Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
Thomas Demas, Managing Director
Michael Warren, Energy Strategist

FED SHADOW

FOMC: The Lady or the Tightener?

Tuesday, September 15, 2015

Donald Luskin

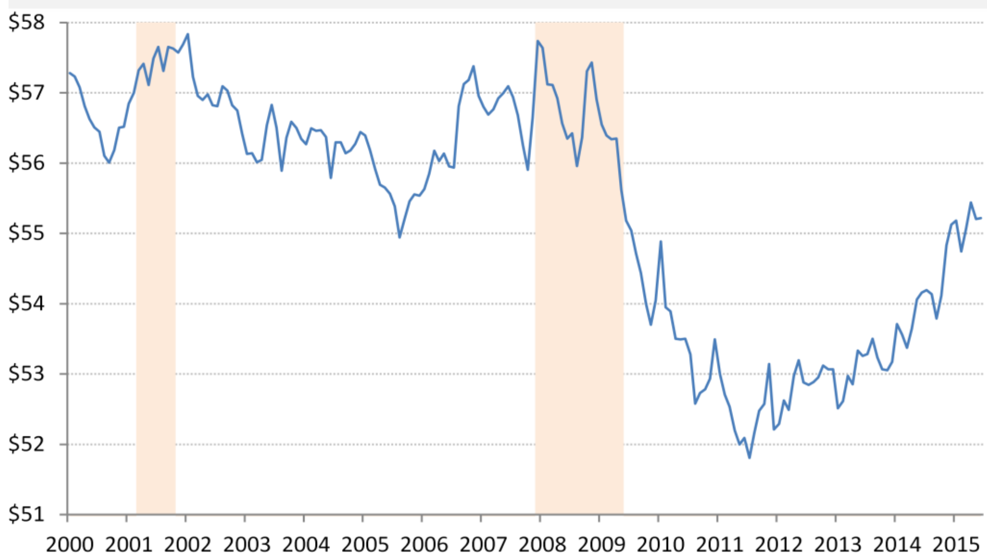
Markets have already done the tightening -- and Yellen likes keeping us all guessing.

We continue to strongly expect no "liftoff" at Thursday's FOMC meeting. *The only mysteries are why the Fed has let uncertainty about it run rampant, and whether new guidance in the FOMC statement language will move to quell that uncertainty.*

Here are our top three reasons:

- Market-based expectations do not support "liftoff" -- and the Fed's failure to correct those expectations effectively ratifies them (see "On Fischer at Jackson Hole" August 31, 2015).
- Core Personal Consumption Expenditures inflation, the Fed's preferred measure, at 1.23% year-over-year, is the lowest since the deflation-scare are 2011, and falling (again, see "On Fischer at Jackson Hole").
- The unemployment rate, at 5.1%, is well known to be a falsely rosy indicator of the labor market. The *under*employment rate is 10.2% -- still 2.4% above the prior cycle low (see "Data Insights: Jobs" September 4, 2015) -- and median real household income,

US real median household income USD thousands **Recession**



Source: Sentier Research, TrendMacro calculations

Update to strategic view

US FED, US MACRO: We say no "liftoff" at the FOMC on Thursday. Markets don't expect it, and the Fed's failure to correct expectations ratifies them. Core inflation is low and falling, and there remains much slack in labor markets. Widening credit spreads and other factors have already tightened financial conditions, and the Fed is hesitant to have to debut new policy tools. Speculation about "liftoff" is rampant, perhaps largely because of what a terrible policy error it might be. The Fed allows the uncertainty to continue to keep a lid on financial excesses, so we would expect little new guidance in Thursday's FOMC statement.

[Strategy Dashboard home]

at $55,218 is still $403 *below* where it was at the official trough of the Great Recession (please see the chart on the previous page, and "Data Insights: A Few of our Favorite Things" August 26, 2015).

There are deeper reasons, which we have been highlighting for many months, and which the consensus is now coming to appreciate.

- Financial conditions have tightened considerably over the last year -- led by the widening of credit spreads that began in June 2014, as falling oil prices began to imperil the large volume of energy sector issuance (see, first among many, "Oilmageddon" December 16, 2014). Looking beyond the high-yield bond market dominated by frackers, even the investment grade spread-to-Treasuries is now wider than it was when the Fed thought conditions were bad enough to initiate QE3 in 2012 (please see the chart below).

