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Quo Vadis, Federal Reserve? – Part 3

Gerold Permoser

Making sense of it all

I will be upfront about it: to me, the Taylor rule is still a helpful tool to assess the future monetary policy of the US central bank. However, it should not be used as blueprint without thinking it through. Instead, it should be seen as heuristic tool that helps structure one’s analysis.

In order to create an idea as to the “right” interest rate according to the Taylor rule, I want to set up a bandwidth of the Taylor interest rate. After that, I am going to offer my personal opinion and assessment and draw a few conclusions with regard to the future development of the monetary policy.

The input variables are the nominal, neutral interest rate (bandwidth of 2% to 5%); the inflation gap (currently -0.6 percentage points), which is the result of the US central bank’s inflation target of 2% and the current value of the CPCE deflator of 1.4%; and the output gap (-0.8% to 1.1%). This results in a Taylor interest rate of 1.3% to 5.25%.

Taylor interest rate estimate

Neutral interest rate	Inflation gap	Output gap	Taylor interest rate
5%	-0.6 percentage points	+1.1%	5.25%
5%	-0.6 percentage points	-0.8%	4.3%
2%	-0.6 percentage points	+1.1%	2.25%
2%	-0.6 percentage points	-0.8%	1.3%

Source: EAM

This, to me, leads to two findings:

- The large bandwidth of results is mainly due to the uncertainty about the actual level of the neutral rate. It is even more difficult to determine than the output gap, which also defies observation, and in many instances, is a case of believing rather than knowing. To me this means that one has to look very closely as to who the decision-makers are or will be at the Fed.
- The lower end of the bandwidth of the estimates above suggests a key-lending rate of 1.3%. This value is slightly above the current bandwidth for the Fed funds target rate of 1% to 1.25%. Even in the "optimistic" case, the key-lending rates are thus below the level suggested by the Taylor rule. To my mind, this definitely supports the notion of further interest rate increases.

With regard to my own personal assessment of the input variables for the Taylor rule:

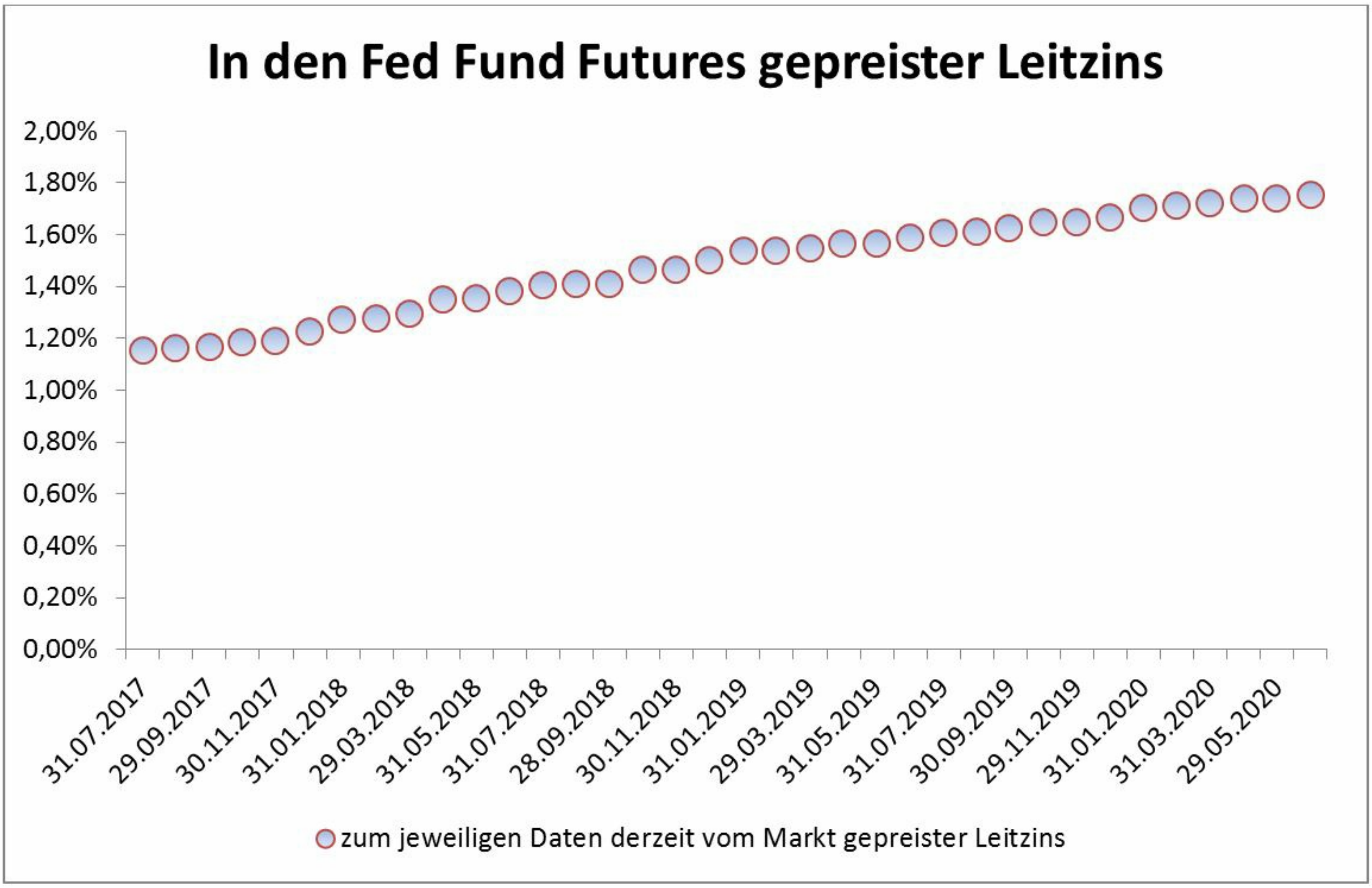
- I expect the neutral rate to be located at the lower end of the bandwidth of 2% to 5%. Lower productivity, lower population growth, and higher propensity to consume suggest higher interest rates. From my point of view, all of this describes the economic status quo and thus differs from the situation in the 1990s.
- I base my assessment of the output gap on the assumption that it is located somewhere towards the higher end of the indicated bandwidth rather than at the lower end. In the course of the financial crisis, the qualifications of many people as well as numerous business models and the resulting investments have lost a lot of value on a permanent basis. Therefore, I think that the econometric models that were calibrated pre-2008 come with the risk of underestimating capacity utilisation. This fits the US labour market. The unemployment rate is currently 4.4% and thus at its pre-crisis lows.
- The current inflation gap amounts to 0.6 percentage points.

