NORTHERN TRUST

MAY 3, 2024

WEEKLY ECONOMIC COMMENTARY

IN THIS ISSUE:

- **The Fed And The Ballot Box**
- **Dollar Gains**
- **Is Hong Kong Losing Its Sheen?**

Global Economic Research
50 South La Salle Street
Chicago, Illinois 60603
northerntrust.com

Carl R. Tannenbaum
Chief Economist
312-557-8820
ct92@ntrs.com

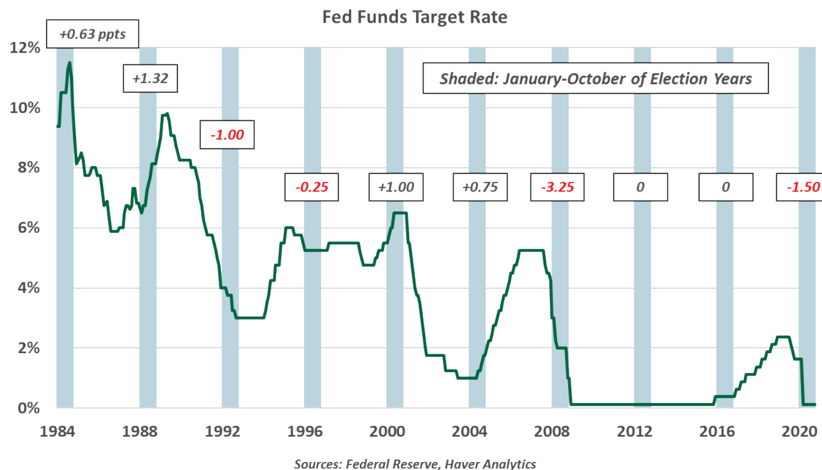
Ryan James Boyle
Chief U.S. Economist
312-444-3843
rjb13@ntrs.com

Vaibhav Tandon
Chief International Economist
630-276-2498
vt141@ntrs.com

Try as we might, we cannot ignore politics in election years. Campaigns creep into our lives through advertisements, yard signs, bumper stickers and casual conversation. The contagion has spread to our discussions of monetary policy: we are often asked whether the Fed will be influenced by the election. We believe not, based on a reading of history and the structure of the organization.

The Federal Open Market Committee (FOMC) is chartered to be apolitical. Seven of its 12 members are Governors of the Federal Reserve System, who serve staggered 14-year terms. While they are nominated by the President and approved by the Senate, their backgrounds are typically well outside the political sphere. The other five voting members are the presidents of the New York Fed and four other regional Federal Reserve Banks. Regional leaders are chosen by the boards of their local Reserve Banks, not through any electoral process.

The Fed's leaders do not live in isolation. A political lens could be applied to all decisions. But a review of the FOMC's actions in the January-October interval of past election years reveals a pattern of decisions based on prevailing economic circumstances, no different from non-election years. The Fed's practice of publishing a specific target rate only began in the 1980s, allowing a review of ten presidential election cycles.



1980s: Finishing the Inflation Fight

The two elections of the 1980s came in the wake of the persistent inflation of the prior decade. The overnight rate stood at 10% as voters went to the polls in 1984, and 8.125% in 1988. Amid volatile rate movements, both years saw rates higher in October than where they started the year.

But higher interest rates were the norm at the time. The Fed did not arrest the growth cycle of the 1980s by hiking, nor did they do any harm to the incumbent. Ronald Reagan won reelection in 1984, and his party held power as his Vice President George H.W. Bush ascended in 1988.

