The Fed “has been navigating between the shoals of overheating and premature tightening with only a hazy view of what seem to be shifting navigational guides.”
— Jerome Powell

October’s market tumult has left investors searching for answers. Market prognosticators and financial media pundits are always quick to respond with thoughtful analysis. After all, plausible explanations for financial asset volatility give us comfort. Deluding ourselves into thinking that we can explain the sometimes unexplainable makes us feel better. It reduces our anxiety about the unknowable.

Conveniently, there is a long list of usual suspects to explain the recent market turmoil. Our deteriorating trade relations with China, the upcoming US midterm elections, rising US interest rates, free spending Italians and potential Saudi Arabian cover-ups top most investors’ lists for market-moving action. Not to mention that October is quite often a volatile month for stocks.

I appreciate the many thoughtful reasons being cited for October’s market meltdown. However, there is an important element missing from these stories. Oddly, it’s often what is right under our nose that goes unnoticed. Something fascinating is going on at the US Federal Reserve (Fed).

In sharp contrast to the comfort in knowing something with confidence, for the last several months Chairman Powell and his merry band of monetary policy makers have been telling anyone who will listen that they don’t have the first darn clue what the neutral rate is for the US economy. Instead, the level at which the Fed’s target fed funds rate neither stimulates nor slows the economy remains hazy.

What’s Up, Doc?

Why should the Fed’s uncharacteristic admission send shivers down our spine? Imagine going to your doctor with a list of symptoms. And, after carefully listening to you and going through the normal diagnostic routine, taking your temperature, blood pressure, etc., the doctor says he doesn’t have the faintest idea what could be ailing you.

Figure 1: Even Before the Financial Crisis, Trend Growth and the Neutral Rate of Interest Had Been Trending Lower

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Chairman Powell put investors in the same uncertain boat when, in August’s Jackson Hole speech, he described several variables that can’t be precisely identified but are critical to setting monetary policy as “stars” that help sailors navigate on the open seas.

These variables include a measure of an unemployment rate below which inflation pressures build and a neutral level of interest rates. Today’s unemployment rate of 3.7 percent is well below the Fed’s estimate of the long-run normal level of the unemployment rate of roughly 4 to 5 percent. This gap between the two unemployment rate measures fuels the Fed’s confidence that wage inflation will accelerate soon. It emboldens them to keep raising rates in anticipation of higher wages as a result of a tighter labor market. The Fed’s shift to focusing on the unemployment rate suggests that for the first time since the early 2000s the Fed is attempting to tighten financial conditions.

Intuitively, most experienced investors recognize equally the futility in attempting to precisely identify both variables. But Powell and other Fed officials publicly acknowledging the limitations of their power, and in some cases even flaunting it, creates a strange brew of refreshing honesty and scary sacrilege. Powell has voiced skepticism about putting too much emphasis on these “stars,” saying in his Jackson Hole speech they “are sometimes far from where we perceive them to be.”

That frank admission prompted investors to pull away the curtain and conclude that there is no Wizard of Oz for monetary policy. Just a man and his Munchkins. And, men are prone to make mistakes. As a result, investors are re-pricing financial assets to reflect the increasing probability of a monetary policy mishap.

**Will They Know It When They See It?**

If the Fed, by its own admission doesn’t know what the neutral level is, how will they determine if they’ve gone too far or not far enough in setting interest rates? Investors had reached the conclusion that the Fed was likely to allow the US economy and inflation to run hot. Additionally, some Fed watchers upon reviewing the Fed’s previously released summaries of economic projections concluded the central bank was already nearing the neutral rate, perhaps signaling an end to the current tightening cycle that began modestly in late 2015.

Chairman Powell dispelled those beliefs in one fell swoop during a question-and-answer session in early October with Judy Woodruff of PBS where he suggested that the Fed has a ways to go before getting to the neutral rate. Noting that, “the extremely accommodative low interest rates that we needed when the economy was quite weak, we don’t need those anymore. They’re not appropriate anymore,” Powell set off a violent market reaction to the potential unexpected change in monetary policy expectations. Yet, investors who blame October’s market volatility on Powell signaling more Fed rate hikes are missing the much bigger picture. The Fed has told us to expect another rate hike in December 2018 and possibly three more hikes in 2019. Financial asset prices already reflected these potential Fed policy moves.
The Power of I Don’t Know: The Fed’s Shocking Confession Results in Market Trouble

Trying to Keep a Steady Hand

The US economy may be able to withstand tighter monetary policy but the fragile global economy clearly is not ready for materially higher US interest rates and a strong US dollar. However, like it or not, the Fed has become the world’s central bank, a responsibility it has not asked for and will likely never acknowledge.

The market tumult has been in reaction to the Fed’s brazen admission that they have no idea about what the neutral rate for the US economy is — or how low the unemployment rate has to get to spur wage inflation. What’s worse, the Fed has likened these important guideposts for setting monetary policy to astrology. That’s mind blowing and asset price moving. The Fed, the world’s reluctant central banker, has publicly admitted that interpreting these variables precisely is an exercise in futility. Like palm reading and reading tea leaves. That’s downright scary. Therefore, as investors search for clues to the depth and length of the current Fed tightening cycle that began gradually in 2015, expect more asset price bumps along the way.

Glossary

**R-star** The inflation-adjusted, short-term interest rate that is consistent with full use of economic resources and steady inflation near the Fed’s target level.

**Taylor rule** A monetary policy rule that stipulates how much the central bank should change the nominal interest rate in response to changes in inflation, output or other economic conditions. In particular, the rule stipulates that for each one-percent increase in inflation, the central bank should raise the nominal interest rate by more than one percentage point.


2 Jeff Cox, “Powell says we’re ‘a long way’ from neutral on interest rates, indicating more hikes are coming,” CNBC.com, published October 3, 2018, updated October 10, 2018.