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Center for Risk Management Strategy at Deloitte Touche Tohmatsu LLC.

Global Risk Watch Newsletter

The FRB as being hawkish, etc.

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1. Overview Macroeconomic and Financial Risks (Trends & Topics)

 # The FRB as being hawkish (Tsuyoshi Oyama, Partner/Head of Center for Risk Management Strategy (CRMS) at Deloitte Touche Tohmatsu LLC/Deloitte Asia Pacific Risk and Capital Management Leader)

Risk-on trends carries on in the risk asset market. U.S. stock prices are embracing consecutive days of record highs while an upward trend continues for Japanese and European stocks. Despite a decision of the Federal Reserve Bank (FRB) for a rate hike, currencies of emerging economies also remain highly stable, so much so that certain countries like Russia and Brazil managed to lower policy rates. Thus far, these risk-on trends have been strong enough to override the U.S. political instability such as “Rusiagate.”

The robust market conditions are underpinned by brisk economy of advanced countries and China, strong corporate earnings in advanced countries, and also surprisingly low long-term interest rates. Why are the rates so low in this booming economy? Under the normal condition, favorable market conditions and tight labor markets with nearly full employment in the U.S. and Japan “should” accelerate growth in wage and prices, leading to higher interest rates. In reality, however, this boost is yet nowhere to be seen.

The FRB decided for the second rate increase in 2017 at the June Federal Open Market Committee (FOMC) meeting. The market had already expected this rate hike, but a little surprised to see the FRB’s planning to start shrinking its balance sheet at the relatively early timing, the unchanged dot chart still supposing 3 rate hikes for 2018, and also the unchanged level of the long-run federal fund (FF) rate being around 3%. Macroeconomic conditions are decent (although not splendid), but given the current decelerating wage and price, the FRB’s “hawkish” stance naturally spurs speculations.

In general terms, slower inflation could be transitory as Chair Yellen pointed out, and it is reasonable for the FRB to turn hawkish in anticipation for higher wages, and consequently accelerated inflation under tight labor markets. However, the FRB's shift to a hard line appears somewhat incoherent with its long advocating "data driven" stance particularly when they have not yet seen any hard cold, supporting data maybe due to a collapse of the stable Philips curve, or the conventional relationship between labor market condition and inflation, as suggested by many economists.

If it is not the data that drove the FRB to become hawkish, the other factors as follows might contribute to this; 1) the FRB wants to secure "buffer" for future monetary easing policies when the expansionary phase of economy has entered into the 8th year and is likely to slow down in the near future, 2) the FRB does not like to risk losing its independence should fiscal deficit expand under the Trump regime and the current scale of balance sheet be considered as "fiscal financing," and 3) the FRB tries to pre-emptively cool down overheating stock and real estate markets, thereby avoiding potential financial instability. All of them have some reasons to convince us of the recent "turnaround" of the FRB.

To my nose, above (1) and (2) smell like the Bank of Japan (BOJ), which saw the economy fell back into deflation crisis after lifting a zero-interest rate policy in 2000 and quantitative easing policy in 2006. To the contrary, (3) has a scent of former FRB chair Greenspan who successfully managed a gradual rate increase after 2004 and realized brisk economy for a long period of time (despite the bubble burst after his resignation). We now have to watch very carefully whether the FRB (or Chair Yellen) turns out to be more like the BOJ, or Mr. Greenspan in the coming months.