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MACROSCOSM

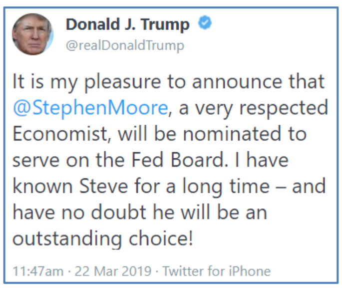
The Curve Inverts, and a "Growth Hawk" for the Fed

Monday, March 25, 2019

Donald Luskin

Maybe there'd be no inversion at all if Trump had picked Moore instead of Powell.

FIRST, ABOUT STEVE MOORE When we met several weeks ago in the White House with our friend Larry Kudlow, director of the National Economics Council, he asked if we had any ideas for filling the two open seats on the Federal Reserve Board. *Kudlow's key criterion: the candidate must be committed, above all, to economic growth.* One of our clients, also a good friend, said we should suggest Steve Moore to Kudlow. We can't say Moore is a friend, exactly – more of an acquaintance, or comrade-in-arms on the battlefield of policy and ideas, with whom we have had a number of productive interactions over the years. We were on the verge of emailing Kudlow to suggest Moore, but we paused when we saw his *Wall Street Journal* op-ed, "The Fed Is a Threat to Growth." *This one writing captures everything that is good and everything that is bad about Moore being on the Fed. Yet we know from close sources that it was this op-ed that triggered Trump to interview Moore (whom he already knew well, from the 2016 campaign), and* offer him the job. *The nomination is not official yet, but presumably it is forthcoming.*


Donald J. Trump
@realDonaldTrump

It is my pleasure to announce that @StephenMoore, a very respected Economist, will be nominated to serve on the Fed Board. I have known Steve for a long time – and have no doubt he will be an outstanding choice!

11:47am · 22 Mar 2019 · Twitter for iPhone

- *Dominating everything else, as the op-ed's title indicates, Moore makes growth the transcendent goal of policy. Such an orientation need not sacrifice caution about inflationary consequences of pro-growth monetary policy, because policy with such consequences is not really pro-growth, or at least not in the long-term.* And Moore is correct, in our view, that the Fed under new chair Jerome Powell has been a "threat to growth," as we ourselves have said many times, as has President Donald J. Trump (see, among many, "Trump 1, Powell 0" November 28, 2018).
- *That's good enough. Moore gets our endorsement.*
- But at the same time, Moore's op-ed reveals an intellectual sloppiness that is perfectly acceptable in opinion writing, but lacks sufficient rigor to form the basis of real-world monetary policy decisions, or for that matter, investment strategy. We assume it's primarily for the sake of persuasion, but Moore makes his case with simplistic cause-and-effect arguments that make Fed policy solely responsible for all global financial events. He throws terms like "deflation" around without definition or context, except for some

Update to strategic view

US FED, US MACRO, US BONDS, US STOCKS, ASIA STOCKS, EUROPE MACRO, OIL: Moore is dedicated to growth above all, which overcomes any weaknesses in his long and checkered record as a pundit. Trump is right to pick a new governor who embodies his outlook, which Powell promised and failed to do. The 3-month/10-year Treasury spread inverted on Friday, but the 2-year/10-year has not yet. The 3-mo/10-year has a slightly better track record as a recession indicator, but not much. If the 2/10 inverts, this will be the first cycle in which it did not invert first. Equity markets are contradicting the seeming pessimism of bond markets. Chinese stocks are leading the world, indicating resolution of the US/China trade war. Forward earnings have begun to substantially bounce back. Oil has stabilized and TIPS spreads have recovered. If bonds are looking at a recession, stocks act as though it was only a near-miss. We think the balance of evidence favors the more optimistic view, and that long-term yields are likely to move higher from here.

[Strategy dashboard]

cherry-picked and exaggerated statistics. *He proposes a commodity-based price-rule as a compass for policy. We think something like that is probably a fine idea, and we've been saying so as long as we can remember (indeed, Knut Wicksell said the same thing 120 years ago)* – but Moore's just plain wrong when he claims that such a rule guided former Chair Paul Volcker's decisions.