1990s: Steady Growth, Steady Rates

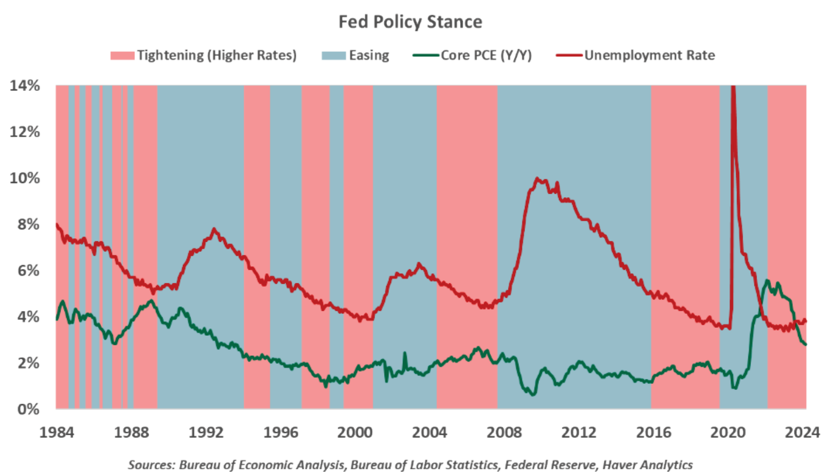
Election-year rate adjustments in 1992, 1996 and 2000 were too minor in magnitude to be of electoral consequence. Leading up to the 1992 election, the Fed Funds Rate was cut from 4.0% to 3.0%, but that small stimulus did not secure Bush's reelection. 1996 brought just one quarter-point hike early in the year, consistent with the stable economy that helped Bill Clinton win a second term. The leadup to the 2000 election included 100 basis points of hikes in February, March and May, as the Fed worked to cool the hot, tech-led economy. Core inflation had leaped from 1.4% in December 1999 to 1.9% in March 2000, meriting a policy response. Republicans narrowly returned to power in 2000 with the election of George W. Bush.

After 2000: Crisis Interventions and the Zero Lower Bound

The Fed reacts to economic data, not polling data.

The dot-com bubble was bursting as Bush took office. A cyclical recession in 2001 was unavoidable; the terrorist attack later that year cemented a difficult interval. The Fed eased in response, from 6.5% to a then-record low of 1.0%. The 2004 election year saw some movement toward normalizing, including a total of 75 basis points of hikes in June, August and September. Inflation was on the rise in the first half of the year as spending picked up. The tightening was consistent with an upturn in economic activity, working in Bush's favor for reelection.

After hiking steadily back to 5.25% in summer 2006, the Fed enjoyed little respite before the housing market correction sparked a financial sector crisis. The FOMC started cutting in September 2007 and continued throughout the following year. The overnight rate stood at 1.0% as of the 2008 election, on its way to the zero lower bound. Deep recessions bode poorly for incumbent parties, with Democrat Barack Obama taking office.



Sources: Bureau of Economic Analysis, Bureau of Labor Statistics, Federal Reserve, Haver Analytics

The recovery was too sluggish to justify any tightening through Obama's first term, with the unemployment rate stuck above 7%. The Fed attempted new interventions like quantitative easing, an afterthought in the 2012 election. The recovery strengthened in Obama's second term, justifying one cautious hike in 2015, and then not again until the end of 2016.

The Fed's long pause before the 2016 election had a whiff of political motivation, with Democrat Janet Yellen at the helm. However, the year was marked by fear of a recession stemming from a

hard landing in China and persistently low inflation. As in 2000, a close election ended two-term Democratic control, with Republican Donald Trump taking charge. After modest hikes and cuts, the FOMC fell back to the zero lower bound in response to COVID. Monetary policy was the furthest thing from most voters' minds in 2020.

The past ten cycles reveal two years of both hikes and cuts, four examples with cuts, two with holds and two with hikes. Rate decisions in election years have twice come as late as September, plus an emergency intervention in October 2008. The FOMC's mandate revolves around inflation and employment, not elected leadership.

Counter to popular perception, the Fed has often changed rates in election years.

We understand the suspicion. The foregoing analysis starts after President Nixon inveighed on rates, contributing to the inflation of the 1970s. Subsequent presidents have mostly respected the Fed's autonomy, and today's Fed governors have steered well clear of political matters. Asked at this week's press conference if the election raises the bar for a rate action, Chair Powell reiterated that "we'll do what we think is the right thing, when we think it's the right thing….If you go down that road, where do you stop?"

We must also challenge the premise that interest rate movements will sway the election. No cut before November would be a sign of economic strength, but also persistent inflation risk. A marginal reduction, while consistent with an optimal soft landing, would still leave rates much higher than they were at the start of Biden's term. Rapid cuts would only accompany a crisis.

We will have more to say about key policy issues as the election draws nearer, but we do not expect the Fed's independence to be one of them.

Currency Capital

I think that if I didn't have bad luck, I would have no luck at all. Every time I travel internationally, the U.S. dollar depreciates against the currencies of the countries I will be visiting. At times, the cost of a light breakfast exceeds the daily meal allowance in our expense system.

