Federal Reserve Bank of Boston®

Perspectives on Monetary Policy and Market Volatility

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Ended 2018 With Significant Financial Market Volatility

- From beginning of October to the end of December stocks declined:
  - Dow Jones Industrial Average fell 12.5 percent
  - S&P 500 fell 14.3 percent
- Over the full year:
  - Dow Jones Industrial Average fell 6 percent
  - S&P 500 fell 7 percent
- Volatility increased – VIX ended December at 25.4 – well above its historical average
- 10-year Treasury, which had reached 3.24 percent, fell below 2.7 percent
- Financial conditions overall have tightened – could portend a decline in future economic growth

Is Financial Market Sentiment Too Pessimistic?

- Financial markets can, and do, reverse themselves
  - Are investors overly pessimistic about potential risks?
  - How resilient is the U.S. economy?
- My personal view is that financial market sentiment may be unduly pessimistic
  - Monetary policy is accommodative, as is fiscal policy
  - Economic growth in 2018 was quite strong and some carry-forward is likely
  - Reasons to believe the consumer remains engaged and willing to spend (labor market conditions, savings rate, consumer confidence)

Current Outlook is Quite Uncertain

- Even at the best of times, it is difficult to navigate a soft landing
- My baseline forecast assumes growth somewhat above potential and modest declines in unemployment in 2019
- However, I am sensitive to heightened risks, and believe policy is currently appropriately balancing risks
- Should risks materialize and significantly impact the economy – not my baseline forecast – policy would need to recalibrate
- At this juncture, with two very different scenarios – economic slowdown implied by financial markets, or growth consistent with economic forecasts – in my view, policy can wait for greater clarity before making adjustments

Monetary Policy

- Financial conditions have tightened
- Forecasts are more uncertain
- Imperative that monetary policy be data dependent
- Current policy should have no particular bias toward raising or lowering rates until the data more clearly indicate the path for domestic and international economic growth

Overview of My Remarks

- Context to recent financial-market movements
- Predictions of private-sector economic forecasters
- Forecasts made by Federal Reserve policymakers in December
- Why my assessment is closer to the relative optimism of economic forecasters than to the more pessimistic outlook suggested by recent declines in financial markets

