# WHY IS THE FED'S JAMES BULLARD OPTIMISTIC ABOUT THE U.S. ECONOMY?

Jeremy Schwartz – Global Chief Investment Officer
03/09/2015

*On February 20, Professor Jeremy Siegel and I had the pleasure of speaking to St Louis Federal Reserve Bank (Fed) president James Bullard, who is a member of the Fed monetary policy committee. 2015 is shaping up to be an interesting year for monetary policy, with the Fed expected to hike interest rates. President Bullard spoke in a rare voice of clarity for Fed presidents. Below are some points I thought were important to focus on:* ***Is It Time to Get Off Zero Bound?*** President Bullard said he cannot rationalize a Fed policy rate at zero, given the jobs growth numbers, the unemployment rate coming down and the state of inflation (which he does not think is much below the Fed's target of 2% when you take out the big price drop in oil.) Bullard further believes the unemployment rate—a key measure tracked by the Fed—will drop to 5% in the third quarter of this year. Bullard thus suggests the Fed needs to get off zero bound and continuously re-evaluate the data. If the economic data that follows is good, the Fed can make another rate hike, or it could just pause its hikes if data is sluggish. Bullard believes there is a risk if the market perceives the Fed as woefully behind the curve—then the Fed would have to play catch-up and may be forced into a 50 basis point hike or—as it did in 1994—a 75 basis point hike that can create the kind of volatility the Fed wants to avoid. *Professor Siegel noted that the Producer Price Index came in weaker than expected and asked where the Fed sees inflation.* Bullard said that the 50% drop in oil prices was no ordinary decline and was keeping inflation subdued. He suggested looking at the Dallas Fed's Trimmed Mean PCE indicator (something Fed chairman Janet Yellen echoed the following week). That measure has been stable at 1.6% over the last six to nine months—which is actually much closer to Fed targets than traditional headline inflation rates. ***Negative Economic Consequences of Oil Drop?*** Bullard believes the 50% drop in oil prices will ultimately be positive. Bullard noted that oil consumption (not production) is a huge part of our economy, especially for low-income consumers, where oil is a large share of their expenditures. Bullard believes this increased spending power should significantly improve the U.S. economic growth rate. ***Okun's Law or Okun's Suggestion?*** Professor Siegel challenged Bullard's optimism, asking him to explain strong growth in jobs with subpar readings on the economy. He cited Okun's law, an economic theory that states that every percentage point drop in unemployment should lead to a 2% gross domestic product (GDP) growth above the mean. Professor Siegel believes we are about 10 standard deviations away from Okun's law vis-à-vis the decline in unemployment and disappointing pick-up in GDP growth. Bullard responded that Okun's law should be demoted to Okun's suggestion. Bullard has marked down the potential growth rate in the economy to 2% or even below 2% over the next 5 to 10 years. This is a big drop from the potential growth rate during the 1980s and 1990s, where it was closer to 3%. During the late 1990s the U.S. had 4% growth—about 1% above trend for four or five years. Bullard sees today's 3% growth rate against 2% potential as a "boom." ***If potential growth rate is lower, shouldn't the Federal Funds Rate come down in the long run?*** *The futures market pricing in a Fed Funds Rate is heading up toward 2%, while the Federal Open Market Committee (FOMC) has stated the long-run rate still stands*



WISDOMTREE®

***at 3.75%.*** President Bullard has lowered his long-run rate estimates from 4.25% to below 4% in a nod to lower long-run potential. But he would not go as low as 2%, as he is not that pessimistic about our economy’s growth potential to imply a zero real Federal Funds Rate (after 2% inflation is taken out). *Author’s Note: I believe this is going to be a major issue the market needs to contend with—as it seems partially unprepared for the Federal Funds Rate to eventually reach the types of levels Bullard and the FOMC discuss.* ***Is the Dollar Rise Equivalent to a Tightening of Policy?*** Bullard stated that a year ago at this time, he saw zero probability attached to the European Central Bank (ECB) doing quantitative easing (QE). It was supposed to be a year of recovery for Europeans in 2014—but in fact things got worse for Europe, and inflation dipped far below their target. The ECB resisted unconventional monetary policies for the last five years, but now it has embraced them with a big QE program. This sent yields in Europe lower and had a spillover in sending yields down in the U.S. This was a “freebie” for the Fed in getting additional stimulus from Euro QE and to Bullard is a bullish factor for growth in the U.S. economy for 2015. This was a total surprise to everyone in 2014—including President Bullard—who thought interest rates were going higher. They didn’t, which in Bullard’s view is entirely due to ECB easing. If the ECB is going to ease and the Fed is going to raise rates, Bullard said one would expect a strong dollar. ***Why Is Productivity Growth Disappointing Right Now?*** Bullard suggested one explanation for low productivity was the re-regulation of the economy—changing the rules, putting stricter controls and rules in place. Bullard suggested that firms are really good at optimizing business plans if they know a set of rules, but uncertainty prevents big investment spending. Bullard also said the main thing the U.S. can do to achieve better growth is to have a national conversation on how to get productivity improving—especially getting people the right type of training, given the large skill premium that exists. *Read the Conversations with Professor Siegel series here.*

**Important Risks Related to this Article**

Investments focused in Europe are increasing the impact of events and developments associated with the region, which can adversely affect performance.

For standardized performance and the most recent month-end performance click here NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

For more investing insights, check out our Economic & Market Outlook

View the online version of this article here.

## IMPORTANT INFORMATION

**U.S. investors only: Click here to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.**

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an “as is” basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the “MSCI Parties”) expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages (www.msci.com)

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Jianing Wu, and Brian Manby are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.

You cannot invest directly in an index.

## DEFINITIONS

**Interest rates** : The rate at which interest is paid by a borrower for the use of money.

**Inflation** : Characterized by rising price levels.

**Producer Price Index** : weighted index of prices measured at the wholesale, or producer level.

**Gross domestic product (GDP)** : The sum total of all goods and services produced across an economy.

**Standard deviation** : measure of how widely an investment or investment strategy's returns move relative to its average returns for an observed period. A higher value implies more "risk", in that there is more of a chance the actual return observed is farther away from the average return.

**Federal Funds Rate** : The rate that banks that are members of the Federal Reserve system charge on overnight loans to one another. The Federal Open Market Committee sets this rate. Also referred to as the "policy rate" of the U.S. Federal Reserve.

**Federal Open Market Committee (FOMC)** : The branch of the Federal Reserve Board that determines the direction of monetary policy.

**Quantitative Easing (QE)** : A government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital, in an effort to promote increased lending and liquidity.

**Monetary easing policies** : Actions undertaken by a central bank with the ultimate desired effect of lowering interest rates and stimulating the economy.