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TRENDMACRO LIVE!

On the January FOMC

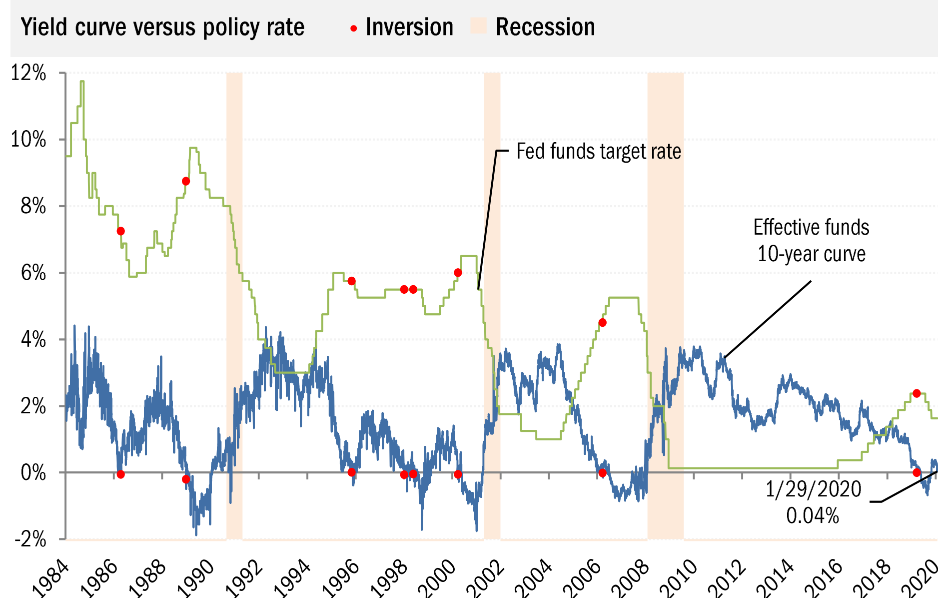
Wednesday, January 29, 2020

Donald Luskin

We don't get it. Spending is slower, inflation is decelerating. Yet the Fed hiked rates today.

Amazing enough – with the world holding its breath to see how bad the Wuhan coronavirus will be in both human and economic dimensions (see "Another Damn Export from China" January 27, 2020) – *the FOMC just raised interest rates*. Not the headline fed funds rate, which remains targeted to a band between 1.5% and 1.75%. This hike wasn't even mentioned in today's FOMC statement, only in an "Implementation note." It's a hike to *the rate on bank reserves held by the Fed – "IOER" – from 1.55% to 1.60%.* Okay, it's only 5 basis points – and while some of our clients tell us they were expecting it, though the published market consensus wasn't. And Chair Jerome Powell assures us in the post-FOMC press conference that it's not a change in policy, just "a technical adjustment." But nothing changes the fact that it is explicitly being done because fed funds are trading below where the Fed wants them – the objective is the 1.625% mid-point of the target range, and they've been at about 1.55% all year. So call it what you will – but *when the idea is to deliberately make the funds rate trade higher, we're going to call that tightening.*

All else equal, assuming it succeeds in driving the funds rate 0.05% higher,



Source: Bloomberg, TrendMacro calculations

Update to strategic view

US FED, US MACRO, US BONDS: With the coronavirus threat still emerging, and an FOMC statement that acknowledges slower spending and inflation, the Fed hiked the interest rate paid on reserves by 5 bp in an effort, in turn, to hike the effective funds rate by the same amount. Based on immediate market reaction, this was expected even though it was not in the formal consensus, and Powell seems to have assured markets that it does not indicate a hawkish turn in policy. If the hike in IOER succeeds in driving the effective funds rate higher, that will flatten the all-important yield curve between the funds rate and the 10-year Treasury. It was already not steep enough. It took the emergence of coronavirus and its impact on the oil price, but we're beginning to see clearly why the market has been discounting all along one more rate cut this year.