- *And then there's the problem that, during the Barack Obama presidency, Moore was quite the hawk.* Before former chair Janet Yellen's ill-timed "liftoff" from the zero funds rate – a time of turbulence very much like late 2018, when waiting a little longer can surely now be seen as the wiser course, as we said it would at the time (see, among several, "One Small Step -- In the Wrong Direction" November 23, 2015) – Moore was using unrigorous "bubble" arguments to egg her on toward rate hikes. That was good advice if what you wanted was to weaken the economy under a Democratic president (and indeed Yellen's December 2015 rate hike did so). Not such good advice if your compass is supposed to point to growth. We have to hope that while he's entitled to one kind of view as an opinion writer and political entrepreneur, presumably he would take a different view once he's taken the oath of office as a Fed governor.
- *In an interview Friday, Moore framed himself as a "growth hawk." We understand that to mean that economic growth is his transcendent goal, but that he believes durable growth rests on a platform of "hard money." That's clever branding – and, we think, quite sincere and legitimate – and we expect we'll hear that expression frequently now.*
- Not surprisingly, the media response has been highly critical, calling Moore a "famous idiot" and claiming he was only picked by Trump as part of the president's "feud with the Fed."
- *We assure you that Moore is no idiot. That's Powell.* Powell has no economics training at all (the highlight of his educational resume is Georgetown Prep, the elite Washington high school where Bret Kavanaugh famously matriculated). *Moore has a masters in economics from George Mason University, and has served as an economist on the Joint Tax Committee of the Congress.*
- Whatever Moore may have said at various times, it's Powell who said at Jackson Hole last year that economists have no actual idea where the neutral rate is, and then just weeks later spooked markets by saying with complete assurance that he knew we were "a long way from" it. It's Powell who said that the Fed's asset portfolio was on "automatic pilot," just minutes after an FOMC meeting that included extensive discussions on how and why to control it. Powell didn't say any of these things as a private citizen expressing opinions. These were statements of policy by a sitting Fed chair who should have been at least more judicious even if he couldn't be more knowledgeable.
- *And as to a "feud with the Fed," a president has every right to select governors who reflect his own policy preferences.* Obama certainly exercised such a right with his twice-nomination of MIT economist Peter Diamond, who despite his Nobel Prize in

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[About us]

Recommended Reading

Who's Afraid of Stephen Moore? And Why?
John Fund
National Review
March 25, 2019

Ten Lessons I Learned While Teaching Myself to Code
Clive Thompson
The Tim Ferriss Show
March 21, 2019

I Want to Be Investigated by the FBI
Alan Dershowitz
Wall Street Journal
March 21, 2019

Speeding the development of fusion power to create unlimited energy on Earth
John Greenwald
Phys.org
March 19, 2019

[Reading home]

Economics, in policy terms is every inch the Left's version of Moore. A multi-year blockade of confirmation in the Senate by majority leader Mitch McConnell (R-KY) led to Diamond's withdrawal, and the political compromise that got Jerome Powell onto the Fed Board just because he was a Republican and not Peter Diamond – not because he had the slightest qualifications by way of training, experience, or dealings with the public.

- *Nor did Powell have any particular policy compass when Trump selected him*. As a Board governor for five years, he gave 51 speeches (the same number as Yellen over the same period), only five of which were about economic or policy matters. We have it on information and belief that he was selected among far more qualified rivals (see "Warsh the Reformer, Powell the Plodder" October 3, 2017 and "The Trouble with Taylor" October 24, 2017) precisely because his lack of a policy compass meant there would be no paper trail that would make Senate confirmation difficult.
- And because Powell promised he would be loyal. Of course, anyone who is corrupt enough to promise to be loyal probably won't be, and indeed Powell was not. Indeed, if there is a "feud" at this point between Trump and the Powell Fed, it is Powell who continues to stoke it – and is possibly spooking markets in the process. Our skin crawled watching last week's FOMC press conference where Powell, in response to a question, could barely bring himself to admit that Trump's tax policies had done anything good for the economy: "…I think, that they should have some supply side effects. I think it's hard to know, it's hard to identify those with any precision." And if they did any good at all, in Powell's mind, Trump gets no thanks: "I wouldn't want to be handing, you know, assigning credit or blame for that…"
- Now Moore is being criticized for having said, over the Christmas weekend, that the FOMC should be "thrown out for economic malpractice." We said the same thing days before (again, see "It's Not 'Quantitative Tightening' – It's Powell"), and then we were delighted when we determined that Powell had promised to back down in order to save his job (see "Did Powell Just Cut a Deal?" December 23, 2018). *Moore said Friday he believes he can work successfully with Powell. That doesn't mean agreeing with Powell. There is still much work to do* (please see below).

