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DANGERS OF STARGAZING

What's happening at the Fed? Opinion seems to be continually shifting.

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SPEED READ:

- This week's remarks from Powell expressed confusion. Translation? We don't really know what's going on.
- The Fed's forecasts have missed the mark since 2008, allowing themselves (and the markets) to get whipsawed by shorter term data.
- A range of forces since the GFC will keep the major central banks cautious for years and fearful of making a big policy mistake.
- Bond markets regularly run ahead of themselves — now is one of those times. Reduce duration, especially in the United States

It would seem that Federal Reserve Chairman Jerome Powell, whose life has been an odyssey through America's most rarefied institutions, has taken a keen interest in, of all things, astronomy. In a speech last summer at the annual Jackson Hole symposium, Mr. Powell expressed frustration with the unusual variability of the metrics he refers to as "celestial stars". To be sure, the Fed's astronomical objects of interest reside within the macroeconomic firmament: the natural rate of unemployment, potential output growth, the neutral interest rate and so on. All riveting stuff for diehard economists.

"Navigating by the stars can sound straightforward," said Powell. "Guiding policy by the stars in practice, however, has been quite challenging of late because our best assessments of the location of the stars have been changing significantly." These are candid words for a central banker (heaven forbid they ever communicate in plain English).

Not much has changed since then. This week's remarks from Powell echoed the same confusion. In fact, the central bank didn't see a strong case for moving rates up or down. Translation? We don't really know what's going on.

Understandably, this rattled markets. It was only last December when Powell said that the federal funds rate could be a long way from neutral levels. Yet, inflation has steadily fallen this year with the bond market pricing in about a 65 percent chance of rate cuts today. The Fed looks increasingly out of touch.

But central banking is a confidence game. Investors should at least believe that policymakers have all the facts and some conviction about the future. Yet, recent monetary policy has been mystifying. The Fed's constellation of misjudgments in the post-crisis period has been hard to ignore. Their forecasts have missed the mark since 2008 (consistently overestimating inflation and growth prospects). Now, being highly "data dependent", as the Fed is today, has created an internal risk whereby they allow themselves to get whipsawed by shorter term data. It's not just the Fed either. Almost all major central banks are terrified of making a policy mistake.

How can they prevent a big misstep? Powell gave some clear signals last summer here too. Arguing in favor of caution on policy rates, he cited the work of William Brainard, recommending that "when you are uncertain about the effects of your actions, you should move conservatively". In other words, be extremely wary of over-tightening as policy gets near neutral levels.

The fact of the matter is that Fed, or any other central bank on planet earth, is in no rush to normalize policy. A range of forces since the GFC have conspired to broadly bring down global growth — deleveraging, a downshift in labor productivity growth, aging populations, a slowdown in technological advances and maturing urbanization in China have all played a role. This will keep them cautious for years.

INVESTMENT IMPLICATIONS

How does the above translate into the outlook for bonds and other fixed income securities? After nearly ten years of generally falling interest rates, many investors have come to believe in lower-for-longer interest rates. It wasn't always this way. In the aftermath of 2008, many were convinced that monetary largesse would translate into a combination of high inflation, a plummeting US dollar and gold at stratospheric levels. It didn't.

Since then, many assets have been bid up on a "lower forever" view. It was a long ride down in yields, boosting the values of a wide variety of interest rate sensitive investments in the West. Through financial alchemy and a masterstroke of marketing genius, REITs, dividend payers and a vast assemblage of ETF product provided a higher and more tantalizing yield.

But no party lasts forever. Large and steady spikes in yields, even if they glacially drift higher over the coming years, are not likely to be sustained. Bond markets will regularly run ahead of themselves. Now is one of those times. Investors should be reducing duration, especially in the United States.

Looking ahead, a demand-deficient world will continue to require lower rates than in the past. Bond markets will be volatile (amplified by policymaker miscommunication) and hostage to high debt levels and other structural headwinds around the world. Expect big bond sell-offs and regular rallies. Most will continue to panic each time. Meanwhile, smart investors will avoid stargazing and focus on the path directly ahead.