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FED SHADOW

It's Not "Quantitative Tightening" – It's Powell

Thursday, December 20, 2018

Donald Luskin

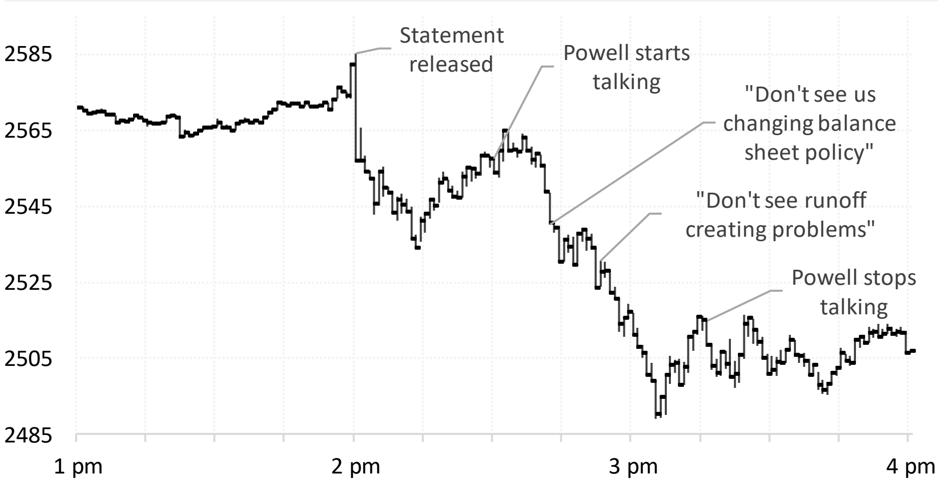
He's gone rogue and lost the market's confidence. One way or the other, he's got to go.

In the aftermath of yesterday's disastrous FOMC meeting and press conference (see "On the December FOMC" December 19, 2018) a narrative has quickly emerged that the problem is that Chair Jerome Powell didn't indicate the Fed would slow or halt the run-off of long-term assets from its balance sheet – a gradual normalization process that has come to be feared, wrongly we think, as "quantitative tightening."

We saw one account that links Wednesday's stock market sell-off to the moment in the post-meeting press conference when Powell indicated that the balance sheet run-off would continue. But make no mistake about it: *stocks sold off hard the instant the FOMC statement was released at 2:00 pm*, with the S&P 500 falling 52 handles in just 13 minutes. There was a brief 20-handle rally from there, but *stocks started falling again almost the minute Powell's press conference began at 2:30 pm. Yes, stocks fell the two times he talked about the balance sheet – but that's only because they fell continuously at everything he said on every subject*. At the worst, the S&P was off 97 handles from where it had been about an hour earlier (please see the chart below).

From first principles, we don't see how Powell's failure to become more dovish on balance sheet normalization could have shocked markets so

S&P 500 and the December 19 FOMC



Source: Bloomberg, TrendMacro calculations

Update to strategic view

US FED: After yesterday's FOMC a narrative has developed that markets were reacting to Powell's failure to talk about scaling back so-called "quantitative tightening." The doesn't square with the timing of the stock market's fall after the statement was released and during the press conference. The problem is that Powell mismanaged expectations for forward guidance, knowingly disappointed those expectations, and showed a careless and superficial demeanor. Having been appointed as a non-independent Fed chair, he seems to have gone rogue, just as Sessions did in analogous circumstances. Otherwise Trump wouldn't have to try so hard to rein Powell in. Like Carter had to get rid of Miller, Trump now must find a finesse to get rid of Powell.

