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FED SHADOW

FOMC Preview: 25 or 50?

Friday, July 19, 2019

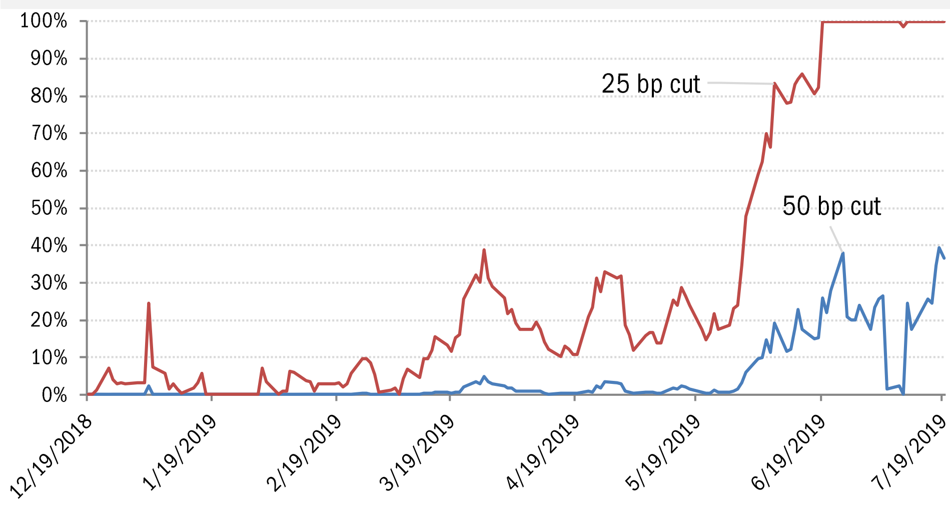
Donald Luskin

Increase accommodation (don't decrease tightening). Save the expansion. Blame Trump.

Futures markets are pricing the complete certainty of a 25 bp rate cut at the next FOMC ten days out. We agree that this should be treated as a forgone conclusion. *Markets have finally caught up to what we've been telling clients for weeks, as of this writing assigning an unusually high 36% probability to a 50 bp cut* (please see the chart below). *We're moving up our estimate: we now think the true probability is more like 75%.* We say that primarily because there's such a drop-dead case for it, and if we sat on the FOMC we'd be pounding the table (see "It's So Time to Cut Rates" June 3, 2019). A broad consensus of our clients feels the same way.

- *The inverted yield curve doesn't disagree. Now requiring a 50 bp cut to un-invert the funds/10-year curve, a guilty verdict has been rendered upon the Fed: the December rate hike, and Powell's insouciantly hawkish "automatic pilot" narrative, were a mistake.*
- *As always for any central bank that has made an error, the challenge is to fix it without admitting having made it.*
- *But in this case, an embarrassing spotlight has been thrown on the Fed's mistake by President Donald J. Trump's relentless criticisms, including a tweet this morning. So the Fed now finds itself in the difficult position of having to reverse course both without (1)*

Futures-implied probability at July FOMC meeting, from December 2018 FOMC



Source: Bloomberg, TrendMacro calculations

Update to strategic view

US FED, US MACRO: 25 bp for sure, but we think 50 bp is a 75% probability. That's what it would take to un-invert the yield curve, and it is an appropriate response to the deep turn toward bearish and uncertainty reflected in the June SEP's polling. The Fed has no inflation constraint now. And the Phillips Curve has been publicly discredited by no less than Ocasio-Cortez, though Powell can't help but cling to empty remnants of it. The Fed is mired in cognitive dissonance, what Trump called in a tweet this morning a "faulty thought process." The trick is for the FOMC to take credit for preserving the expansion – by "increasing accommodation" rather than relenting on mistaken tightening – while deflecting onto Trump blame for imperiling it, thus avoiding the appearance of political influence. Powell has set that narrative in motion. We think 50 bp is the whisper number, and warn of a negative market reaction if it's only 25. reaction if it's only 25.

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admitting they were wrong and Trump was right, and (2) appearing to be subject to political influence.

