July 2017

A lazy summer day is for enjoying the outdoors, getting ready for or recovering from vacations, or late evenings on the patio. Not so much this summer for the economy. Congress unsuccessfully attempted to pass the first leg of its fiscal agenda, but extended the drama well into the summer. Never say never in D.C. and this may come back again. Still, Congress now pushes forward with the second leg, tax law reform.

Global markets generally just sighed and moved on. Keeping market watchers at their desks this summer are the statements and actions of central banks. This month, in her semi-annual Congressional testimony, Fed Chair Yellen commented that "because the neutral rate is currently quite low by historical standards, the federal funds rate would not have to rise all that much further to get to a neutral policy stance". This implies just a few more rate hikes could get the Fed to a neutral position, neither accommodative nor restrictive, and that the pace of rate hikes would be slow and gradual, or rather data dependent. Giving the Fed some breathing room is a lack of inflationary pressure. The latest inflation data, as measured by the consumer price and producer price indices would indicate a reversal of moderate increases in inflation earlier this year. This comes despite the textbook examples that when an economy approaches or passes full employment, wage inflation begins to build. This aberration has been attributed to an aging labor force that remains employed longer, global competition for labor and ability to shift production, and automation replacing certain jobs. Second quarter gross domestic product figures are due at month end and estimates are for a stronger showing than a tepid start to the year. Tame inflation data, lack of signs of wage inflation, and improving economic growth provide the Fed some time to gradually normalize the interest rate environment.

Another of Chair Yellen's comments did not draw as much attention. In her testimony she stated, "we do not intend to use the balance sheet as an active tool for monetary policy in normal times". Some of the proposals to reduce the $4.8 trillion Fed balance sheet have been discussed by various members of the Federal Reserve. It is possible that details will be worked out at the July meeting of the Open Market Committee and begin to be implemented as early as September, if not by December. Still, the Chair's statement would also imply a slow and gradual reduction of balance sheet holdings so as not to be disruptive to the markets or considered an active tool (a stealth rate hike) of monetary policy.

This theme, of a steady and gradual reduction of the accommodative monetary policy implemented after the financial crisis of a decade ago, appears to have been joined by other central banks. Earlier this month, the Canadian central bank raised its prime lending rate for the first time in almost a decade. The European Central Bank decided against extending its quantitative easing in June, yet failed to change rates or remove the possibility of extending its bond purchasing program, if necessary, this month. The Bank of Japan recently kept its dovish monetary policy in place and extending the time expected to reach its inflation target a year, to 2020.

Is the Fed signaling all clear and smooth sailing ahead with a straight and defined path of measured rate hikes? No, the Fed Chair was clear that any steps were data dependent. What could interrupt a slow and steady normalization process? The Fed is of the opinion that the decline in inflation is transitory. A low rate of inflation may be due to structural changes in the global economy, primarily an aging demographic in most major economies. The lack of wage inflation in spite of full employment has economists scratching their heads. Typically wages begin to outpace inflation with unemployment running at 4.4% and productivity constraints adding wage pressures. The advent of automation has disrupted classical economic models, adding some hesitation. Another unknown at this point is the nature and size of fiscal stimulus, either in the form of tax cuts, tax reform, or infrastructure spending. There is the matter of a budget for next fiscal year and a debt ceiling that will be reached in late October or early November. Potential international developments also come into play as Chinese monetary officials attempt to wring out some credit excesses in that country's economy, European economies appear to have moved into a growth mode, moving away from populists and protectionist rhetoric, but they still have the Brexit negotiations to resolve.

On the whole, it appears global central banks are working toward normalization of the interest rate environment and reducing excess accommodative policy. The global economy is increasingly generating positive surprises, with improving growth expected in the U.S. and in Europe. Inflation appears tame giving central bankers plenty of time to digest data and to react as changes take place. Despite the headlines, maybe a lazy, slow, and steady summer is underway after all.