[Strategy dashboard]

much. Yes, the subject of quantitative tightening is of great concern to investors – indeed, it comes up very frequently in client conversations. *But coming into this FOMC, there had been no signaling whatsoever that balance sheet policy would be subject to adjustment, or even special scrutiny, at this particular meeting. Failure to deal with it just wasn't a surprise – so how could it move markets?*

- No, we're sticking with our original analysis that the surprise – the disappointment – is that the FOMC didn't more robustly honor the strongly implicit promise made in the minutes of the November meeting (see "Data Insights: FOMC Minutes" November 29, 2018): to deliver in December a "dovish hike," assuring markets that recent signs of disinflation and global macro risk would cause the FOMC to be extra-cautious before making any further rate hikes.
- *If there's more to it than just the risk that the Fed is bull-headedly blundering into further "gradual" rate hikes no matter what the risk, it's the inability of Powell to manage expectations, stick to his commitments and instill confidence.* Some clients had feared that no hike at all yesterday would dangerously signal the Fed's lack of confidence in the economy, but just the opposite happened. *With a hike that showed the Fed's excessive confidence in the economy, confidence in the Fed itself was undermined.*
- No, it's worse than that. It's Powell's demeanor and choice of words, and what that says about him as a person whom we have trusted with great responsibilities. We noted yesterday that he seemed nervous and hurried (again, see "On the December FOMC"). Yet at the same time he affected a rather forced briskness, chirpy and inappropriately casual given the matters at hand – leaving you not quite sure whether his seeming superficiality means he doesn't respect your intelligence enough to go into more depth, or whether he himself lacks the intelligence to take it any deeper. We never thought we'd miss Janet Yellen's sing-song preachiness, but we do.
- In response to questions about the balance sheet run-off, he spoke almost gaily – "it's on auto-pilot… we don't see it causing any problems…" and so on. *"Auto-pilot"? Really? You mean it doesn't even need to be monitored?*
- Perhaps oddly, we actually agree with Powell on the policy fundamentals here. We see QE as having been nothing more than a vast fixed-for-floating swap designed to reduce private-sector risk aversion at a time when that desperately needed to be done (please see the chart on the following page, and "Is the Fed Moving the Stock Market?" March 11, 2013). But risk-tolerance has substantially revived, and now we don't see this glacially-paced run-off causing any problems either, except perhaps that fear of it could become something of a self-fulfilling prophecy. *But "auto-pilot"? Seriously?*

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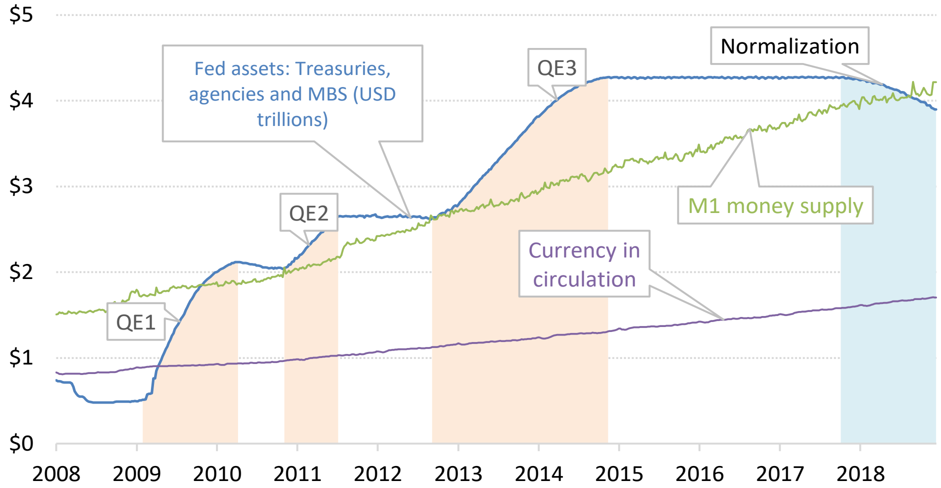
Fed quantitative easing: accumulation and normalization USD trillions



