



## Supply-Side Yellenomics Is (Slowly) Losing Its Grip on Markets

Should investors worry about the possibility that the Federal Reserve might raise interest rates this year? How about the negative economic consequences of the rally in the U.S. dollar? “Hawkish” Fed mistakes?

Well, the Fed can't keep its grip on markets forever, and it doesn't want to, either. Indeed, the era of “Yellenomics” rooted in excess labor supply justifying extraordinary accommodation is slowly coming to an end.

That said, when constructing investment portfolios we suggest investors stay calm and focus on the path of the Fed's policy rate and its ultimate destination, as well as policy rates abroad, which are likely to stay low for the rest of the decade, compelling investors to keep reaching for higher yields and returns. In addition, look for opportunities to arise in equity and credit markets when markets inevitably become anxious in response to a Fed rate hike.

### **Yellen and the FOMC offer a soothing statement**

Ever cognizant of its influence on financial markets, the Fed, in both its March 19 policy statement and its quarterly Summary of Economic Projections (SEP), demonstrated that it is sympathetic to much that has been worrying markets of late, and Janet Yellen in her post-FOMC press conference put an exclamation point on it.

Most soothing for investors was the lowering of the Fed's projection for its policy rate, the federal funds rate. Specifically, the Fed lowered the *cumulative* amount of rate hikes it expects to implement this year and through 2017 by about half of a percentage point. Sensibly, the Fed also lowered its forecast for economic growth and inflation (see Figure 1). The Fed obviously has a few worries of its own.

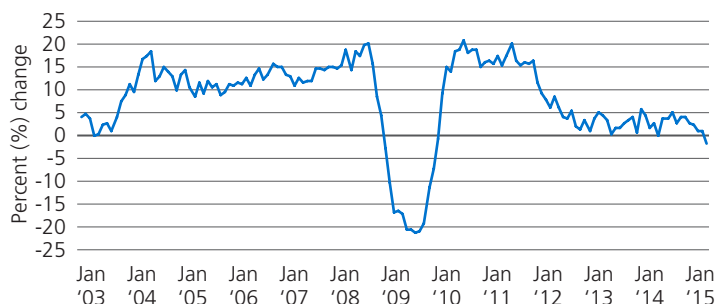
**FIGURE 1: ECONOMIC PROJECTIONS OF FEDERAL RESERVE BOARD MEMBERS AND FEDERAL RESERVE BANK PRESIDENTS, MARCH 2015**

Variable	Central tendency (percent)			
	2015	2016	2017	Longer run
Change in real GDP	2.3 to 2.7	2.3 to 2.7	2.0 to 2.4	2.0 to 2.3
December projection	2.6 to 3.0	2.5 to 3.0	2.3 to 2.5	2.0 to 2.3
Unemployment rate	5.0 to 5.2	4.9 to 5.1	4.8 to 5.1	5.0 to 5.2
December projection	5.2 to 5.3	5.0 to 5.2	4.9 to 5.3	5.2 to 5.5
PCE inflation	0.6 to 0.8	1.7 to 1.9	1.9 to 2.0	2.0
December projection	1.0 to 1.6	1.7 to 2.0	1.8 to 2.0	2.0
Core PCE inflation	1.3 to 1.4	1.5 to 1.9	1.8 to 2.0	
December projection	1.5 to 1.8	1.7 to 2.0	1.8 to 2.0	

The central tendency excludes the three highest and three lowest projections for each variable in each year. Longer-run projections for core PCE inflation are not collected.  
Source: Federal Reserve

Showing it recognizes it is not blind to its influence in the global sphere, the Fed also expressed concern about “international developments” and the negative impact that the dollar’s recent rally is having on U.S. exports, a worry that seems well-placed given recent trade data (see Figure 2).

**FIGURE 2: U.S. EXPORTS (YEAR-OVER-YEAR % CHANGE)**



Source: U.S. Census Bureau as of January 2015.

By elevating the dollar and international developments to the level of the policy statement, and to the SEP and Janet Yellen’s press conference, the Fed is now more aligned with market sentiment on these matters. This demonstrates the importance the Fed places on financial conditions in its formulation of monetary policy. While the Fed can’t be held hostage to the financial markets, it knows it must show

deference to them, because its policies transmit through markets into the economy. This happens through these five channels in particular:

1. Stock prices
2. Bond yields
3. Credit spreads
4. Lending standards
5. The value of the U.S. dollar

It’s that fifth channel – the value of the U.S. dollar – that lately is getting the most attention, even though the other four have a far larger bearing on economic activity (see Figure 3).