[Strategy dashboard]

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that will virtually flatten the all-important yield curve between the funds rate and the 10-year Treasury yield (please see the chart on the previous page). Yes, the same curve that Powell himself watches, believing that when it inverts, that's the market telling the Fed "your policy is probably too tight" (see "Video: What Jay Powell should be telling you about the inverted yield curve" April 1, 2019).

- Tragicomically, this tightening for the sake of getting better control over the funds rate was advertised by Powell, in the press conference, as proof that the Fed's recent asset purchase program – in response to the repo crisis – has "proceeded smoothly" and allowed the Fed to "effectively control the funds rate." So why is this tightening necessary?
- This is all part of the growing pains the Fed is experiencing after it shifted, starting in October 2008, to a totally unfamiliar operating regime in which, for the first time in history, it pays interest on required and excess reserves. The Fed is still experimenting to determine the sufficient quantity of reserves required so that, by changing the interest rate paid on them, it will be able to control the marginal cost of bank credit. As much as anything an exercise in nostalgia, the Fed still nominally targets the fed funds rate, and uses IOER to guide the funds market to trade in the middle of the target range.
- During the years of a zero funds rate target – actually a targeted range of 0.00% to 0.25% – IOER was set at the top of the range and funds traded at the mid-point of 0.125% very reliably (please see the chart below).
- *That all changed after lift-off, when the Fed had to go through a series of experiments to set IOER so that funds would trade at the*

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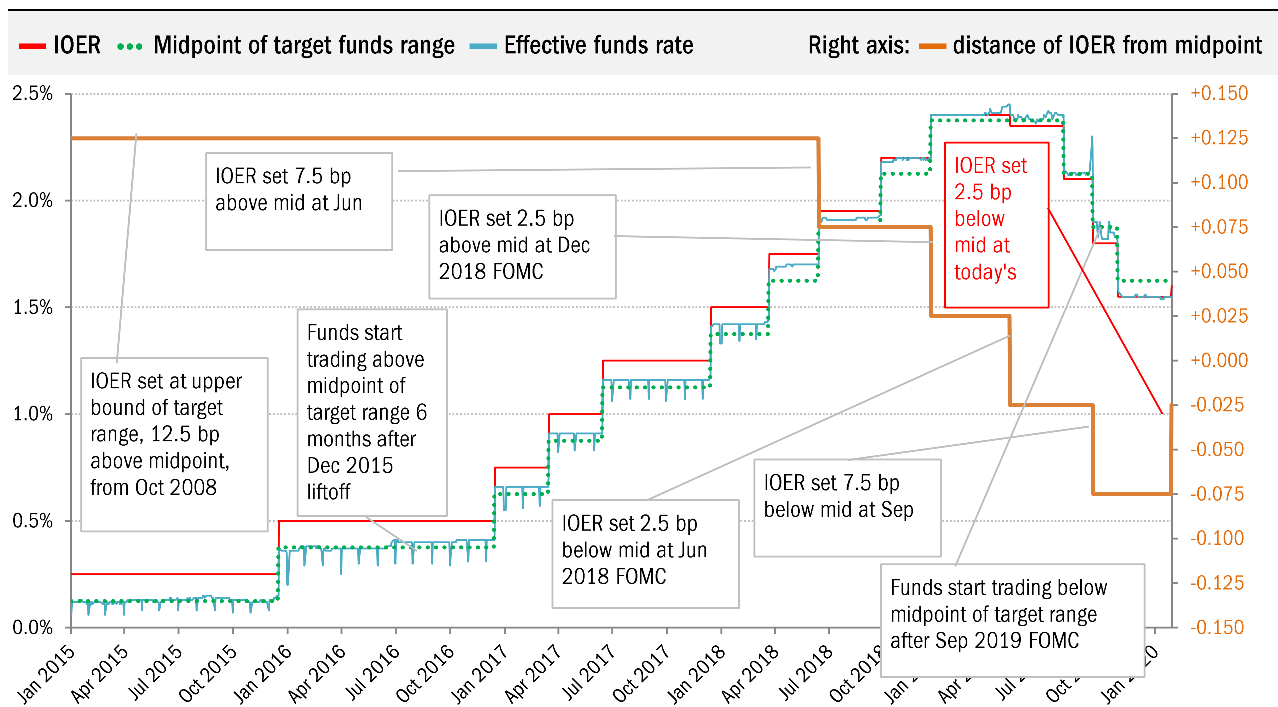
[About us]