Investment grade spread-to-Treasuries BBB-Baa to 10-year

Source: Bloomberg, TrendMacro calculations

- This is our key indicator. Combined with dollar-strength over the same period, the correction in global equity markets and stresses in emerging economies, Goldman Sachs opined last week that the tightening financial conditions overall is the equivalent of three Fed rate hikes, suggesting that "markets have done much of the Fed's 'dirty work.'"
- We have also been arguing that the Fed will be hesitant to "lift off" because to do so will require the first use of completely new policy tools. For the first time in history its key policy rates will be the rate paid on excess reserves and on reverse-repos with non-bank counterparties, and all in a completely new policy environment of a massive balance sheet and a moribund fed funds market (see, earliest, "On Yellen's Senate Testimony" February 24, 2015, and in more detail, "On the April Jobs Report" May 8, 2015).

Contact TrendMacro

On the web at
trendmacro.com

Follow us on Twitter at
twitter.com/TweetMacro

Donald Luskin
Chicago IL
312 273 6766
don@trendmacro.com

Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

Michael Warren
Houston TX
713 893 1377
mike@trendmacro.energy

[About us]

Recommended Reading

Meet the Man Who Holds the Balance in Spain's Upcoming Election
Maria Tadeo, Esteban Duarte and Edward Robinson
Bloomberg Markets
September 9, 2015

The Racial Reality of Policing
Edward Conlon
Wall Street Journal
September 5, 2015

Inflation, the Fed, and the Big Picture
Carmen Reinhart
Project Syndicate
September 3, 2015

[Reading home]

- We're finally beginning to see some discussion of this in the financial media, but the emphasis is on the unpredictable risks in markets -- without recognizing that the presence of those risks is itself a motivation for the Fed to avoid "liftoff" as long as possible.

If it's such a drop-dead case that there will be no "liftoff" on Thursday, why is there so much speculation about it, and why has the Fed done so little to quell it?

- We think the speculation about "liftoff" is, to some extent, a manufactured media event. It perfectly caters to investors who are flummoxed by massive uncertainty about China, for which data is scarce, opaque, and unreliable. The Fed, by comparison, is a much more comfortable thing to worry about.
- Or maybe there is more to it. Perhaps investors are so focused on "liftoff" because, however unlikely it is, there is some case to be made that it would be a terrible policy mistake. Indeed, if we are correct that the labor market still has plenty of slack and that there is no inflation threat, then it would be. And indeed, if any of the operational risks we think the Fed is worried about actually materialized, it would be.
- All that said, the rampant speculation about the Fed is to some extent a form of tightening financial conditions. That is, conditions would be more accommodative if there were less policy uncertainty. Indeed, at the recent G-20 meeting, finance ministers from emerging economies were quoted as wishing the Fed would "lift off" simply to get it over with, to end uncertainties that are arguably contributing to currency instability and capital flight.
- So why does the Fed allow the speculation to persist? We think it's because the Fed is happy, as Goldman put it, to let markets do the dirty work, at least to the extent of dampening financial excesses that are potentially a negative externality of the continuing deferral of "liftoff." It's the same reason that Fed Chair Janet Yellen said in a speech in May that equity valuations were "quite high" (see "Ms. Yellen, We Don't Quite Agree" May 21, 2015).
- If that's right, then on Thursday, when the Fed does not "lift off," we would expect little new guidance as to the rest of the year. Why would intentions be revealed if the purpose is to keep financial conditions a bit tight by keeping the markets guessing?

Bottom line

We say no "liftoff" at the FOMC on Thursday. Markets don't expect it, and the Fed's failure to correct expectations ratifies them. Core inflation is low and falling, and there remains much slack in labor markets. Widening credit spreads and other factors have already tightened financial conditions, and the Fed is hesitant to have to debut new policy tools. Speculation about "liftoff" is rampant, perhaps largely because of what a terrible policy error it might be. The Fed allows the uncertainty to continue to keep a lid on financial excesses, so we would expect little new guidance in Thursday's FOMC statement.