Source: Federal Reserve Board, TrendMacro calculations

- Surely Ben Bernanke or Yellen would have said that the Fed stands ready to review, revise, or even reverse its balance sheet policy at any time should the need arise. And they would have admitted that the run-off is a learning-by-doing experience that requires constant caution and scrutiny. They would have said that the ultimate terminal point of the run-off will be at a time and at a level that can't be predicted yet, because we don't yet know the quantity of assets that will be required for effective conduct of policy (our guess is about $2.5 trillion at mid-2023). All that is in the Fed's normalization policy. It doesn't take a genius.
- We're not just nit-picking about Powell's choice of words. It goes much deeper than that. *What happened began before Powell opened his mouth yesterday. His FOMC horribly mis-managed market expectations. It then knowingly disappointed those mis-managed expectations, and then he took absolutely no responsibility for any of it.* That is a deep blow to confidence in an institution for whom confidence is by far the most important asset.
- The issue of confidence attaches also to the question of whether Powell's decision yesterday was influenced by President Donald Trump's very public campaign to make the Fed more dovish.
- Like many of Trump's initiatives, on the one hand it is important to think separately about (1) whether it is appropriate for Trump to comment so aggressively and (2) whether, even if it is not, Trump is nevertheless right. In this case, propriety notwithstanding, we think Trump is right (see "Like It or Not, Trump is Right about the Fed" July 20, 2018). But on the other hand, the matter of propriety has consequences, whether or not Trump is right. In this case, many clients tell us they fear that Trump's hectoring forced Powell to be wrongly hawkish simply to demonstrate his independence.
- We shouldn't have to be worrying about this. A truly independent Fed chair would simply disregard Trump. He would not cave to Trump's demands if they prevented him from doing his duty as he sees it. But nor would he do the opposite of what Trump demands

simply to demonstrate his independence – a truly independent man has no need to demonstrate anything.

- *But we do have to worry about this because, as we have said from the very beginning, Powell was appointed to be Fed chair over several far more qualified candidates precisely because he agreed that he would not be politically independent* (see "Bull Market, Meet Your New Fed" January 29, 2018). That makes him not only the first non-economist to be Fed chair since G. William Miller during the Carter administration, but also the first since Miller to not be politically independent.
- *The mystery, then – and the worry – is why Trump has had to go to such lengths to try to rein in a Fed chair who was not supposed to be independent.* We have to assume that, perhaps like Jeff Sessions as attorney general, Powell turned out to be more independent than promised (another case of mis-managing expectations, disappointing them, and then accepting no responsibility). Trump may have to learn the lesson that while hacks may seem to have their utility, they cannot be trusted. In this case, we have to assume that Treasury Secretary Steven Mnuchin probably at some point made Trump's wishes known to Powell, perhaps over one of their regular lunches, and Powell said "no." So the tweets began. The particulars are total speculation, but here we are.
- *Let us take no comfort that Powell has turned out to be more independent than we thought. Independence is a virtue only in honest men. In the case of a man who promises not to be independent, and then decides to become independent nevertheless, a better word would be "rogue."*
- Jimmy Carter ended up quickly fixing his blunder in having picked Miller for Fed chair by promoting him to Treasury secretary. Maybe the finesse here is for Trump to fire Robert Mueller and name Powell special counsel.
- We've been hard on Powell (see "Warsh the Reformer, Powell the Plodder" October 3, 2017), but we also tried to see the best in him (see "On Powell's Debut at Jackson Hole" August 24, 2018). But after yesterday, *one way or another, he's got to go.*

Bottom line

After yesterday's FOMC a narrative has developed that markets were reacting to Powell's failure to talk about scaling back so-called "quantitative tightening." The doesn't square with the timing of the stock market's fall after the statement was released and during the press conference. The problem is that Powell mismanaged expectations for forward guidance, knowingly disappointed those expectations, and showed a careless and superficial demeanor. Having been appointed as a non-independent Fed chair, he seems to have gone rogue, just as Sessions did in analogous circumstances. Otherwise Trump wouldn't have to try so hard to rein Powell in. Like Carter had to get rid of Miller, Trump now must find a finesse to get rid of Powell.