Overall, a lot suggests that the key-lending rate should currently be 1.65% (0% neutral real interest rate; 1.4% current inflation; -0.6 percentage points inflation gap; 1.1% output gap).

Conclusion

- The Fed funds futures, i.e. derivative contracts that illustrate the market expectation of the future key-lending rate, show that the market expects to see the key-lending rates at 1.75% in the middle of 2020. A Taylor interest rate of 1.65% is roughly in line with the expectations for the Fed funds rate for 2020 currently priced into the market. There is a little wiggle room for an increase in inflation or the continued growth of the economy at its current pace.

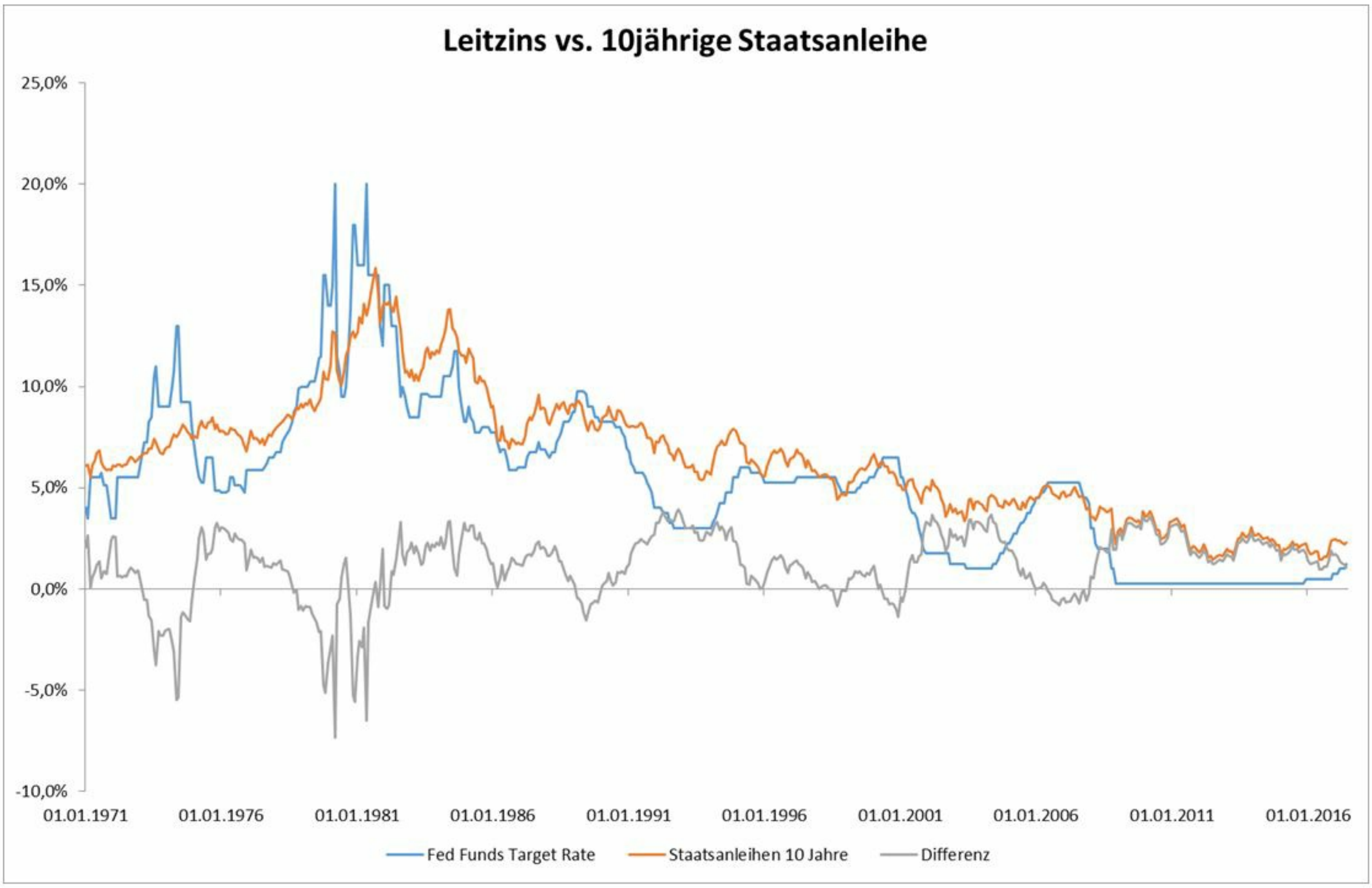
Fed funds rate priced into the Fed fund futures contract



Source: EAM/Bloomberg
Please note: Prognoses are no reliable indicator of the future performance of a fund.

- If inflation were to be around 1.9% twelve months from now, which would be in line with the current market expectation, the model would suggest a Taylor interest rate that was 0.75% higher (Inflation is an input variable both for the nominal interest rate and the inflation gap). This also explains why the market is currently paying so much attention to the inflation data. If inflation rises, the Fed will come under pressure to raise interest rates faster and more drastically than currently priced in by the market.
- Based on a Taylor interest rate of 1.65% and a spread of 1.2% for 10Y US Treasuries, which is in line with the average value since 1970, the 10Y yield should be 2.85%. This value is about 60 percentage points above the actual value at the moment.

Fed funds rate vs. 10Y Treasury bonds



Source: EAM

