Trend Macro™

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TRENDMACRO LIVE!

On the January FOMC

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Promises kept. A dovish pause with "patience," and the balance sheet off "automatic pilot."

Fed Chair Jerome Powell has pulled out of his career-long slump. As of this writing, today looks like it will be the only Powell FOMC day ever on which the stock market was up. Prior to this, he's been a seven-for-seven loser, and the cumulative S&P 500 loss over Powell's seven FOMCs has been 3.41%. If we include the day he took office, the day of the release of the first meeting minutes for which he was responsible, the day he gave his first Congressional testimony and the day he made his first speech, the cumulative loss is 11.03%. *Without Powell, US stocks would have had a positive year in 2018.*

- Today's FOMC statement more than made up for the sin of December's, which had failed to fulfill the covenant promised in the minutes of the November meeting (see "Data Insights: FOMC Minutes" November 29, 2018), that is, to shift to a cautious and data-dependent outlook on future rate hikes. The December FOMC didn't deliver a widely expected "dovish hike" – and now today's delivers a dovish pause.
- *Critically, all the December (and prior-meeting) language about "further gradual increases" is completely gone* (see "Data Insights: Federal Reserve" January 30, 2019). *It's a pure pause. As we expected, the statement has officially enshrined the watchword of Powell's post-December apology tour: "patient"* (see "Next Stop on the Jay Powell Apology Tour" January 28, 2019).
- In today's post-meeting press conference, Powell was asked what it would take to end his "patient" stance and drive another rate hike. His answer was simple and sensible: "I would want to see a need for further rate hikes" – implying there is no *need* right now. He went on to say that among other possibilities, an unwelcome rise in inflation would constitute a "need."
- At the same time, the FOMC released an entirely separate document titled "Statement Regarding Monetary Policy Implementation and Balance Sheet Normalization." As we expected, it stated that the primary purpose of the balance sheet was simply to enable control of the target funds rate range. This calls for an "ample" level of reserves, but rules out requiring the level of reserves having to be "actively managed" for its own sake (again, see "Next Stop on the Jay Powell Apology Tour").
- *We think "ample" is a code-word designed to indicate to the market that the size of the Fed's balance sheet will be larger than*

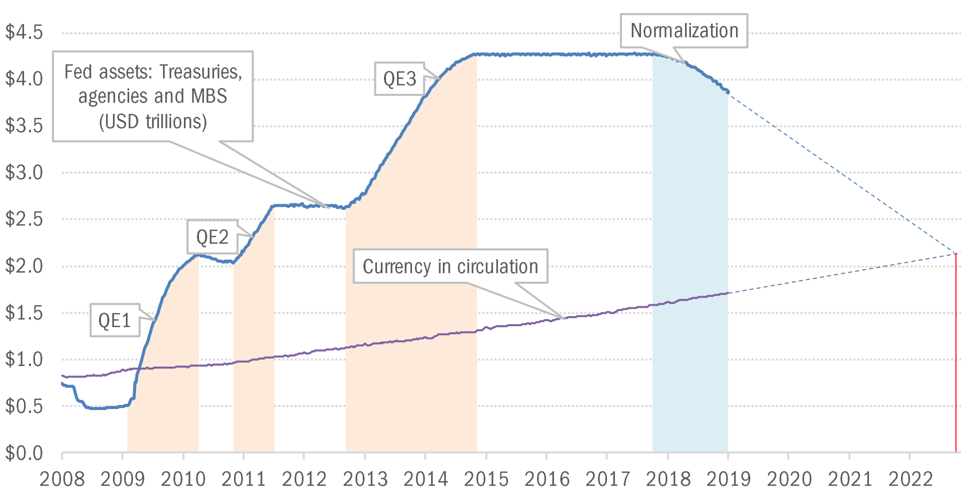
Update to strategic view

US FED, US MACRO, US STOCKS, US BONDS: The removal of any mention of "gradual further increases" in the FOMC statement, and the enshrinement of the buzzword "patient," fully make up for the failure at the December FOMC to deliver the promised "dovish hike." We now have a dovish pause. In the press conference, Powell clarified that the next hike will be when it is "needed," with an unwelcome rise in inflation offered as the only factor that would constitute need. A separate statement indicated that the balance sheet would be larger than expected, but not actively managed. Yet the Fed stands ready to use it again in an emergency. Powell amplified on that in the press conference,but avoided premature commitment to exact parameters. This evidence that Powell can listen to markets, and be more articulate about policy, removes a substantial risk, justifying the first-ever Powell FOMC day on which stocks posted gains. When the bond markets grasp that these policies are pro-growth and pro-inflation, 10-year yields should rise.

previously expected – precisely what the report published mid-day Friday in the *Wall Street Journal* (which we believe was planted by Powell himself) – indicated the FOMC would say (again, see "Next Stop on the Jay Powell Apology Tour").

- Indeed, in the prepared remarks in today's post-meeting press conference, Powell amplified on the written statement to indicate explicitly that, in the post-crisis environment, the level of reserves demanded by the liquidity needs of the banking system are higher than typically thought as recently as a year ago. This is Powell walking back his prior story, spoken just two weeks ago in an interview in Washington, that the size of the balance sheet ought to be about the same level as the value of currency outstanding, which suggests drawing down to about $2.1 trillion by the end of 2022 (please see the chart below, and sorry, but yet again, see "Next Stop on the Jay Powell Apology Tour").

