First Trust
Monday Morning OUTLOOK
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Powell Moves Markets

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Federal Reserve Board Chairman, Jerome Powell, who has been remarkably quiet as he adjusts to his new role at the Fed, finally roiled markets last week. He made comments on Wednesday, during the Atlantic Festival at a session moderated by Judy Woodruff of the PBS News Hour.

Powell said, "The really extremely accommodative low interest rates that we needed when the economy was quite weak, we don't need those anymore."

He added, "(I)nterest rates are still accommodative, but we're gradually moving to a place where they will be neutral. We may go past neutral, but ***we're a long way from neutral at this point.***" [Our emphasis added.]

The reaction of the markets was swift and dramatic. The 10-year Treasury note rose from 3.06% on Tuesday to 3.23% on Friday, its highest yield since 2011. From their intraday highs on Wednesday to Friday's close, the Dow Jones Industrial Average fell 1.8%, the S&P 500 fell 1.8%, and the NASDAQ Composite fell 3.3%.

To begin with, we agree completely with Mr. Powell. There are a number of models that purport to measure a "neutral" interest rate – a federal funds rate which does not hurt growth, but also does not lift inflation. Rates above neutral hurt the economy, rates below neutral lift inflation.

One model is the "Taylor Rule," which is based on setting separate targets for real GDP growth and inflation and then adjusting short-term interest rates when these data deviate from the targets. For example, if inflation and economic growth are above the target, then the "neutral" rate should move higher. If the economy or inflation fall, then so should the neutral rate. There are multiple versions of the Taylor Rule and right now these versions suggest a neutral federal funds rate somewhere between 3% and 5%.

While we very much like a rule-based monetary policy, and think the Taylor Rule is a fine rule, we try to simplify things even more. We think the growth rate of nominal GDP (real growth plus inflation) is the best target. Nominal GDP (or total spending in the economy) is a measure of the average growth rate of all business plus government. When interest rates are below this average growth rate there's an incentive for business to borrow even for projects that return less than average. This can cause distortions in the market. When rates are above this average, it can shut down activity.

Our model uses a two-year moving average of nominal GDP growth to avoid the volatility of shorter time frames. In the past, when the Fed has lifted the federal funds rate above two-year nominal GDP growth, recessions have occurred. It happened in 1969, 1973-74, twice in the early 1980s, 1990-91, 2000-01, and 2007-08.

Right now, nominal GDP growth over the past two years has been 4.6%. Looking back, a federal funds rate of roughly 50 to 75 basis points below nominal GDP growth is roughly neutral. As a result, we currently estimate a neutral rate around 4%. Moreover, we believe real GDP will keep growing at least 3% annually, while inflation continues to rise by 2% or more. In other words, the "neutral" rate is rising. And likely moving toward 4.5%.

This is why we agree with Chairman Powell. At the same time, we think the stock market has over-reacted, while the bond market is finally bowing to the reality that longer-term rates are heading much higher.

We have never believed that long-term rates were being held down by recent slow growth or low foreign rates. We believe they have been held down by the Fed's policy of low short term rates and the market belief that the Fed would hold them low. That has now changed.

And, yes, higher interest rates do reduce the fair value of equities. But even with current earnings, it would take a 3.7% 10-year yield to make current equity values "fair." With earnings likely to grow 20%+ this year and 10%+ next year, the market can handle higher interest rates and continue to rise. Higher rates are coming, but that doesn't mark the end of the recovery or the bull market.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
10-10 / 7:30 am	PPI – Sep	+0.2%	**+0.2%**		-0.1%
7:30 am	"Core" PPI – Sep	+0.2%	**+0.2%**		-0.1%
10-11 / 7:30 am	Initial Claims – Oct 6	210K	**206K**		207K
7:30 am	CPI – Sep	+0.2%	**+0.2%**		+0.2%
7:30 am	"Core" CPI – Sep	+0.2%	**+0.2%**		+0.1%
10-12 / 7:30 am	Import Prices – Sep	+0.2%	**0.0%**		-0.6%
7:30 am	Export Prices – Sep	+0.2%	**+0.2%**		-0.1%
9:00 am	U. Mich Consumer Sentiment- Oct	100.6	**100.6**		100.1