**FIGURE 3: U.S. TRADE-WEIGHTED DOLLAR INDEX**



Source: Federal Reserve as of 20 March 2015.

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Given its influence on markets, the Fed worries that if it raises rates prematurely, it could prompt a disorderly exit by investors who for many years ventured ever outward along the risk spectrum (at ever higher prices, mind you), harming economic growth. The Fed has experience in this regard from the “taper tantrum” of 2013, when markets swooned on indications the Fed might end its bond-buying program. Notably, markets eventually strongly rebounded.

Yet, out of an abundance of caution, to manage the risk of a rate spike, as well as to safeguard the substantial progress seen on the economic front, the Fed these days is taking no chances: It is working exhaustively to convince investors to continue doing what they have done in recent years and in fact for centuries, which is to take a leap of faith and stay invested in hopes of making a profit, chiefly by aiming to convince investors it will move cautiously on rates.

### **Supply-side Yellenomics is (slowly) losing its grip on markets**

The recent rally in the U.S. dollar indicates very clearly that the Federal Reserve’s post-crisis efforts to influence market prices are giving way to more traditional influences and in particular economic data and underlying economic fundamentals. For almost eight years, the Fed through its bond buying and zero interest rate policy has aimed to influence markets on several fronts:

1. Reduce forward rate expectations
2. Suppress interest rate volatility
3. Compel investors to move outward along the risk spectrum

Now, because of the cumulative progress seen in reducing economic slack and in particular in getting people back to work, the Fed can no longer *sustainably* keep investors from pricing in an eventual rate hike. For now, this is manifesting itself mainly in the value of the U.S. dollar, where a divergence in the path of monetary policy in the U.S. versus

that of Europe and Japan has become prominent – while the Fed is poised to raise interest rates, the European Central Bank and Bank of Japan are continuing to ease policy and they are years away from rate hikes of their own.

The dollar’s surge suggests that market participants believe the U.S. economy is inching closer to full employment, which in the Fed’s eyes will be reached when the unemployment rate is between 5.0% and 5.2% (see Figure 1 again). In other words, fundamentals – not the Fed’s words, mind you – are increasingly driving market prices.

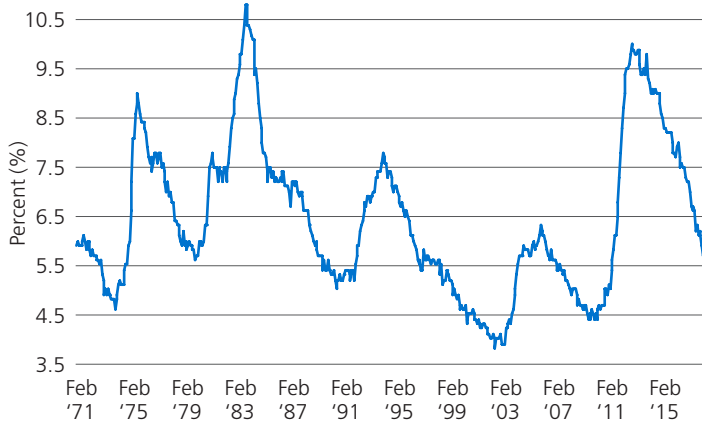
The era of the Fed providing substantial near-term forward guidance is over. It has given way to economic data, and now every Fed meeting is “live.”

Therefore, with the underutilization of labor resources continuing to diminish, the Federal Reserve’s ability to control market prices will diminish, too, because markets will expect the Fed to end its emergency policy rate, and this will be the major driver of market prices rather than the Fed’s forward guidance. This is in contrast to recent years when the Fed easily convinced investors it would keep its policy rate at zero using the argument that wages and thus inflation would be kept down by a vast supply of untapped labor. Now, with the jobless rate at a relatively low 5.5%, this argument is becoming less potent a force in shaping market prices.

Yellenomics – in other words, the Yellen-era policy framework that utilizes the supply argument as a rationale for maintaining an extraordinarily accommodative stance on monetary policy – is on the wane, albeit slowly, because the debate over labor supply is moving from one of obvious abundance to one that is less obvious.

The U.S. jobless rate is the most convincing example, even if a somewhat flawed indicator (see Figure 4).

