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FED SHADOW

Chairman Powell, You Have Just Been Hazed

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Donald Luskin

Markets are punishing him for his rank amateurishness, but he showed he's no hawk.

Press accounts and Wall Street instant analysis would have us believe that yesterday's 14-handle rally in the S&P 500 after the release or the January FOMC minutes – followed by a 47-handle whipsaw decline into the close (and another 16-handle drop overnight) – is because they showed the Fed's "growing confidence in the U.S. economy… bolstering their plans to continue raising short-term interest rates as soon as next month." But all that was known three weeks ago from January FOMC statement itself.

- No, this is a painful initiation ritual for Jerome Powell into the fraternity of Fed chairs. His paddled bottom will be sore for weeks, or until he gives a better explanation than yesterday's for why the seemingly hawkish word "further" was inserted into the FOMC's long-standing rate hike guidance at the January meeting (see "Data Insights: Federal Reserve" January 31, 2018).
- *We said at the time that the stock market correction underway then was triggered by this*, and that it "will likely continue while this gets processed and contextualized" (see "On the January FOMC" January 31, 2018). Obviously we didn't anticipate it would turn into a high-velocity VIX-driven cataclysm (see "Inside the VIX Engine of Destruction" February 8, 2018), but that's where it started. So surely every Fed-watcher in the world feverishly word-searched the minutes yesterday, the moment they were released, examining each of the 28 instances of the word "further" to see how Powell shaped the minutes to handle this (see "Data Insights: FOMC Minutes" February 22, 2018). To be sure, that word was former chair Janet Yellen's handiwork – but nevertheless it was up to Powell to use the minutes to clean up after her.

- *Sadly, being a lawyer by training, perhaps he thought he could get away with this cascade of repetitious newspeak:*

  "Members expected that economic conditions would evolve in a manner that would warrant further gradual increases in the federal funds rate. They judged that a gradual approach to raising the target range would sustain the economic expansion and balance the risks to the outlook for inflation and unemployment. Members agreed that the strengthening in the near-term economic outlook increased the likelihood that a gradual upward trajectory of the federal funds rate would be appropriate. They therefore agreed to

Update to strategic view

US FED, US STOCKS, US BONDS: Yellen's last FOMC left Powell with the job of explaining what "further" gradual rate increases means, via yesterday's minutes. He obfuscated rather than explained, but we see him as trying to downplay the hawkish interpretations. And yesterday's yield and TIPS breakeven back-ups imply a more dovish Fed. But rising yields and inflation have become part of the dominant negative narrative for stocks, and it was "further" that started the stock market correction that became a VIX-driven rout. Now Powell's ham-handed debut has re-awakened volatility. He is being punished for his rank amateurishness, but he's shown he's no hawk, albeit clumsily. We think the healing process for stocks that we called for two weeks ago will continue.

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update the characterization of their expectation for the evolution of the federal funds rate in the postmeeting statement to point to 'further gradual increases'..."

- Let us rephrase: *"We agreed again, as we have for more than two years, that gradual rate increases are the way to go. We decided this time we'd call the same old gradual increases 'further' gradual increases. See? Nothing has really changed. Hey everybody, it's just a word!"*
- This seems all the more ham-handed in light of another sentence, earlier in the minutes, using the word "further," which serves to highlight and emphasize the very thing that Powell tries to conceal and trivialize:

"A majority of participants noted that a stronger outlook for economic growth raised the likelihood that further gradual policy firming would be appropriate."