Powell's embarrassment was on display when he was questioned last week in the Senate by Patrick Toomey (R-PA). Toomey asked about the inverted curve, noting that "virtually the entire Treasury yield curve is trading below the fed funds rate." No doubt Toomey was recalling his question to Powell about the curve one year ago, when it was narrow but not yet inverted. As we have quoted many times, Powell wisely replied a year ago that when the funds rate is above the 10-year yield, "your policy's tighter than you think" (see, recently, "Trump Wants to Cut Interest Rates. Powell Should Do It Anyway." June 4, 2019).

- But this time Powell wouldn't make that admission. He vaguely cited a litany of worrisome global macro developments – "weakness everywhere" – responsible for the inversion, and hinted at "providing more accommodation" in response.
- Toomey actually interrupted Powell – practically unheard of in such proceedings – to shoot back that "the yield curve was suggesting that even before" macro developments became so worrisome. In other words: "Why did you hike in December, and why haven't you cut yet?"
- Powell's embarrassment was palpable when he replied by stammering out a true whopper:

"I think some of that has recovered, but that in part is because we have stepped forward and indicated that we're – that's what happens is, we – we address that through our policy and indicated that our last meeting that we were looking at changing rates."

- We cite this exchange at perhaps tedious length because it reveals the Kafka-esque narrative that Powell is laying out for the FOMC to operate within: *it's not our fault when our actions make things worse, but our words alone are enough to make things better.*
- This is why he speaks of a cut now as "more accommodation," as though somehow the Fed is *already accommodative* and now will become even *more* so. Let it never be admitted that the Fed got too *tight*, and now must become *less* so.
- This narrative has the problem that not everyone agrees the economy needs "more accommodation," when the matter is artificially put in those terms. So last week two regional Fed presidents came out saying a cut isn't warranted, with Atlanta's Bostic saying "I am not seeing the storm clouds generating a storm yet," and Richmond's saying it's "hard to make a case for stepping on the gas." Powell tries to deflect this by endlessly repeating the goal to "preserve the expansion."

Nevertheless, simply by the numbers, the balance of opinion on the FOMC has decisively tilted toward the pessimistic, and toward an increase sense of uncertainty about the future. That's the stuff of big rate cuts. With the release of the minutes of the June FOMC, the Summary of Economic