Headlines on-line on the morning of March 25, 2019

ECONOMY | CENTRAL BANKS

Fed's Harker Says Central Bank May Raise Rates This Year Despite Risks

Philadelphia Fed leader sees one rate increase in 2019 and one more in 2020

Economics

Evans Says Fed May Have to Ease If Downside Risks Take Hold

Source: Wall Street Journal, Bloomberg, TrendMacro calculations

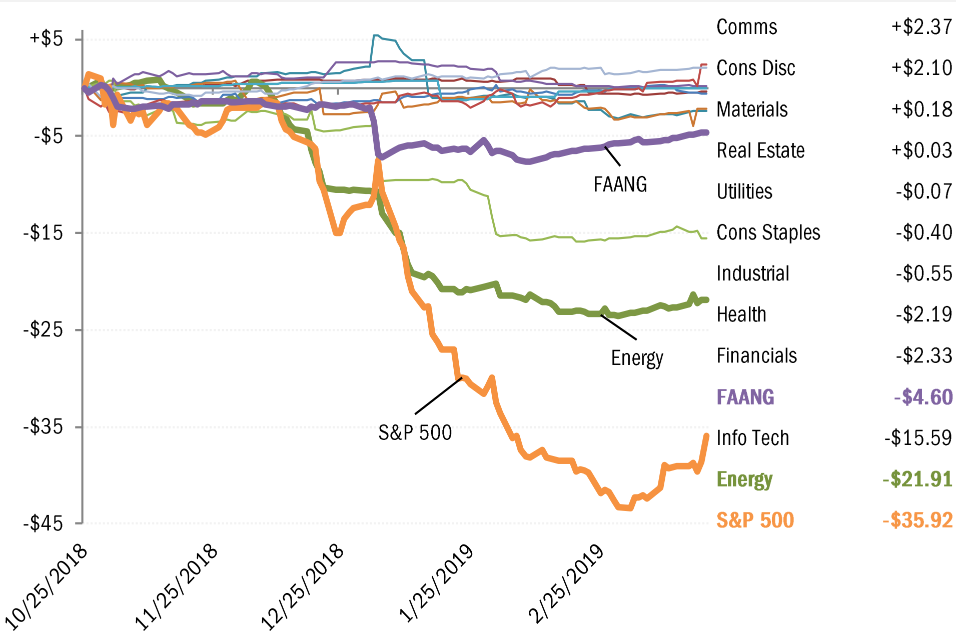
- Powell, the nobody, the swamp thing who had been moldering for five years on the Fed Board with no distinction whatsoever, selected specifically for his promises of loyalty, did indeed sail through the Senate. It won't be so easy for Moore, because he is too salient a political target. We expect that Moore will come through it intact (he knows how these games are played) and go on to perform distinguished service as a member of the Board of Governors of the Federal Reserve System. With any luck, he'll be made chair when Powell finally accepts that cushy ambassadorship we think Trump has dangled before him.

NOW, ABOUT THAT YIELD CURVE INVERSION. We said the sharp drop in the 10-year Treasury yield immediately following last Wednesday's FOMC meeting was a mistaken knee-jerk reaction, soon to be reversed (see "On the March FOMC" March 20, 2019). So far we've been very wrong, with a quiet day on Thursday (and a big equity rally) followed by another violent leg down for yields on Friday (and a big equity decline), leading to the first inversion of the 3-month/10-year Treasury spread in this cycle.

- Tying Wednesday's and Friday's big down-moves in the 10-year yield to events, it would seem that Wednesday's was a reaction to the FOMC, and Friday's was a reaction to a contractionary German purchasing managers index reading, which drove the German 10-year government yield to zero and then below.
- But both days occurred in the intermediate-term context of an ongoing decline that began early last October, when first oil prices rolled over, then TIPS inflation-compensation spreads collapsed, then credit spreads widened, then S&P 500 forward earnings peaked (see "Recession Risk at Last?" November 20, 2018) – and then the Fed, in December, raised rates without giving the expected dovish forward guidance, and Powell said the Fed's asset portfolio was on "automatic pilot" (see "On the December FOMC" December 19, 2018, and "It's Not 'Quantitative Tightening' – It's Powell" December 20, 2018.)
- We're having a hard time seeing how anything the Fed said or did last week made matters any worse. Indeed, things started improving over Christmas weekend when Powell cut a deal with Trump and Treasury Secretary Steven Mnuchin (again, see "Did Powell Just Cut a Deal?"). *Last Wednesday's FOMC completed the post-Christmas apology tour with what should have been seen as a pro-growth bang – with the "dot plots" not just ceremonially nudging down, but ruling out any hikes at all in 2019, and only one-and-a-half by the end of 2020* (see "Data Insights: Federal Reserve" March 20, 2019).
- We just can't take seriously the idea that the bond market takes that as an expression of the Fed's pessimism for the future, and then goes on to treat it or anything else the Fed predicts as even remotely accurate or actionable. Since when has the Fed ever been right about anything?
- And there's some "reflexivity" here. *The more pessimistic the Fed is, the less likely its pessimistic prediction will come true, because*