I have an overseas trip coming up, but it looks like my fortunes may change. The U.S. dollar has been on quite a run this year, gaining ground against a broad range of its rivals. This development is easy to understand at one level, but surprising at another.

The American economy has been the best performer among major developed markets for well over a year. Growth continues to be fueled by consumers, who are enjoying sizeable real wage gains and appreciation of their investments. Government spending in the United States is escalating at a much faster pace than is the case in other nations, adding to aggregate demand.

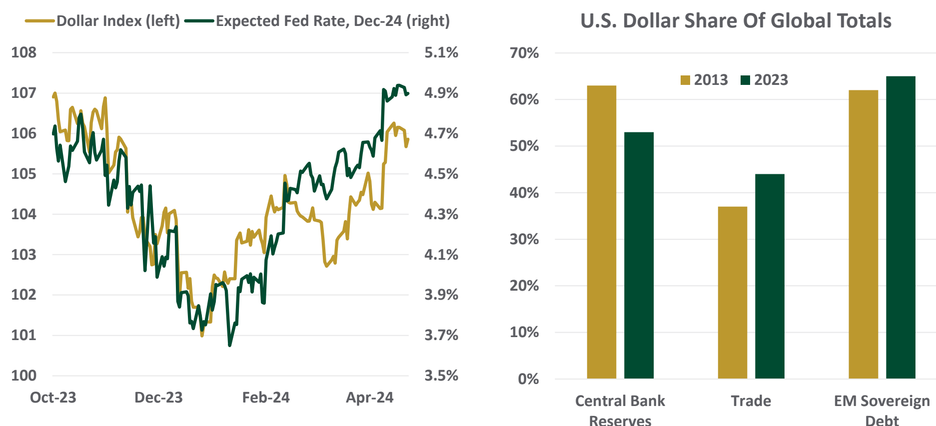
Capital is also flowing into the U.S. Equity markets have gained, led by a technology sector which is leading innovation. And yields on Treasury securities remain very attractive, especially after increasing in the wake of revised expectations of Fed policy. Interest rate differentials between markets can be a catalyst for inbound investing, which requires trading into the U.S. dollar.

While beneficial to America (and its outbound business travelers), recent developments in the foreign exchange market have been problematic for a number of other countries. The prices of many essential commodities, including oil, are denominated in dollars; the strength of the dollar raises import costs abroad. Debt repayments on dollar-denominated borrowing have become more taxing for some emerging markets.

Preserving the strength of local currencies has led overseas central banks to keep rates higher than they would prefer, even though local inflation is benign. Economic performance in those areas

is therefore at some risk. Countries with adequate reserves have been forced to intervene actively to keep their currencies from depreciating; China has been defending the yuan for some time now, and Japan likely intervened this week after the yen hit a 34-year low.

In these latter two cases, local authorities were probably anxious to dispel notions that they welcomed a weaker exchange rate. In recent decades, China and Japan have occasionally been accused of improving their terms of trade by steering their currencies lower; this risks retribution (often in the form of tariffs) from their export partners. In the present day, however, the realignment seems attributable to natural market forces and not intervention.



Sources: Bloomberg, Morgan Stanley

Despite a troubling debt outlook, the U.S. dollar still reigns supreme.

While the dollar's improvement is consistent with economic fundamentals, it is somewhat surprising when viewed in a broader context. The United States is dealing with a significant long-term debt problem and a disappointing lack of resolve in addressing it. The use of economic sanctions to punish bad actors has led some countries to dissociate themselves from the dollar and the financial systems centered around it. The development of digital currencies allows transacting without foreign exchange conversion, which also serves to take the edge off dollar dominance.

In spite of all this, the U.S. dollar remains the world leader by a wide margin. Its shares of central bank reserves, trade transactions and non-native debt issuance remain substantial, topping its nearest competitors by a wide margin. This may have more to do with weakness among alternatives, as opposed to unquestioned strength of the dollar. For better or worse, currencies are graded on a curve, and the dollar is still the best relative brand.

The head of Northern Trust's foreign exchange department visited me last year, and asked if I could keep him current on my travel schedule. Ever since, his group has enjoyed unusual success advising clients to take long positions in the currencies of the countries I visit. I've asked for a share of the fees, but so far, no luck.