Figure 1: Ten-Year Treasury Yield

January 4, 2016 - January 4, 2019

Source: Federal Reserve Board, Haver Analytics

Figure 2: Stock Price Indices

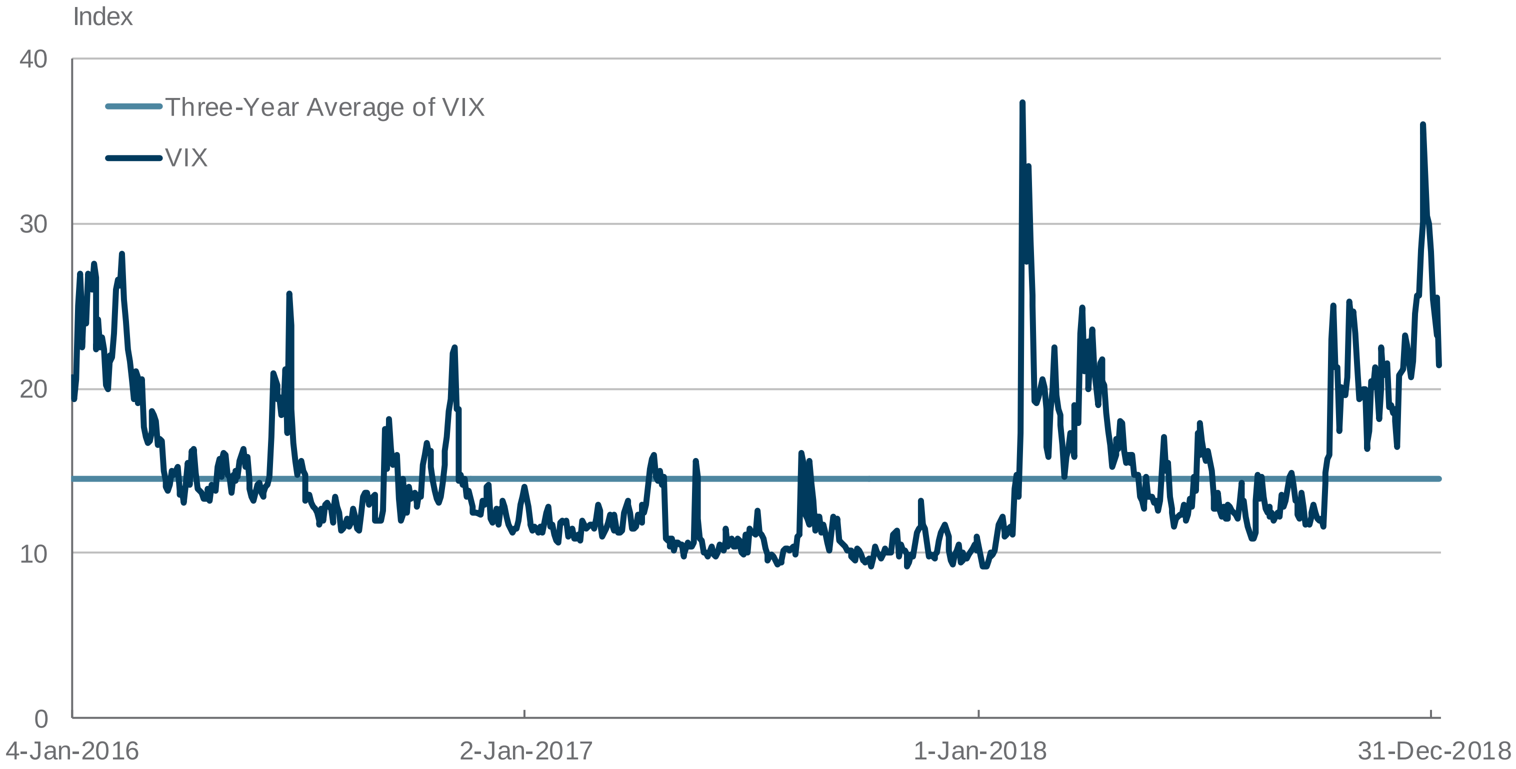
January 4, 2016 - January 4, 2019

Note: Index level January 4, 2016=100.

Source: DJ, S&P, WSJ, Haver Analytics

Figure 3: CBOE Market Volatility Index (VIX)

January 4, 2016 - January 4, 2019