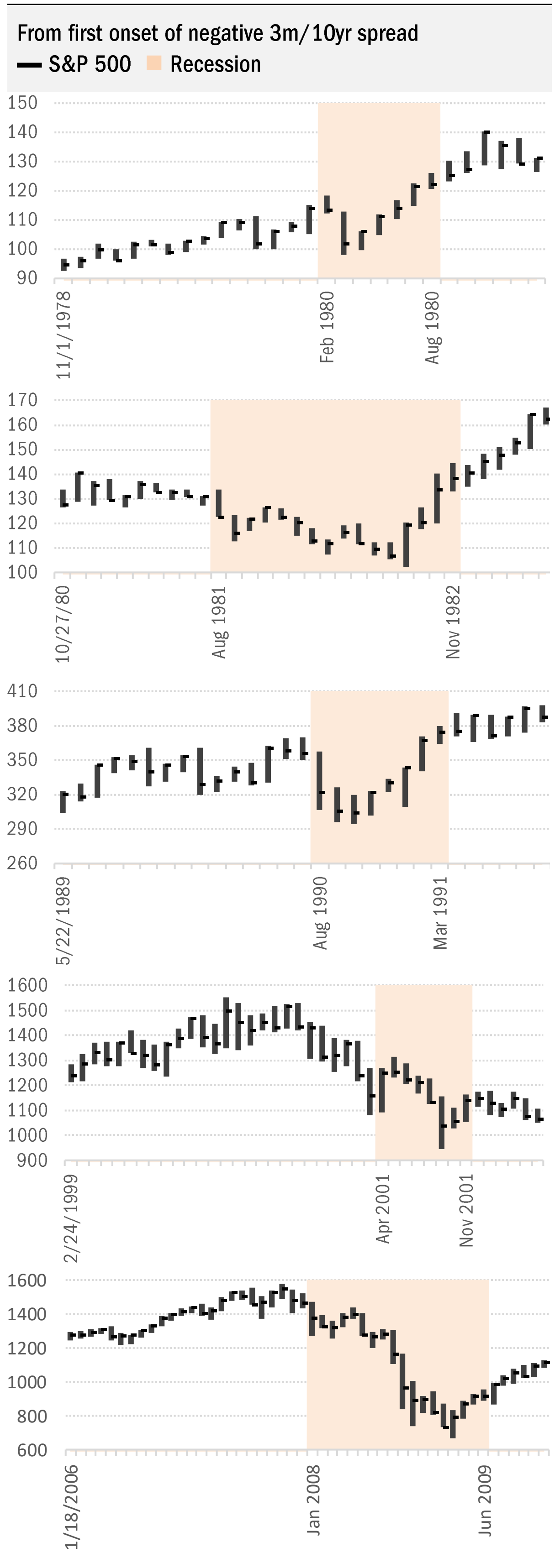
it will act in light of that prediction precisely to prevent it from coming true. Is the problem, then, that Wednesday's forward guidance was not dovish enough? Maybe. But if that's the problem, then the bond market would have had to have come into Wednesday expecting more. It's hard to know what expectations for the "dots" were, but it felt to us intuitively that Wednesday was a dovish surprise.
- The other element of last week's FOMC that was arguably a surprise was the announcement that the draw-down of the Fed's asset portfolio would end in September at about $3.5 trillion, and that going forward, maturing and prepaying mortgage-backed securities would reinvested in Treasuries with an average maturity matching that of the overall Treasury market. None of that was entirely a surprise, but it feels to us like all the specific details of it came down on the side of dovishness – which we doubt was fully expected.
- _So with all those doves flying around at the corner of 20th and C in Washington, why the drop in the 10-year yield? Isn't all that, at the margin, pro-growth and pro-inflation?_
- _It's a little easier for us to see why Friday's German manufacturing PMI reading would have had some effect, at least directionally, and at least in terms of timing – it is, after all, a real and a negative economic development – but it's still not a fully satisfying explanation_. At 44.7 it was a big downside surprise. Odd that it was 10 points higher in mid-2016, the last time the *bund* had a negative yield. Nevertheless, an often-heard story on Friday was that low German yields were, by arbitrage, dragging down US yields. If that were really an arbitrage, though, why does the US/German 10-year spread move around so much – and why

Change in S&P 500 forward earnings from October 25 USD billions



Source: Bloomberg, TrendMacro calculations wouldn't the arbitrage operate just as well the other way, with higher US yields propping up lower German ones?