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Ai Weiwei: Can Hong Kong's Resistance Win?
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New York Times
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Adam Smith's Refreshing Idea of Justice
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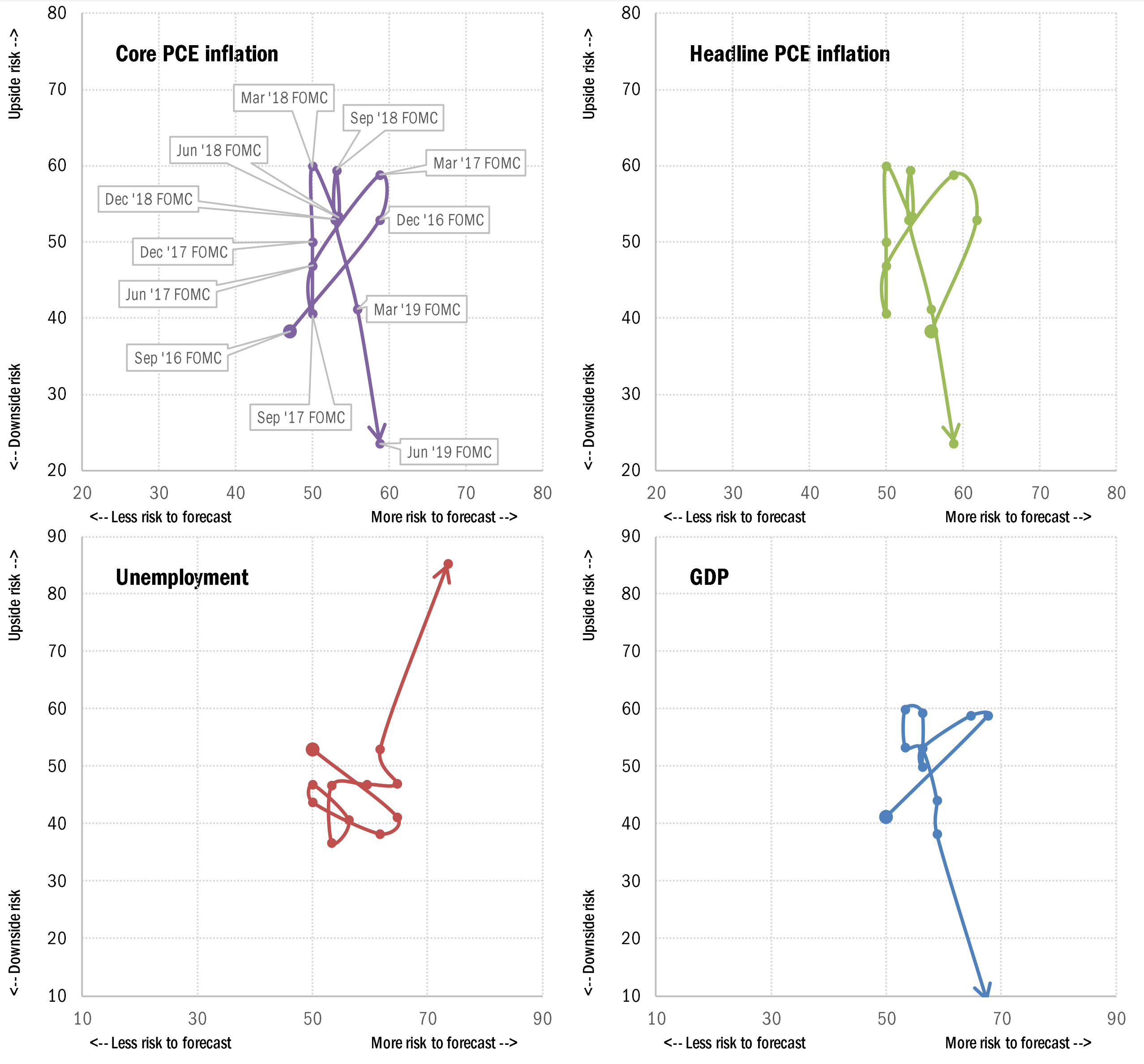
Projections was updated to include polling data as to participants' subjective impressions as to the direction of risk to their forecasts, and the degree of uncertainty around them. We have created diffusion indices that correlate these two dimensions of polling data, and they clearly reveal a sharply darkening and less certain vision (please see the charts below, and "Data Insights: FOMC Minutes" July 10, 2019).

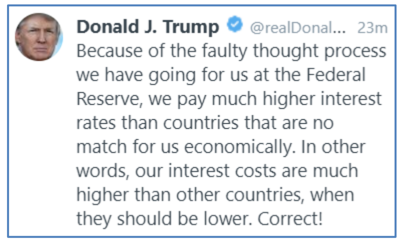
Diffusion indices of forecast risks in Summary of Economic Projections
From ● September 2016 FOMC to → June 2019 FOMC



Source: FRB SEP, TrendMacro calculations

- With such a wholesale shift to the bearish – and with such a wholesale shift to increased uncertainty – the question for us isn't so much whether the FOMC will cut rates by 50 bp next week. <u>*It's why the hell didn't they cut at all at the June FOMC, if this is how they felt?*</u>

- The answer is probably that such wholesale shifts in sentiment are accompanied by cognitive dissonance, which can result in a freeze-response, like when a rabbit suddenly realizes it is in the presence of a predator and can't even decide which way to run. But when the rabbit finally runs, it *really* runs.
- The cognitive dissonance comes not only being proven wrong by unanimously agreeing to hike rates in December despite very obvious economic turbulence – and by being humiliated for it in real time by a president who turned out to be right (see "On the December FOMC" December 19, 2018, and "It's Not 'Quantitative Tightening' – It's Powell" December 20, 2018). *It comes more deeply from the irrefutable discrediting of a false shibboleth by which the Fed has erroneously operated for decades – the Phillips Curve.*
- *All this is what Trump was referring to in his tweet this morning about the Fed's "faulty thought process."*