History and projected path of Federal Reserve LSAPs (large-scale asset purchases)



Source: Federal Reserve Board, Bloomberg, TrendMacro calculations

- But at the same time, *the statement was clear that the balance sheet is anything but "on automatic pilot," and could, if necessary, be used as a direct policy instrument*. It states:

  "The Committee is prepared to adjust any of the details for completing balance sheet normalization in light of economic and financial developments. Moreover, the Committee would be prepared to use its full range of tools, including altering the size and composition of its balance sheet, if future economic conditions were to warrant a more accommodative monetary policy than can be achieved solely by reducing the federal funds rate."

- *We see this as a minimalist position on a complex subject about which there will likely be more learning and more debate with the FOMC and with the Fed staff. We are also delighted to say that Powell did a perfectly serviceable job amplifying upon this statement in the press conference.*

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[About us]

Recommended Reading

Taxing the Rich Is an Idea Whose Time Has Come — and Gone
Stephen Mihm
Bloomberg
January 29, 2019

Is Jerome Powell The Most Hated Fed Chairperson Ever?
Rob Hanna
Quantifiable Edges
January 27, 2019

A Tiny Screw Shows Why iPhones Won't Be 'Assembled in U.S.A.'
Jack Nicas
New York Times
January 28, 2019

[Reading home]

- He was asked many questions to pin him down further as to the eventual size of the balance sheet, and the pace of normalization. He generally deflected them.
- *Significantly, Nick Timiraos, the author of the planted* Journal *story, asked the single most important question, and we don't rule out that it, too, was planted. Timiraos asked Powell to talk about the sector-structure (Treasuries versus MBS) and the maturity structure (long-term versus short-term) of the larger-than-expected balance sheet. This is exactly the right question: in our view, size doesn't matter: what counts is the quantum of duration risk and credit risk that the Fed takes out of the private sector and puts on its own balance sheet.*
- *It was the right question, and Powell had the right answer: no answer at all. He said he couldn't second-guess the FOMC's and the staff's decision process. This is the right answer because one should neither prejudice a future decision, nor pretend a decision has been made when it hasn't. And most important: Powell signaled with his non-answer that he recognizes the importance of this element of policy – and assured markets that it is very much not "on automatic pilot."*

We think Powell made all the right policy moves today.

- It's right for the Fed to be "patient." Would you rather it was "impatient"?
- Why should the Fed not "wait and see," as Powell put it? Is there anything gained by having Powell second-guess himself and make unjustifiable policy forecasts in an uncertain world, which would serve only to be psychological hurdles if, in the future, flexibility were needed?
- Powell pointed only to the one factor that should really matter – inflation – as the one that could change the FOMC's stance.
- Today's statement concerning the balance sheet is entirely sensible. It too should be seen as a prudent "wait and see" stance, offering a sensible framework for future policy details: the need for "ample" reserves to support interest rate targeting, and the need for flexibility in case of emergency.
- *Going forward, the battleground on the balance sheet will be the critical matter of its maturity and sector composition.*
- Once again, the key is that Powell took if off "autopilot."
- *As we expected, today's FOMC has been a risk-on event for equities* (one last time, see "Next Stop on the Jay Powell Apology Tour"). *What seems to be a major step in Powell's rehabilitation removes a very large risk factor that has been hanging over the confidence that growth requires.*
- *The small drop in the 10-year yield, however, is a perverse reaction. We've seen it before as a knee-jerk response – Treasuries sometimes act as though a lower path for the funds rate implies automatically a lower path for long-term yields. But we think that's wrong. A more sensible – and less reflexively hawkish – Powell is good for growth and good for inflation, so it should drive*

yields higher. We suspect it will over the coming days, once the initial quick-take reaction has run its course.

We expect that some clients will be disappointed by Powell today. They have argued to us that the stock market's poor reaction to Powell has had nothing to do with any fault of his. They believe his post-crisis predecessors created an asset-bubble that Powell is expertly deflating without causing an outright crash, in which case reasonably orderly pullbacks in equities in response to him are a vote of confidence, not a danger-signal. So today's decisions might be interpreted as having fearfully caved in – to pressures from the market, or perhaps to the constant hectoring of President Donald J. Trump (see "Trump 1, Powell 0" November 28, 2018).

We believe that Powell did indeed cut a deal with Trump, through Treasury Secretary Steven Mnuchin, on Christmas weekend (see "Did Powell Just Cut a Deal?" December 23, 2018). If that's too speculative for you, then let's just say we think the market – and Trump – got Powell's attention, and triggered a great deal of deep thinking that he ostensibly had not done before (see "On Powell in Rehab" January 4, 2019). Now he is "patient" and wants to "wait and see" incoming evidence, and he has put sharper definition to the future shape of the balance sheet – which properly will be a different shape than it would have been if the Fed didn't now pay interest on reserves. *It's a good thing – a feature, not a bug – that he has been able to listen to feedback and profit from it. That he listened to the market does not mean he is now deviating from the path of normalization. He's just gotten better at it*.

Bottom line

The removal of any mention of "gradual further increases" in the FOMC statement, and the enshrinement of the buzzword "patient," fully make up for the failure at the December FOMC to deliver the promised "dovish hike." We now have a dovish pause. In the press conference, Powell clarified that the next hike will be when it is "needed," with an unwelcome rise in inflation offered as the only factor that would constitute need. A separate statement indicated that the balance sheet would be larger than expected, but not actively managed. Yet the Fed stands ready to use it again in an emergency. Powell amplified on that in the press conference, but avoided premature commitment to exact parameters. This evidence that Powell can listen to markets, and be more articulate about policy, removes a substantial risk, justifying the first-ever Powell FOMC day on which stocks posted gains. When the bond markets grasp that these policies are pro-growth and pro-inflation, 10-year yields should rise.