Source: CBOE, WSJ, Haver Analytics

Figure 4: Brent Crude Oil Price

January 4, 2016 - January 4, 2019

Source: FT, Haver Analytics

Figure 5: Global Stock Market Indices

January 4, 2016 - January 4, 2019

Note: Index level January 4, 2016=100.

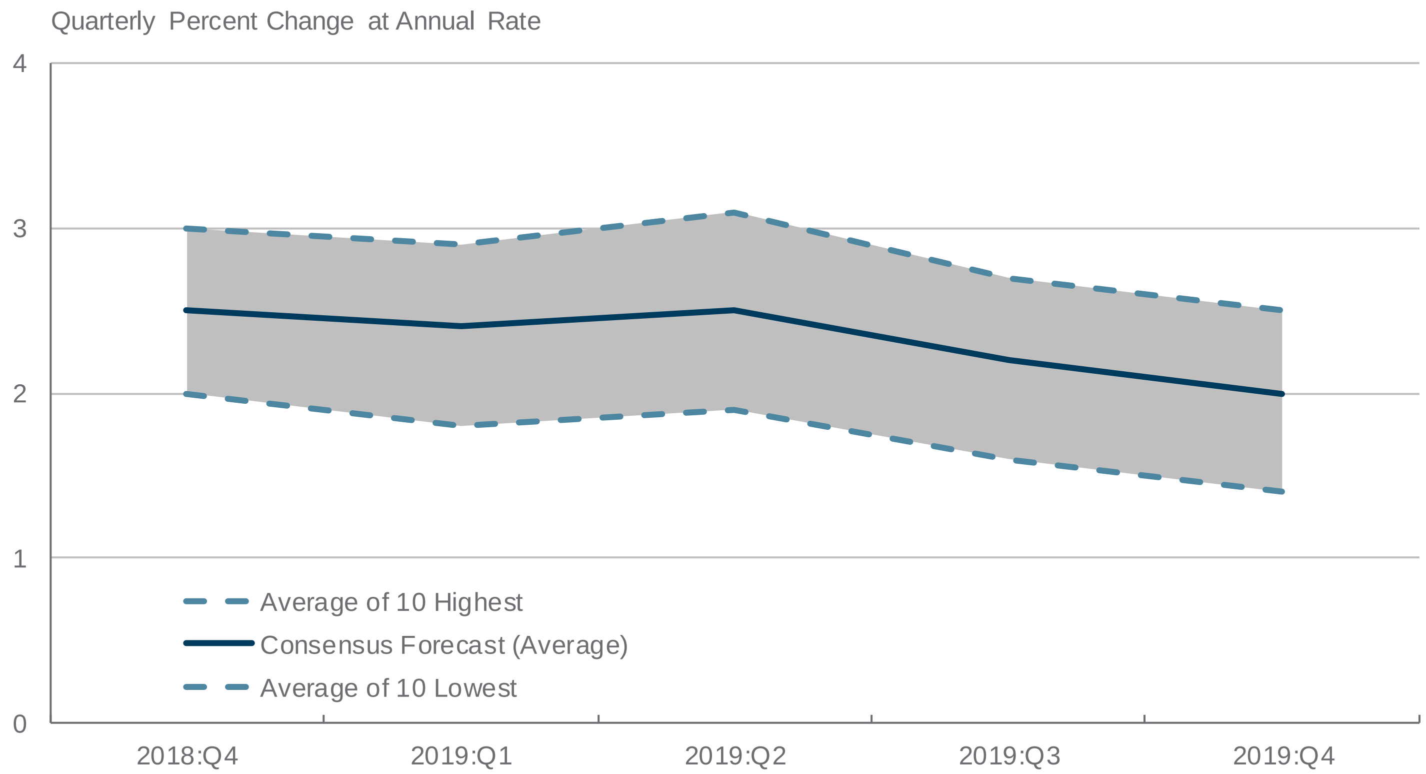
Source: S&P, FT, STOXX, Bloomberg Finance L.P., Haver Analytics