- After last week's House testimony, representative Alexandria Ocasio-Cortez (D-NY14) masterfully trolled Powell for clinging to Phillips Curve logic, while over the last three years unemployment has fallen to record lows with inflation still below-target (see "Video: What you're not hearing about Alexandria Ocasio-Cortez and Jerome Powell" July 11, 2019). Powell sheepishly replied, "Absolutely!"
- But the next day when confronted in the Senate on the same topic by Richard Shelby (R-AL), Powell just couldn't let go of the Phillips Curve relation between low unemployment and high inflation. He started out great:

  "So the relationship between slack in the economy or unemployment and inflation was a strong one 50 years ago, if you remember in the 60s there was a close correlation there. And that – that has gone away."

- But he just can't top talking. Maybe he has a confession compulsion. Or maybe he craves to be regarded like former Fed chair Alan Greenspan, as an oracular expert on all subjects. But he just can't stop talking, and finally he said:

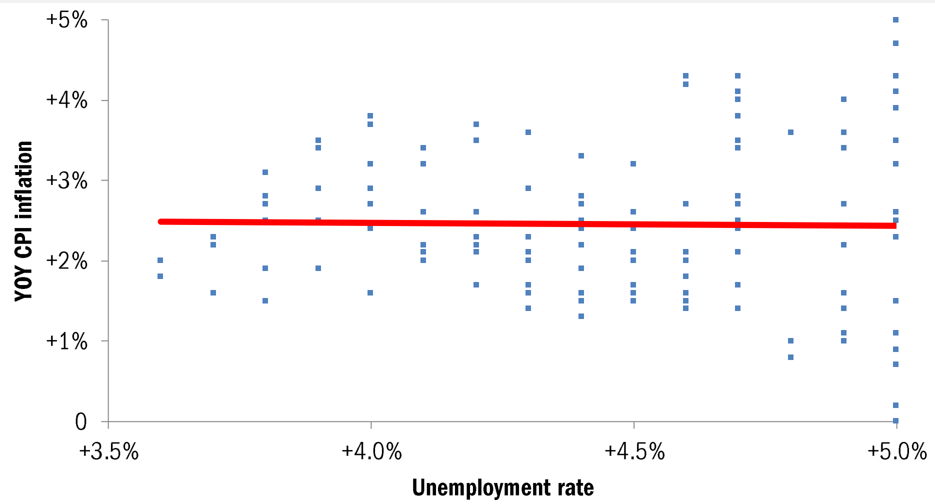
  "At the end of the day there has to be a connection."

- There "has to be." *Spoken with the devotional ignorance of a dilletante who clings to the few principles of economics he feels he can understand, even if they aren't true. There "has to be."* Even when the data shows there is not a connection – not in the last three years, as AOC correctly pointed out, and indeed not in the last 45 years, as *we* pointed out (again, see "Video: What you're not hearing about Alexandria Ocasio-Cortez and Jerome Powell").
- Powell went on to say:

"there has to be"…"because low unemployment will drive wages up and ultimately wages – higher wages will drive inflation but we haven't reached that point."

- So Powell has idiosyncratically and *ad hoc* re-defined the Phillips Curve to not be a continuous curve at all – but rather a tipping-point, a function that only operates at some critical level that "we haven't reached." *How much lower beyond already record-low unemployment do we have to go to reach it?*
- If there were any truth to this at all, we'd expect the Phillips Curve relation – which shows up in the data slightly in the reverse over the last 45 years – would at least show up pointing the right direction when unemployment is especially low. *But no. This is totally wrong.* Looking at data only at 5% unemployment and below, there is no relation between inflation and unemployment at all (please see the chart below). The r-squared of the regression is zero.