- It's highly unusual for the minutes to speak of a "majority of participants" (the last time was over a year ago), so it's especially emphatic. It is *this* short punchy sentence that showed up in most of the media coverage of the minutes, not the lengthy and incoherent denials.
- *What Powell should have done is shape the minutes to emphasize the FOMC's cognizance of the "neutral rate of interest" – and to be clear that "further" previously unexpected improvement in it would drive "further" previously unexpected gradual rate increases, in order to keep policy neutral, where it is now* (see "Bull Market, Meet Your New Fed" January 29, 2018).
- *Hopefully he'll say something like that next week at his first congressional testimony.*
- *That would thwart all the "good news is bad news" fears triggering so much volatility – because it would make clear that the Fed would not be tightening just because it hiked rates, provided that the hikes were indexed to a rising neutral rate of interest, itself indexed to improving growth and inflation.*
- This framework may have started out as only our voice in the wilderness – our lone interpretation of a few speeches by former chair Yellen and former vice chair Stanley Fischer (see, among many, "Yellen's March to Neutrality" March 6, 2017). But it's real, and now it's going mainstream. Yesterday morning even a plain-vanilla Bloomberg roundup piece speculated that the minutes would show that "policy makers…discussed increasing their estimate of the neutral interest rate – a theoretical level that neither speeds up nor slows down the economy – in light of new U.S. fiscal stimulus."
- There is, in fact, a passage in the minutes that touches on this:

"Some participants also commented on the likely evolution of the neutral federal funds rate. …it was expected to rise slowly over time toward its longer-run level. However… [it] might move up more

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Recommended Reading

Solving the Productivity Puzzle: The Role of Demand and The Promise of Digitization
Jaana Remes, James Manyika, Jacques Bughin, Jonathan Woetzel, Jan Mischke, and Mekala Krishnan
McKinsey Global Institute
February 2018

The Minimal Persuasive Effects of Campaign Contact in General Elections: Evidence from 49 Field Experiments
Joshua Kalla and David E. Broockman
Stanford University Graduate School of Business Research Paper No. 17-65
October 19, 2017

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than anticipated as the global economy strengthened."

- But that barely begins to establish Powell's continuity on this key point. We'd like to think that a sadder-but-wiser Powell will do it definitively at the March FOMC, his first as chair. This will be confirmed when we see a slight uptick in the "dot plot" for the "longer-run" funds rate in the March FOMC's Summary of Economic Projections, and hear his explanation at the postmeeting press conference.
- *Nevertheless, what we take away from all this is that Powell is no hawk. He is surely a rank amateur. But no hawk.*
- *After all, while excellence of execution leaves much to be desired, he did try to defuse the hawkish signaling properties of the word "further."*

It's not easy to infer what markets took from all this, except for what they knew all along – that Powell is rookie.

- We don't accept that the back-up in the 10-year Treasury yield a half hour after the minutes were released indicates expectations of a more hawkish Fed. To be sure, that's the conventional wisdom – but it's not ours. We see the nominal 10-year yield as consisting of a "growth component" – the real yield – and an "inflation component" – the TIPS spread, and both components backed up yesterday. *A hawkish Fed diminishes both growth and inflation expectations – and thus makes nominal yields lower, not higher.*
- By our logic, stocks should have gone up and stayed up yesterday. We don't have a good story for why they didn't, except that for the moment the dominant narrative seems to be that rising long-term yields and inflation – even if they are linked to faster growth – are a threat to stocks, growth and seemingly life itself. We don't agree (see "Inflation Fears are Over-Inflated" February 15, 2018).
- *We continue to believe that reflation is a good thing* (see "It's Just the Reflation Trade, People!" February 5, 2018). *That seemed clear enough to markets in December, when everyone was worrying about the flattening yield curve and hoping for a little reflation.*
- *But "further" was the starting point for the intense bout of volatility experienced by equity markets in February, and Powell's fumbled minutes have reawakened it. We don't think there's any substance to the whole "further" thing – so we expect markets will process this, and the healing process we called for two weeks ago* (see "Inside the VIX Engine of Destruction") *will continue. Further.*

Bottom line

Yellen's last FOMC left Powell with the job of explaining what "further" gradual rate increases means, via yesterday's minutes. He obfuscated rather than explained, but we see him as trying to downplay the hawkish interpretations. And yesterday's yield and TIPS breakeven back-ups imply a more dovish Fed. But rising yields and inflation have become part of the dominant negative narrative for stocks, and it was "further" that started the stock market correction that became a VIX-driven rout. Now Powell's ham-handed debut has re-awakened volatility. He is being punished for his rank amateurishness, but he's shown he's no hawk, albeit clumsily. We think the healing process for stocks that we called for two weeks ago will continue.