mid-point. For some unknown reason, it seems that they traded habitually above. So IOER was lowered from top-of-the-range for the first time at the December 2018 FOMC – otherwise famous for Powell's gaffe about the balance sheet being "on automatic pilot" (see "It's Not 'Quantitative Tightening' – It's Powell" December 20, 2018).

- But it wasn't enough. IOER was lowered relative to the funds rate range twice more, at the June 2019 and September 2019 FOMCs. Then, suddenly it was too much. Since then, funds have been trading *below* the midpoint. Hence today's 5 bp hike in IOER, designed to move the funds rate up to the mid-point.
- That's right. To move the funds rate higher. *That's tightening*. It may be for technical reasons, it may be a small move. *But it is tightening*.
- Powell's protestations that it's just a "technical adjustment" makes it worse. The story that this tightening is "not a change in policy" is a description of the mental state of the Fed staff – that is, *they* haven't changed *their* minds about anything, *they* are still trying to hit *their* same old target for the funds rate. *But when you raise the funds rate – when you flatten the barely-uninverted yield curve – that's a change in policy, as far as the real world is concerned*.

Comparing today's FOMC statement to the prior one in December (see "Data Insights: FOMC Minutes" January 3, 2020), there were literally only two words that were changed. Spending is now being said to be "rising at a moderate pace" rather than a "strong" one. Policy is now said to be "appropriate to…inflation returning to" – rather than already being "near" – "the Committee's symmetric 2 percent objective."

- *At the margin, both these language changes point to a darker outlook – spending has decelerated, and inflation is further from target.*
- *So this is the time for a "technical adjustment" that, in fact, tightens policy at the margin?*
- *As of this writing, the ho-hum reaction in markets would seem to indicate that, as our client conversations led us to believe, this small tightening was reasonably well expected. Maybe there's some relief that it wasn't more of a hike, say another 2.5 bp all the way to the mid-point of the target range – or that Powell didn't make any major gaffes in talking about it. At least he managed to communicate it is not an indication of a more hawkish policy outlook, and perhaps that's the important thing.*
- *But the yield curve is too flat, and all else equal this will only make it flatter. The coronavirus crisis will weigh on oil prices, which will weigh on inflation expectations, which will weigh on long-term Treasury yields, which will weigh on the yield curve.*
- *"Mister Market" can't have known about the coronavirus – but again, the outbreak may be the thing that fulfills the market-implied expectation that the Fed will have to cut one more time later this year* (again, see "Another Damn Export from China").

Recommended Reading

Video: Dershowitz says charges against Trump are 'outside' of impeachment offenses
Alan Dershowitz
Testimony at Impeachment Trial of Donald Trump
January 27, 2020

[Reading home]

Bottom line

With the coronavirus threat still emerging, and an FOMC statement that acknowledges slower spending and inflation, the Fed hiked the interest rate paid on reserves by 5 bp in an effort, in turn, to hike the effective funds rate by the same amount. Based on immediate market reaction, this was expected even though it was not in the formal consensus, and Powell seems to have assured markets that it does not indicate a hawkish turn in policy. If the hike in IOER succeeds in driving the effective funds rate higher, that will flatten the all-important yield curve between the funds rate and the 10-year Treasury. It was already not steep enough. It took the emergence of coronavirus and its impact on the oil price, but we're beginning to see clearly why the market has been discounting all along one more rate cut this year.