Financial Market Summary

- Ended 2018 on a sour note
- U.S. stock indices have performed better than foreign counterparts – but were still down 6 to 7 percent last year
- Raises concerns about the durability of the economic recovery
- At least to date economic data and the outlook of forecasters have been more optimistic

Figure 6: Blue Chip Forecast for Real GDP Growth

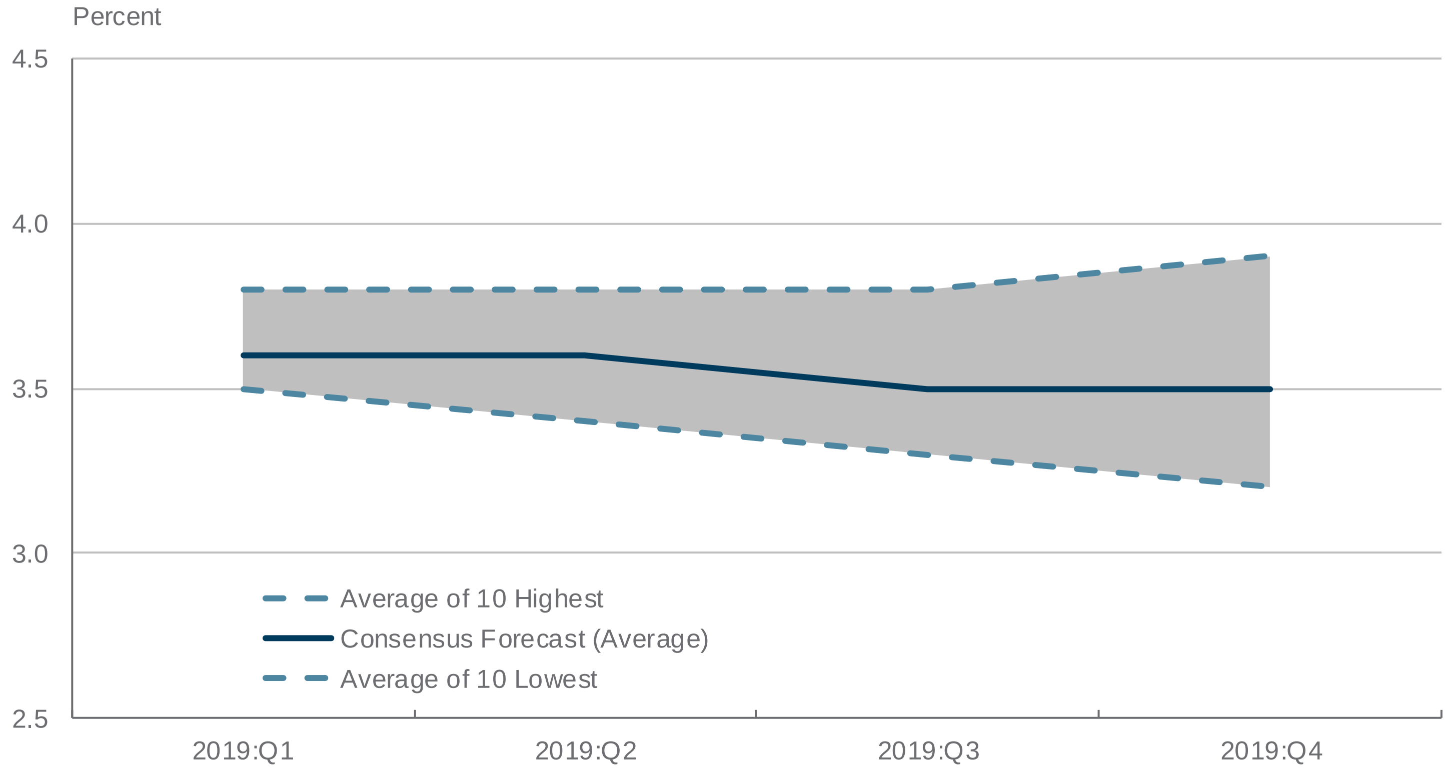
2018:Q4 - 2019:Q4



Source: Blue Chip Economic Indicators, December 10, 2018

Figure 7: Blue Chip Forecast for the Unemployment Rate

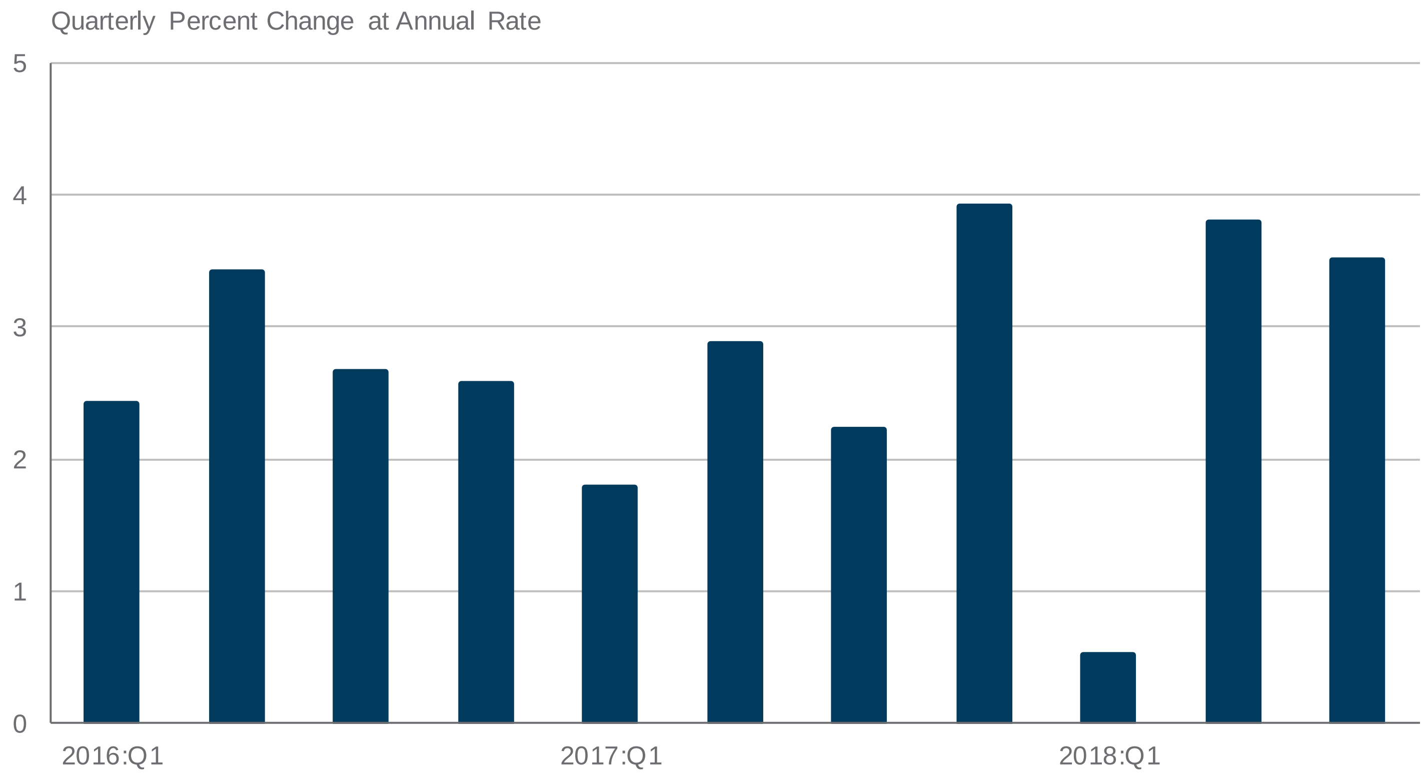
2019:Q1 - 2019:Q4



Source: Blue Chip Economic Indicators, December 10, 2018

Figure 8: Consumption Growth

2016:Q1 - 2018:Q3



Source: BEA, Haver Analytics

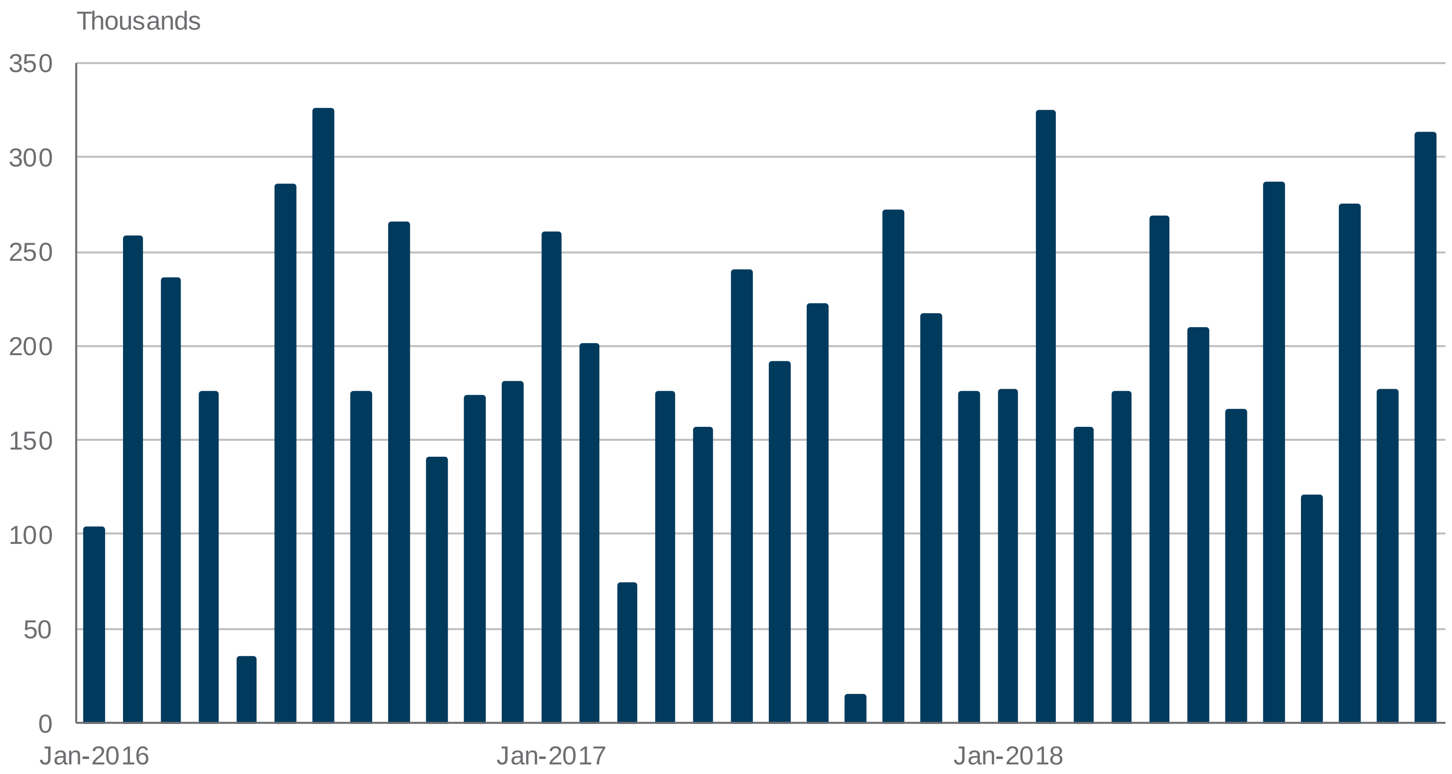
