion in economic capacity.

Financial markets are notably most fearful (or most exuberant) near a turning point. Letting markets guide policy suggests that, on this occasion, financial markets will be the better judge of what happens next, despite having typically failed the test in the past.

Even as the Fed worries about "global crosscurrents" and contemplates a more marked directional shift in response to already re-priced financial assets, another sign of a change in the momentum of economic activity is emerging.

The OECD leading economic indicators, having fallen throughout 2018, have stabilised in the first half of 2019. Intensifying market pessimism has once again coincided with the first signs of a directional shift in conditions, raising the prospect of the Fed being out of step with the economic cycle once again if it follows the dictates of the market.

Monetary policy changes are most likely to boost growth when restrictions on access to capital have constrained activity. That has not been the case. Neither corporate investment decisions nor household spending has been limited by the availability of capital. US banks are shedding capital because they have too much.

Loosening monetary policies now may have little impact on activity. If fresh infusions of financial liquidity have no purpose in the real economy, they will flow into financial assets, raising the chance of a subsequent and more dramatic asset price collapse.

Alternatively, the Fed could go back to its original intention to patiently wait for the data to direct the next move. Even with some easing in the breakneck employment expansion of the past few years, upward pressure on wages and inflation could become evident in the year ahead.

If one or two more interest rate rises are warranted in due course, bond yields will have been taken down too far and equity prices will have become unsustainably inflated by expectations of a never-ending expansion of liquidity.

In either scenario - a classic asset bubble stoked by the Fed or the Fed dampening market exuberance as it attempts to manage the cycle - wobbly markets are balancing atop an unstable precipice.

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