- *Another analytic difficulty for us is inflation expectations.* They were almost entirely responsible for the dramatic Q4-2018 drop in the US 10-year yield, driven down by a 45% bear market in oil in just 10 weeks from early October to mid-December. Now oil prices have significantly recovered. 2-year TIPS breakevens have made it all the way back. 10-year TIPS breakevens have made up half their Q4 contraction. So this, too, is not a satisfying answer.
- *Finally, there's the stark contradiction between the way the stock and bond markets have behaved year-to-date. Since the resolution of the Powell crisis during Christmas week, the S&P 500 has experienced a whole 20%-plus bull market, and S&P 500 forward earnings have begun to materially recover, potentially reversing a dangerous recession signal* (please see the chart on the previous page, and again, "Recession Risk at Last?"), *and Chinese stocks have led the pack world-wide* (see, most recently, "Fail in Hanoi, Win in Beijing" March 4, 2019), *pointing to a conclusion to the dangerous US/China trade war seen as the point of origin for much of the weakness of the last two quarters. Meanwhile, the 10-year yield has mostly been stagnant all the while, that is, until it finally took a substantial tumble last week.*
- *On Friday, it seemed that the stock market took its cue from the bond market – as though it took seriously the recession-signal in the inversion of the 3-month/10-year spread. Why would stocks suddenly start listening to bonds?*
- *As we wrote last year, when the 2-year/10-year Treasury spread was slightly lower than it was Friday, or as of this writing, the yield curve is in fact a terrible business cycle indicator* (see "The Yield Curve: The World's Worst Indicator, But…" December 6, 2018). *Every cycle, inversion occurs many months, or even a small number of years, before either the coming stock market top or business cycle top. Again, the 2-10 spread hasn't inverted yet, anyway.*
- *The 3-month/10-year spread did invert on*



Source: Bloomberg, NBER, TrendMacro calculations

Friday. Its track record is slightly better. It isn't quite so excessively early, improving on the 2/10 spread's record by anywhere from one to seven months in the last five business cycles (please see the charts on the previous page).

- Still, not very useful. It is simply to say that, in the five past business cycles, the 2-10 spread has inverted first, followed one to seven months later by the 3-month/10-year spread. This time the 3-month/10-year spread inverted first (that is, "first," assuming the 2-10 spread ever inverts at all, which it still hasn't).
- Obviously, this is because the 3-month/2-year spread is inverted. It inverted for just one day in early January, widened back out, and then inverted again last week. *We have no basis on which to assign any particular significance to that. The 3-month/2-year spread, on its own, has no better a recession prediction track record than any of the other spreads. Clients ask us all the time, which one is the best? They are all terrible.*
- As we pointed out when we examined this question late last year (again, see "The Yield Curve: The World's Worst Indicator, But…"), it's not just that inversion itself is a poor recession-onset indicator. *It is also the case that the steepness of the curve, at all points, positive or inverted, is completely unrelated to subsequent economic growth or stock market performance.*
- *Instead of thinking of the curve as an indicator of the future – which credits entirely too much market-efficiency magic to the Treasury market for our taste – we think of it as a residual of fallible contemporaneous market prices which, over time, will be determined by events as they actually unfold. There's no doubt we were facing recessionary shocks (including the Powell Fed) in Q4-2018* (again, see "Recession Risk at Last?")*, and came into Q1-2019 in a crisis of confidence, again including the Powell Fed* (see "2019 Outlook: Confidence Rots from the Head Down" December 31, 2018)*. Those things have certain consequences, including what will likely be reported as a poor real growth in Q1. But the recovery from those negatives has consequences, too. The bond market just isn't seeing that. We believe it eventually will.*

Bottom line

Moore is dedicated to growth above all, which overcomes any weaknesses in his long and checkered record as a pundit. Trump is right to pick a new governor who embodies his outlook, which Powell promised and failed to do. The 3-month/10-year Treasury spread inverted on Friday, but the 2-year/10-year has not yet. The 3-mo/10-year has a slightly better track record as a recession indicator, but not much. If the 2/10 inverts, this will be the first cycle in which it did not invert first. Equity markets are contradicting the seeming pessimism of bond markets. Chinese stocks are leading the world, indicating resolution of the US/China trade war. Forward earnings have begun to substantially bounce back. Oil has stabilized and TIPS spreads have recovered. If bonds are looking at a recession, stocks act as though it was only a near-miss. We think the balance of evidence favors the more optimistic view, and that long-term yields are likely to move higher from here.