Figure 9: Consumer Confidence

January 2016 - December 2018

Source: The Conference Board, Haver Analytics

Figure 10: Change in Payroll Employment

January 2016 - December 2018



Source: BLS, Haver Analytics

Figure 11: Initial Claims for Unemployment Insurance

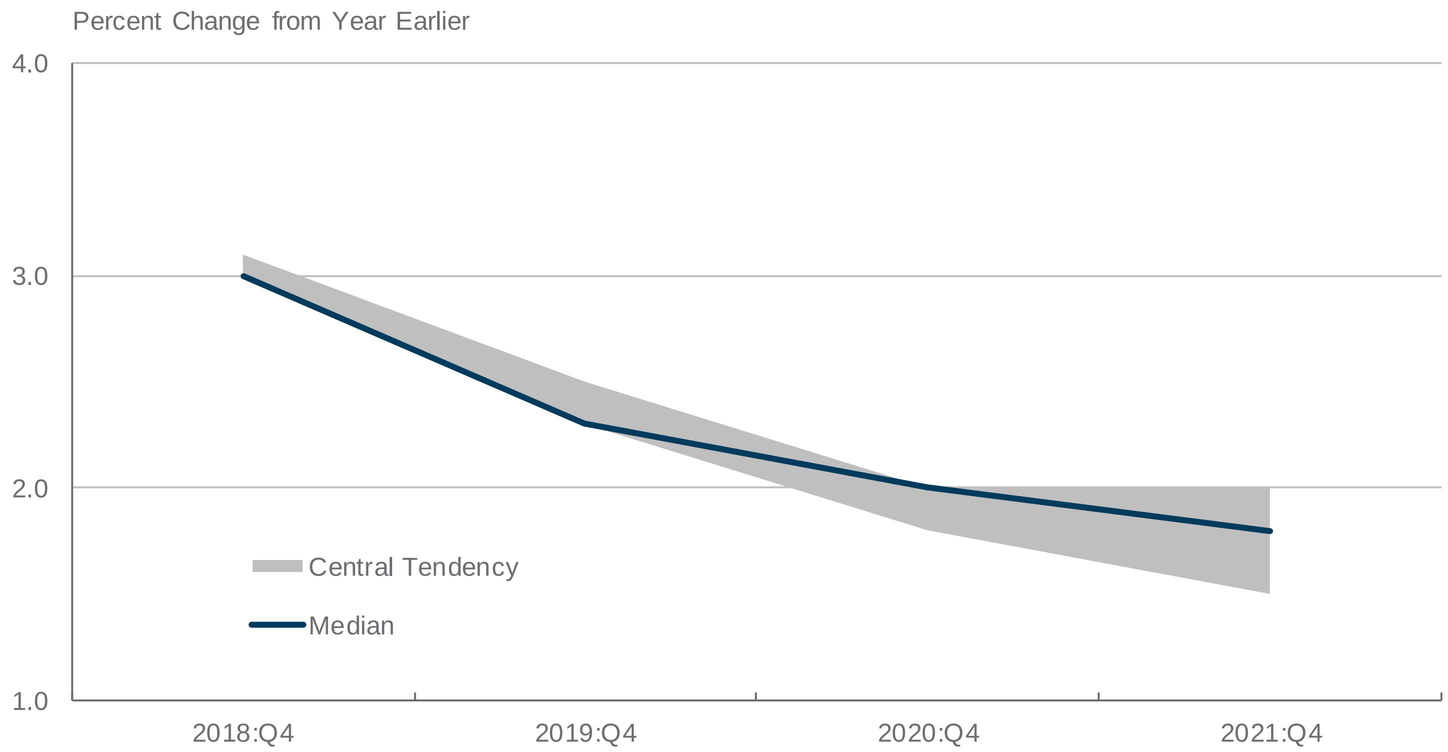
January 2, 2016 - December 29, 2018

Note: Four-week moving average.