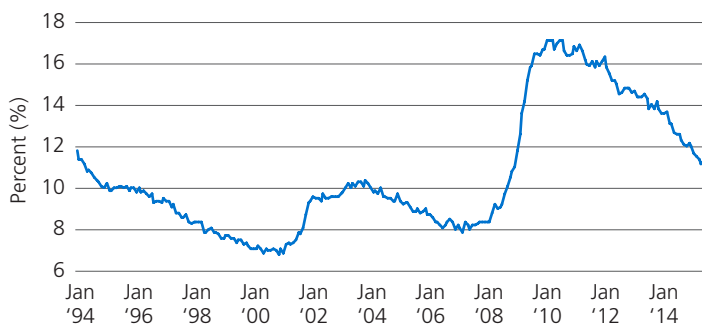
**FIGURE 4: U.S. UNEMPLOYMENT RATE**



Source: U.S. Bureau of Labor Statistics as of 28 February 2015.

So is the so-called U-6 jobless rate (see Figure 5), which tallies the number of people who left the workforce because they were discouraged about finding a job, and the number of people working in part-time jobs who would rather work full time. Although not back to normal, this gauge is falling fast enough to weaken it as a basis for the Fed to keep its policy rate at zero.

**FIGURE 5: U-6 UNEMPLOYMENT RATE**

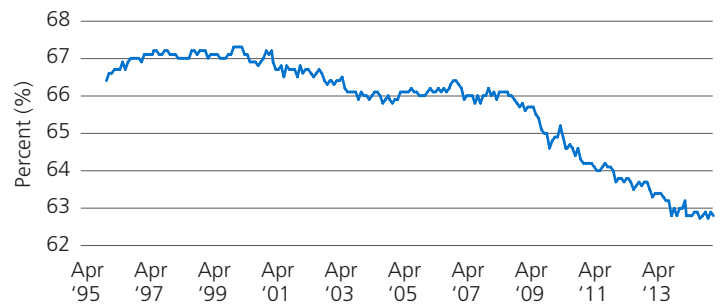


Source: U.S. Bureau of Labor Statistics as of 28 February 2015.

### Where are they, Janet?

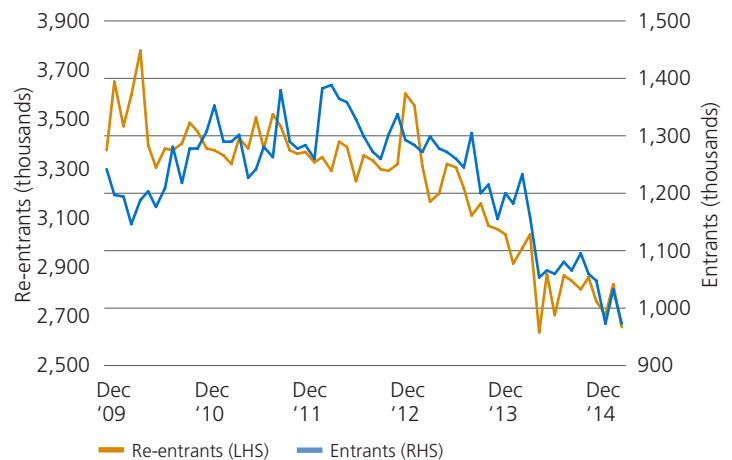
In thinking about the post-crisis decline in labor force participation, market participants are beginning to wonder: Where are they, Janet? Where are the throngs of people that you and many others said would return to the labor force when job conditions improved? These sidelined workers were expected to slow the speed of decline in the jobless rate and thereby keep a lid on future inflation pressures. Yet, despite the job market having turned up some time ago, labor force participation (see Figure 6) and the numbers of entrants and re-entrants to the labor force (see Figure 7) have been very weak. These data suggest the supply argument is weakening, as is the case for keeping the fed funds rate at zero.

**FIGURE 6: U.S. LABOR FORCE PARTICIPATION RATE**



Source: U.S. Bureau of Labor Statistics as of 28 February 2015.