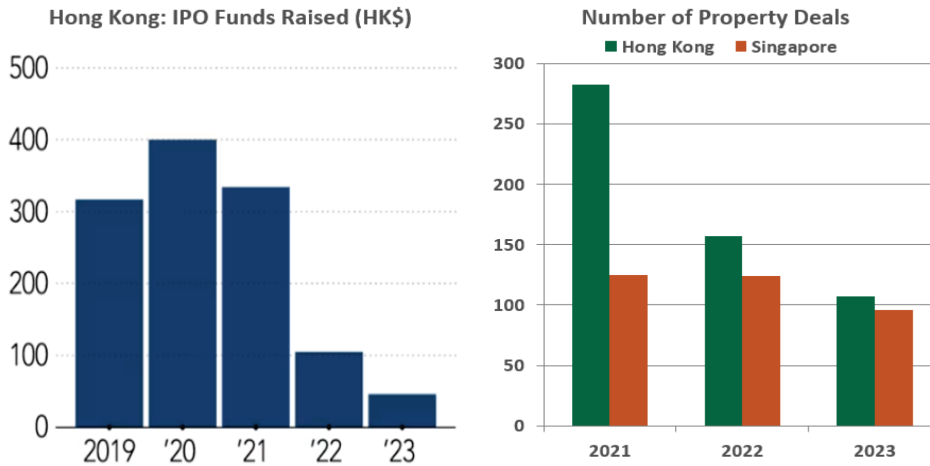
A Better Tomorrow?

I have never journeyed to Hong Kong, but I have seen movies which are set there. The neon-soaked streetscapes in the films reflect the shining heritage of the city. But the once-famous glow has faded in recent years. So too has the excitement surrounding Hong Kong's economy.

Hong Kong has been struggling to get back on its feet since the pandemic. Real gross domestic product (GDP) is lower than it was five years ago. Inbound tourism remains depressed. Demand for offices has slumped; property values have fallen by about 25% since the 2019 peak.

Hong Kong's equity market has been stumbling, with the Hang Seng Index posting the worst performance among Asian exchanges in 2023. The index has generated negative returns for four straight years and lost close to 50% of its value in the past three years. Fundraising activity dropped to a two-decade low in 2023. The number of delistings is also on the rise. These trends could jeopardize Hong Kong's standing as an international financial center.

Hong Kong's struggles are linked to that of mainland China's, owing to close economic ties. Mainland companies account for a little over two-thirds of the Hong Kong stock exchange's market capitalization and over 90% of new listings (in 2023). Beijing's economic slowdown and geopolitical tensions with the U.S. have contributed to the underperformance of the city and the shift in investor sentiment. High interest rates have also weighed on the fundraising environment.



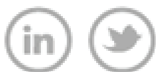
Sources: Nikkei, PwC, Bloomberg

Close ties to Beijing, which helped Hong Kong advance, have created concerns among Westerners.

Nevertheless, Hong Kong remains a leading global financial center, and not just for Chinese businesses. The city is home to a large concentration of global fund managers, advisory businesses and private banks. A total of 2,600 Japanese and American firms have a presence in the city, against 2,100 Chinese businesses. Hong Kong is the world's largest clearing center for the yuan outside of the mainland, processing close to two-thirds of cross-border yuan payments. The city does not have any foreign exchange or capital controls, thus allowing investment to flow in or out without any restrictions.

So while the glow of Hong Kong's markets has certainly dimmed in recent years, the lights will not go off anytime soon.

northerntrust.com



@NT_CTannenbaum

Information is not intended to be and should not be construed as an offer, solicitation or recommendation with respect to any transaction and should not be treated as legal advice, investment advice or tax advice. Under no circumstances should you rely upon this information as a substitute for obtaining specific legal or tax advice from your own professional legal or tax advisors. Information is subject to change based on market or other conditions and is not intended to influence your investment decisions.

© 2024 Northern Trust Corporation. Head Office: 50 South La Salle Street, Chicago, Illinois 60603 U.S.A. Incorporated with limited liability in the U.S. Products and services provided by subsidiaries of Northern Trust Corporation may vary in different markets and are offered in accordance with local regulation. For legal and regulatory information about individual market offices, visit northerntrust.com/terms-and-conditions.