Relation of unemployment and inflation, 1974 to present, when UE below 5%



Source: BLS, TrendMacro calculations

- Well, as Powell himself went on to say in that inimitable style of his, in which in his inability to stop talking he inevitably undercuts himself, "…in any case that connection between the two is is [sic] quite small these days." Okay, so then why is it "there has to be" a connection when he admits there isn't one "these days."
- Meanwhile, [elite opinion](#) exemplified by Clinton-era Fed vice-chair Alan Blinder insists that this pathetic amateur is "smart, experienced, with good judgment, and measured in both words and demeanor." We suspect that establishment figures like Blinder would say such things about anyone who resists Trump.
- Powell is resisting Trump to a degree that is getting downright unseemly. Consider this exchange [in the House last week](#) with Representative Maxine Waters (D-CA43):

WATERS: Thank you very much. Mr. Chairman, if you got a call from the president today or tomorrow and he said, "I'm firing you. Pack up. It's time to go," what would you do?

POWELL: Well of course I would not do that.

WATERS: I can't hear you.

(LAUGHTER)

POWELL: My answer would be no.

WATERS: And you would not pack up and you would not leave?

POWELL: No, ma'am.

- Whatever you may think of the propriety of Trump bullying Powell by threatening to fire him or demote him, considering that Trump has actually done neither one yet, surely no one should condone Powell playing to Trump's most over-the-top political enemies in this way, which entails a nuclear threat by a Fed chair to provoke a Constitutional crisis with the president. Consider what the suave and Sphinx-like Greenspan would have done if he found himself in this position. Words would have come out of his mouth, but the question would go unanswered, and Greenspan would have appeared the better man for his forbearance. That's how a Fed chair gets respect as a truly politically independent leader, not just another opportunistic virtue-signaling #NeverTrumper.

We are belaboring these examinations of the political and cognitive environment of next week's FOMC because, in some sense, the economic facts are beyond dispute. For whatever reasons – some combination of actual economic shocks compounded with the Fed's December error – the economy has been through a difficult quarter, and it's showing up loud and clear in the yield curve. With equities and forward earnings-per-share at all-time highs, and the 10-year Treasury yield making a stand at about 2%, it's not exactly an emergency, though. With core PCE inflation well below the Fed's target, a 25 bp cut is nothing more than common-sensical, and we think 50 is ever better (that would un-invert the yield curve, all else equal).

- *In a nutshell, there is every reason to cut rates, and no reason not to.*
- *But how much?*
- The FOMC has no idea, because it is deprived of confident reliance on its trusty policy axiom, the Phillips Curve.
- That means we'll get decisions made at the margin and on the range of the moment, without deep conceptual underpinnings and, once made, lacking credible explanations.
- *All that's left is politics and appearances. For Powell, that's all about unexpected suddenly arisen "uncertainties" centered on*

“trade tensions,” which is a “blame Trump” narrative (see “On the June FOMC” June 19, 2019). *It both makes Trump wrong (even though he’s been right) and the Fed right (even though it has been wrong). In its own demonic way, it’s the perfect set up for a 50 bp cut.*

- The right thing for the wrong reasons. We’ll take it, if it turns out we’re lucky enough to get it.
- Which leaves us with one closing thought. Despite the far less than certain market-implied probability for a 50 bp cut, we suspect that the whisper-number is more like or own considerably higher estimate. *We are concerned that if it’s only 25 bp – and if Powell, as usual, fumbles the forward guidance that leads the market to confidently to expect the next cut (tricky, because the more confidence he gives about next time, the harder to explain why it was only 25 this time) – there will be a rough reaction in markets.*

Bottom line

25 bp for sure, but we think 50 bp is a 75% probability. That’s what it would take to un-invert the yield curve, and it is an appropriate response to the deep turn toward bearish and uncertainty reflected in the June SEP’s polling. The Fed has no inflation constraint now. And the Phillips Curve has been publicly discredited by no less than Ocasio-Cortez, though Powell can’t help but cling to empty remnants of it. The Fed is mired in cognitive dissonance, what Trump called in a tweet this morning a “faulty thought process.” The trick is for the FOMC to take credit for preserving the expansion – by “increasing accommodation” rather than relenting on mistaken tightening – while deflecting onto Trump blame for imperiling it, thus avoiding the appearance of political influence. Powell has set that narrative in motion. We think 50 bp is the whisper number, and warn of a negative market reaction if it’s only 25.