Source: U.S. Department of Labor, Haver Analytics

Figure 12: Real GDP Growth Forecast from the Summary of Economic Projections

2018:Q4 - 2021:Q4

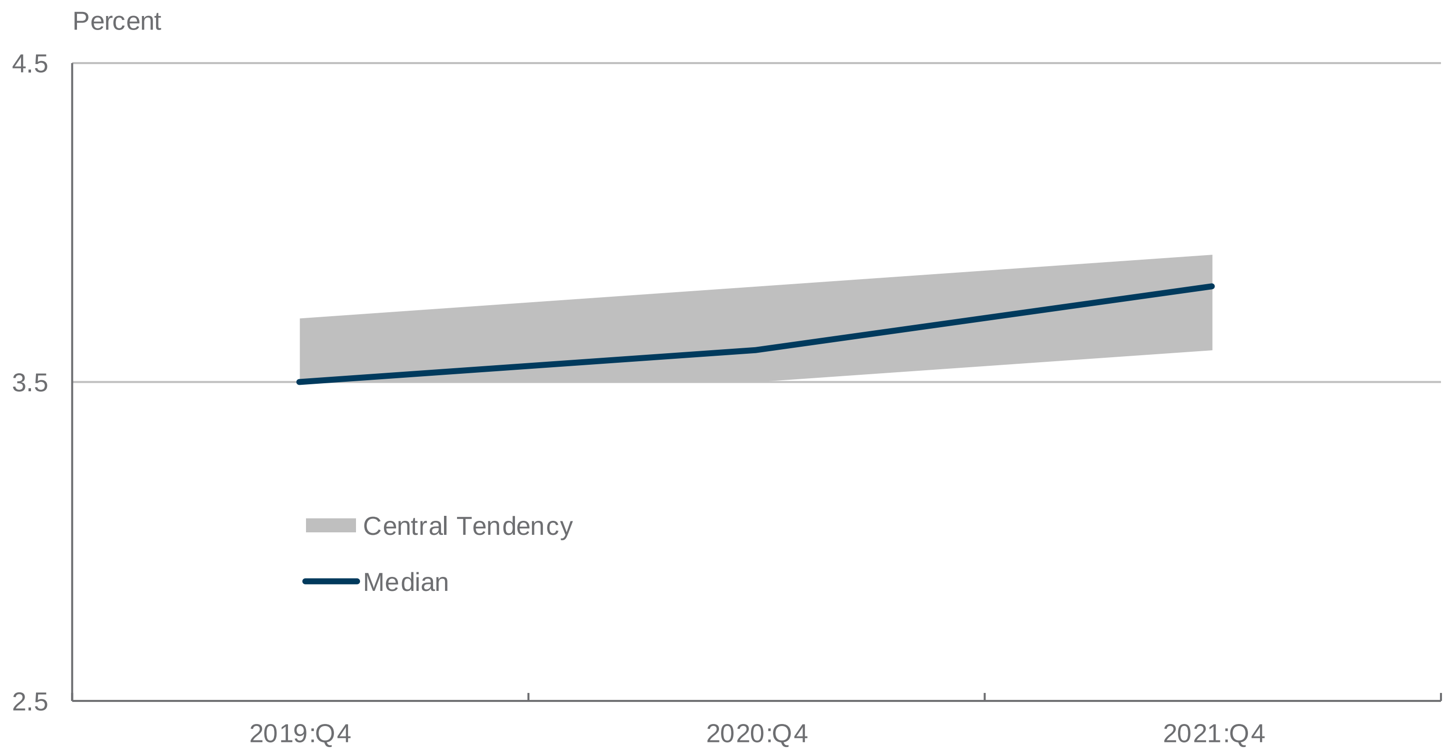


Note: The central tendency excludes the three highest and three lowest observations.

Source: FOMC, Summary of Economic Projections (SEP), December 19, 2018

Figure 13: Civilian Unemployment Rate Forecast from the Summary of Economic Projections

