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TRENDMACRO LIVE!

On the July FOMC

Wednesday, July 27, 2016

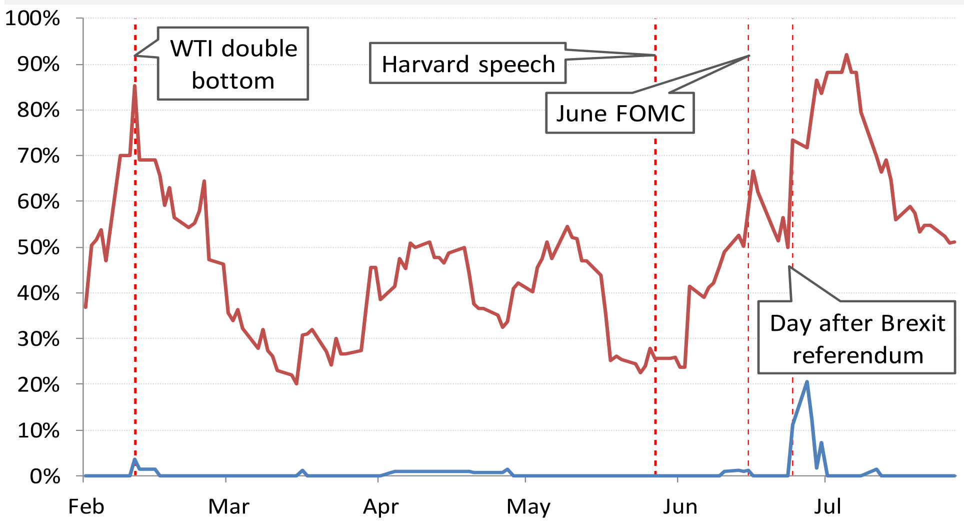
Donald Luskin

"Risk" has "diminished," but "uncertainty" rules post-Brexit and pre-election. No hikes.

The FOMC added this sentence to today's FOMC statement: "Near-term risks to the economic outlook have diminished." Sigh. Now we suppose we will have to go back to acting as though another rate hike is imminent, and treat every FOMC as a close call. But we don't buy it.

As recently as early June, Fed cheerleader Goldman Sachs was still calling July a "live meeting." But coming into today's FOMC, there was a market-implied only a 48% probability of a hike at the December meeting – barely "live" and still five months out. As recently as a month ago, even that had come completely off the table after the Brexit referendum surprise. Indeed in the immediate aftermath (see "On the Brexit Referendum" June 24, 2016), there was a market-implied 20% probability of a rate *cut* at the December FOMC (please see the chart below).

Futures-implied probability Dec FOMC — No funds rate change — Cut



Source: Bloomberg, TrendMacro calculations

- Okay, blame Brexit for that. And now, according to that new sentence in today's statement, that risk is gone? Sorry, but it's not that simple.

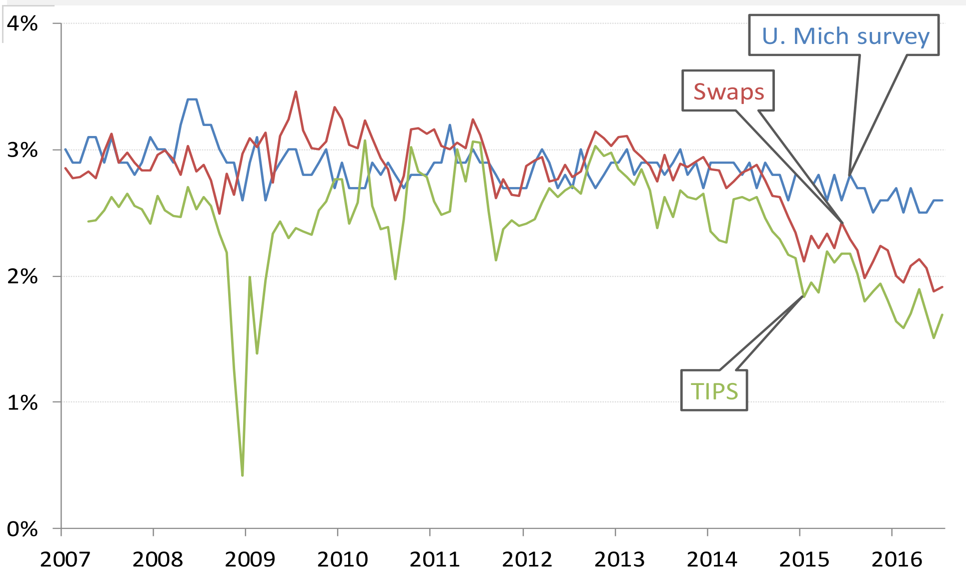
Update to strategic view

US FED: Today's FOMC statement says "risks to the economic outlook have diminished." Yet the Brexit referendum surprise and global markets' schizophrenic reaction to it is a perfect case of the "uncertainty" that Yellen says now informs her thinking. And November's presidential election only heaps it on. The statement's recital of economic conditions only underscores the prevailing uncertainty. But this is only a sideshow – a rate hike any time soon should not be seen as a close call, subject to mere uncertainty. Long-term inflation expectations continue to be at or near the lowest in the history of the data, so uncertainty or not, there is no case for a rate hike. We reiterate our long-standing call for no more rate hikes until December at the very soonest, and probably not even then. If anything, as Japan's flirtation with "helicopter money" suggests, the case potentially to be made is for some form of easing.