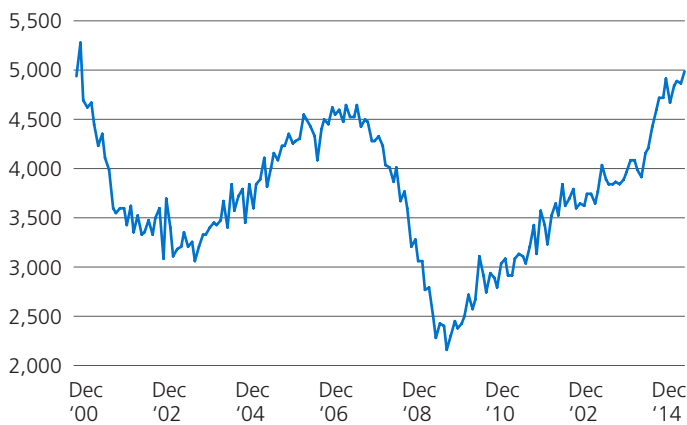
**FIGURE 7: ENTRANTS AND RE-ENTRANTS INTO THE U.S. LABOR FORCE (IN THOUSANDS OF PERSONS)**



Source: U.S. Bureau of Labor Statistics as of 28 February 2015.

Data on the number of job openings also make a compelling case for the Fed to escape from zero, with openings rising to a 14-year high of 5.0 million in January (see Figure 8), up by 1.0 million in 2014. This occurred despite payroll growth of 3 million people in 2014. The fact that job openings increased so substantially amid such robust job growth suggests that even if supply-siders are correct in believing there remains a great deal of excess labor supply, demand for new workers appears to be strong enough to absorb a significant portion of the excess that remains.

**FIGURE 8: U.S. JOB OPENINGS (IN THOUSANDS)**



Source: U.S. Bureau of Labor Statistics as of 31 January 2015.

### Clipping the tails

In light of growing indications of declining excess labor market supply, it can be argued that the earlier the Fed moves the less it will have to move later. Let me explain: Risk management for the Fed up until now has been to avoid acting prematurely. Former Fed Chair Ben Bernanke, who participated in PIMCO's latest quarterly Cyclical Economic Forum, noted that *no* nation had ever escaped the zero bound in the postwar era. Moving *too* early is therefore probably a bad idea.

Yet, so is moving late, because market participants may begin to price in an even larger amount of rate hikes than if the Fed were to move earlier, causing a greater tightening of financial conditions than is desirable. This bolsters the case for a shift in the Fed's risk management focus to one of guarding against acting too late. The Fed's doves may coalesce around this idea and vote for rate hikes in order to clip the tails on scenarios where markets price in more rate hikes than they would themselves want to see.

### Tightening is not tightening

A key message the Fed is likely to convey in the time leading up to rate hikes is that *"tightening is not tightening."* Stanley Fischer, the Fed's vice chair, said in the days after the Fed's March meeting that the Fed's initial rate hikes would merely move the Fed's stance from "ultra-expansive" to "extremely expansive."

In remarks at the San Francisco Fed on March 27, Yellen said that "the economy's equilibrium real federal funds rate ... is currently quite low by historical standards" – a comment entirely consistent with PIMCO's views about The New Neutral policy rate.

The Fed's policy rate would remain historically low, especially relative to where the U.S. jobless rate is, and this will likely be the case for years. Moreover, the Fed's \$4.45 trillion balance sheet will continue to provide stimulus for the U.S. economy, by helping to keep interest rates lower than they would otherwise be – because the Fed's securities holdings reduce the amount of bonds that traditional investors can buy, raising their prices and lowering their yields.

### Investment implications: Focus on the path of hikes

To reiterate our key investment theme, *when constructing portfolios, we suggest investors stay focused on the potentially (slow) speed and (low) magnitude of future Fed rate hikes, as well as the outlook for rates around the world, rather than the timing of the Fed's initial hike.*

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Second, we expect “Yellenomics” to lose its grip on market prices, as has been occurring with the U.S. dollar in recent months, leading to an increase in market volatility. In addition, we expect markets to become even more volatile when anxieties inevitably grow in response to the imminence of a Fed rate hike, creating risks but also opportunities. We suggest investors be prepared to act when opportunities inevitably arise.

In summary, we suggest investors *invest for the day(s) after the Fed’s first hike(s) and think long-term*, in particular about the low interest rate climate that will likely prevail for the rest of the decade, compelling investors to continue to reach for higher yields and returns. We suggest investors position themselves accordingly, favoring a bias toward overweighting credit and equity risk, taking advantage of opportunities to add to both if anxieties creep into markets, as they so often do. Favor also an underweight to U.S. duration, a bias toward a flatter yield curve, as well as a stronger U.S. dollar ahead of the Fed’s rate hike cycle.

The Fed is losing its grip – be alert and prepared to catch what moves!

**A word about risk: Past performance is not a guarantee or reliable indicator of future results.**

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