2019:Q4 - 2021:Q4

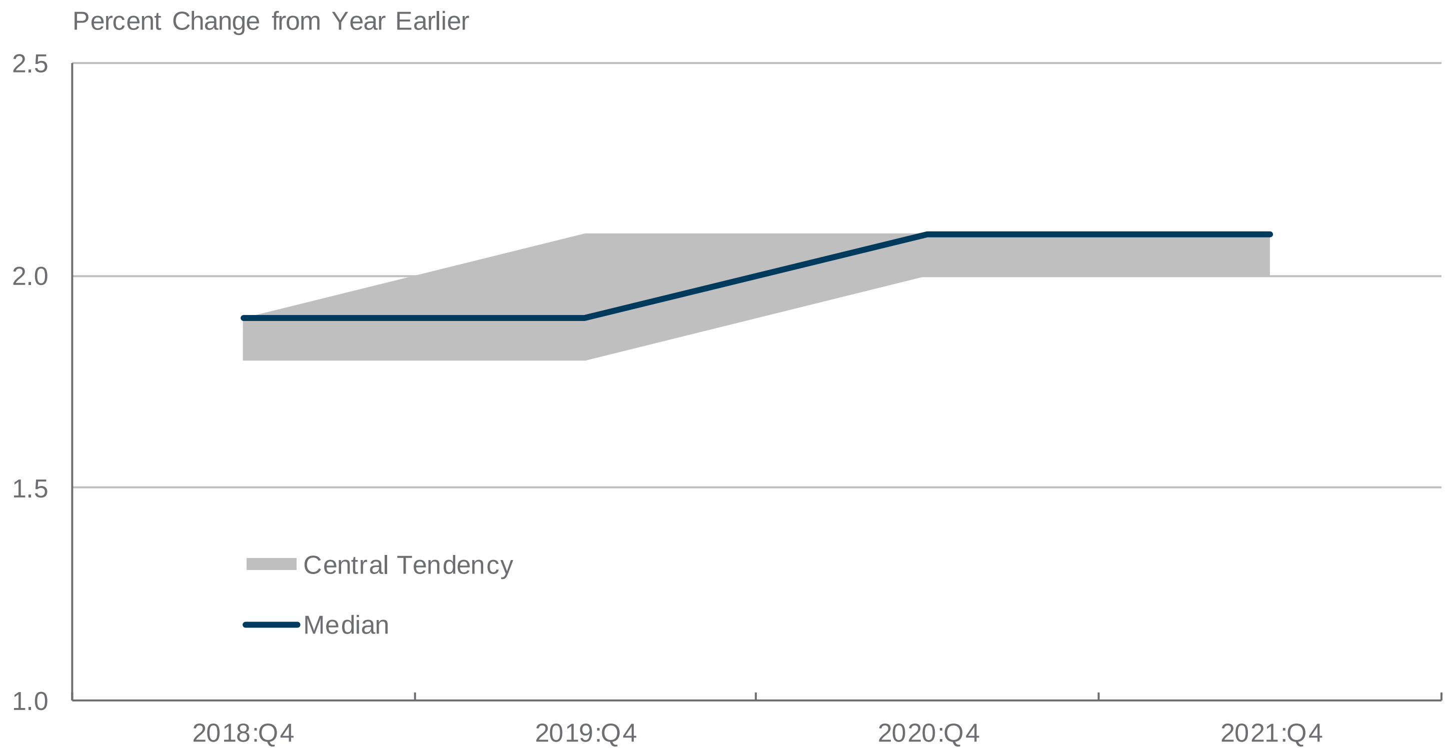


Note: The central tendency excludes the three highest and three lowest observations.

Source: FOMC, Summary of Economic Projections (SEP), December 19, 2018

Figure 14: PCE Inflation Forecast from the Summary of Economic Projections

2018:Q4 - 2021:Q4



Note: The central tendency excludes the three highest and three lowest observations.

Source: FOMC, Summary of Economic Projections (SEP), December 19, 2018

Concluding Observations

- Economic outlook is actually brighter than the outlook one might infer from recent financial market movements
  - I expect 2019 economic growth sufficient to tighten U.S. labor markets somewhat
  - My views are closer to the outlook of many professional forecasters and FOMC participants than to the recent pessimism in financial markets
- How to respond to heightened risks?
  - Concerns with global growth, international trade, and geopolitical upheaval
  - Prudent warning that actual economic outcomes could diverge from forecasts

Implications for Monetary Policy

- Monetary policy should not be on set course – should take into account and reflect how real economic data unfold
- If the pessimism reflected in financial markets shows through to economic outcomes: less need (and perhaps no need) for further increases in interest rates
- My own view is more optimistic – consistent with forecasts
- Yet, in light of slowing abroad and volatile financial markets
  - Policy should not have a bias toward moving in either direction
  - Monetary policy is appropriate for now and, in my view, we can patiently observe future economic developments