AN ECONOMIC UPDATE FROM CHICAGO FED PRESIDENT CHARLES EVANS

Jeremy Schwartz – Global Chief Investment Officer
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I just returned from a trip to Europe with the Global Interdependence Center, which hosted a series of economic and central bank-focused discussions in Frankfurt and Madrid, with Chicago Federal Reserve (Fed), President Charles Evans keynoting events in both cities.

Despite his busy schedule, we also had the opportunity to interview Evans on our "Behind the Markets" podcast.

Below are highlights from our conversation on the current state of the economy:

Evans believes the fundamentals of the U.S. economy are quite "solid." Evans sees U.S. growth holding steady at 2.25% in 2019, while he estimates trend gross domestic product (GDP) growth closer to 1.75%. Usually above-trend GDP growth may lead to more of a tightening stance for monetary policy than an accommodative stance of cutting interest rates, but Evans justified the Fed's recent cuts due to inflation failing to achieve their symmetric target of 2%. He also said he believes the trajectory for growth is heading down from 2.25% toward 2% next year, and trend growth may slow even further afterward.

Evans repeatedly focused on the term "symmetric inflation" when referring to the Fed's target of 2% because he believes we need to spend time on average at 2% to indicate longer-term health in the economy. Since inflation has disappointed in staying below the 2% target for so long, the implication is that the Fed should encourage inflation above 2% for some considerable amount of time to boost the longer-term average. There could be fear the U.S. has not experienced 2.5% inflation without it moving significantly higher, and Evans pointed out that we haven't faced this type of inflation regime in modern times with quite well-anchored inflation expectations.

Evans discussed how the Fed is undertaking a monetary policy framework review, and steps to emphasize this symmetric 2% target are high in his mind, while the only feature of the Fed's framework that is currently not up for debate was the 2% inflation target itself. One might ask why 2% is so special, but that figure currently is ingrained in all Fed thinking.

Evans said his ideal long-run neutral interest rate, the rate that is neither accommodative nor contractionary, is 2.75%, which implies a 75 basis point real neutral rate given the Fed's 2% inflation target.

We also discussed why rates have been so low throughout the rest of the world. Certainly, monetary policy has played a role and has reduced term premiums around the world (this is compensation required to extend maturity). Evans pointed to the immense

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appetite for safe assets like the German bund and the Japanese government bond. The low rates in the U.S. persist during an environment in which we increased the Federal deficit by $1.5 trillion over a course of 10 years with corporate tax cuts, which require financing via the issuance of more bonds and more complexity added to the current rate regime.

A hot topic of conversation in Europe was the negative interest rate policy of the European Central Bank. Evans said he does not recall a great deal of discussion at the Fed regarding negative rates during the implementation of the Fed's first asset purchase program, and it seems that the Fed has avoided going down this path.

Regarding volatility in the repurchase agreement (repo) markets, Evans wanted to assure listeners that there are ample reserves in the market to not create widespread volatility, and he was open to longer-term solutions that provide the adequate funding and reserves. Notably, Evans downplayed the importance of the size of the balance sheet as an important policy tool, at least saying rates were more significant.

This was a great conversation that we were fortunate to have with Evans. Please listen to the full conversation below.

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DEFINITIONS

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

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

Monetary tightening : A course of action undertaken by the Federal Reserve to constrict spending in an economy that is seen to be growing too quickly or to curb inflation when it is rising too fas.

Monetary policy : Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

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

Inflation : Characterized by rising price levels.

Basis point : 1/100th of 1 percent.

Term premium : The term premium represents the incremental yield that investors require to hold a longer-term bond, as opposed to a combination of shorter-maturity bonds.

Maturity : The amount of time until a loan is repai.

German bunds : A debt security issued by Germany’s federal government, which is the German equivalent of a U.S. Treasury bond.

Japanese Government Bond (JGB) : A bond issued by the government of Japan. The government pays interest on the bond until the maturity date. At the maturity date, the full price of the bond is returned to the bondholder. Japanese government bonds play a key role in the financial securities market in Japan.

Volatility : A measure of the dispersion of actual returns around a particular average level. .

Repurchase agreement : a short-term investment similar to a money market security.

Balance sheet : refers to the cash and cash equivalents part of the Current Assets on a firms balance sheet and cash available for purchasing new position.