- If the nominal interest rate is really 2%, the unorthodox measures we have seen taken as part of the monetary policy will not have been a one-off event but will continue to play an important part. After all, the next recession will undoubtedly come our way some day. The Fed could then cut the Fed funds rate significantly less than in the past.

Ironically, the eponym of the Taylor rule, John Taylor, could mess up the aforementioned analysis. He famously does not think that the neutral interest rate has fallen significantly in the past years. Therefore, he regards the current Fed funds rate as too low. If John Taylor were to become the next Fed chairman, he might therefore raise rates more significantly than anticipated by the market and myself.

Wichtige rechtliche Hinweise

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Gerold Permoser has been Chief Investment Officer at Erste Asset Management since early April 2013. He is responsible for all asset management activities and investment strategies for all investment funds held by the Erste Asset Management Group in Austria, Germany, Croatia, Romania, Slovakia, the Czech Republic, and Hungary. Before joining the company, he served this function at Macquarie Investment Management Austria KAG. Permoser has gathered experience in investments since 1997.

He began his career as a fixed-income analyst at the Creditanstalt in Vienna. He moved to asset management at Innovest KAG in 2000. He made significant contributions in the investment field there and advanced to CIO (director of asset allocation and research). Gerold Permoser studied at the University of Innsbruck and is a CFA charter holder. He offers training at the University of Vienna and at various post-graduate institutions for analysts and portfolio managers (i.e., at VÖIG, the Association of Austrian Investment Fund Companies).