[Strategy dashboard]

- That new sentence fits into the dominant narrative which seems to be that the Fed "missed its chance" to hike rates a year or so ago, and now must seize the soonest opportunity to do so. That means December's disastrous "liftoff" must have only been a mistake of bad timing – conceptually, though, it was a good idea. But why? We don't see why hiking rates – or "normalization" as its advocates prejudicially call it – should be seen as a consummation devoutly to be wished, for which a "chance" must be not "missed."
- Why would the Fed even consider hiking rates when long-term steady-state inflation expectations – market-implied and survey-implied – are at or near the lowest in the history of the data (please see the chart below)? Surely the Fed should take this as assurance that there is no threat of an inflationary breakout (so why hike?), or indeed as evidence that expectations are becoming dangerously unanchored to the downside (maybe we should cut instead?).

Long-term steady-state inflation expectations



Source: Bloomberg, TrendMacro calculations

- The Fed used to justify turning a blind eye to this fact by claiming that these expectations were biased downward by very low energy prices. But as inflation expectations continued to fall – even as the oil price doubled over four months from its February bottom – the Fed had to recant that silly excuse in the minutes of the June FOMC meeting.
- If anything, in light of this evidence, the Fed ought to be thinking about ways to *ease* policy, not tighten it – as has been hinted in Japan, where inflation expectations have in fact become unanchored on the downside (see "On Bernanke's Helicopter Money for Japan" July 14, 2016).
- To be sure, the Fed remains captured by the Phillips Curve paradigm that low unemployment causes consumer inflation – even though there are no market-based expectations for dangerously higher inflation, and even though the Phillips Curve theory has

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failed to prove out across decades of actual data (see "One Small Step -- In the Wrong Direction" November 23, 2015).

- *But however twisted up the Fed has gotten in discredited theories, Chair Janet Yellen has a no-fault excuse all limbered up – which will allow her to do nothing until there really is some reason to do something*. In March, in a notable speech (and an increasingly rare one, for a Fed chair who usually can't shut up), she enshrined "uncertainty" as the watchword for her Fed (see "Yellen Adds 'Uncertainty'" March 30, 2016).
- So now, no matter what she's said in the past to justify last December's disastrous "lift off" and no matter what she's hinted about this year with respect to upcoming hikes (see "For the Fed, Wrong is Better than Stupid" May 31, 2016), all she has to do now is say, "So I realize that the 'data' which this 'data-dependent' Fed is 'dependent' on says we should be 'normalizing' based on all our past theorizing – but there's too much 'uncertainty' to do that."
- But the Brexit surprise – and moreover global markets' schizophrenic reaction to it (see "Brexit: Who Won, Who Lost, What's Next?" July 11, 2016) – makes Yellen seem very right to be focusing on uncertainty. And Janet Yellen is a Fed chair who very much needs to be right – and much more needs *not* to be wrong (see, among others, "Yellen and Screamin' at the Fed" December 5, 2013).
- To be sure, today's new sentence about "risks" having "diminished" is a way of saying that Yellen is, marginally, less uncertain now than she was at the last FOMC.
- *But the great thing for Yellen about her new "uncertainty" doctrine is that while she has to be more humble than she might prefer, at least she can never be made wrong by waiting*.

Other than that new sentence about "risks to the economic outlook" in today's FOMC statement, the text is only changed from last month's by way of updates on economic conditions (for a full red-line comparison, see "Data Insights: Federal Reserve" July 27, 2016).

- Last month, following May's terrible jobs report (see "On the May Jobs Report" June 3, 2016), the statement had declared flatly that "the pace of improvement in the labor market has slowed." Now, after a better June jobs report (see "On the June Jobs Report" July 8, 2016) – in which the revisions to May only made that disaster worse – today's FOMC timidly says, "Job gains were strong in June following weak growth in May. On balance, payrolls and other labor market indicators point to some increase in labor utilization in recent months."
- That's damning the labor market with faint praise. It sounds to us like a case for continued "uncertainty."
- At the last meeting, household spending had "strengthened," and today it has been upgraded to "growing strongly." But last meeting's "but" remains: "but business fixed investment has been soft."
- That's a two-handed economist if we've ever seen one. It sounds to us like a case for continued "uncertainty."

- Last meeting's statement that "the housing sector has continued to improve" was eliminated today. The subject of housing is simply not mentioned. Odd – housing, by our reckoning, is a bright-spot coming out of the mini-recession of Q4-2015 and Q1-2016 (see "Data Insights: A Few of Our Favorite Things" July 27, 2016).
- That's a curious omission. It sounds to us like a case for continued "uncertainty."
- And what about those scary-low long-term inflation expectations? Last meeting's statement noted they had "declined." Today's statement says they "remain low." True enough, if "remain low" means "thank God they haven't gotten any worse."
- That's pure spin. It sounds to us like a case for continued "uncertainty."

In the immediate wake of today's statement, as of this writing, there hasn't been a great deal of market reaction. Perhaps most significant, the market-implied probability of a December hike has fallen from 48% to 46%. So at least directionally, that new sentence about "risks" having "diminished" doesn't really change the reality of Yellen's "uncertainty" doctrine.

Oh, and did we mention that an election is coming up (see "Will Yellen Get Trumped?" February 11, 2016)?

- We reiterate our long-standing call for no more rate hikes until December at the very soonest, and probably not even then.

Bottom line

Today's FOMC statement says "risks to the economic outlook have diminished." Yet the Brexit referendum surprise and global markets' schizophrenic reaction to it is a perfect case of the "uncertainty" that Yellen says now informs her thinking. And November's presidential election only heaps it on. The statement's recital of economic conditions only underscores the prevailing uncertainty. But this is only a sideshow – a rate hike any time soon should not be seen as a close call, subject to mere uncertainty. Long-term inflation expectations continue to be at or near the lowest in the history of the data, so uncertainty or not, there is no case for a rate hike. We reiterate our long-standing call for no more rate hikes until December at the very soonest, and probably not even then. If anything, as Japan's flirtation with "helicopter money" suggests, the case potentially to be made is for some form of easing.