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

FED SHADOW

Is the Fed Stuck on Stupid?

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Donald Luskin

No good reasons to hike, and lots not to. It won't happen. If it does, markets will unravel.

Markets are right to be shocked at the flurry of statements by Fed officials (Williams, Lockhart and Dudley), and the minutes of the April FOMC meeting, raising the malign specter that the Fed is likely to raise rates again this year, perhaps as soon as June. It's not so much that 25 basis points one way or another determines the fate of the world. *Instead, it's the hard fact that this Fed acts like it's stuck on stupid. Its spokespeople come off like a bunch of amateur day-traders positioning and repositioning in response to every random tick. More broadly and more worrisome, the Fed's ongoing narrative makes it seem cultishly committed to some group-think notion of "normalization," seemingly willing to seize on any window of opportunity, however narrow and briefly open, to cram it down.*

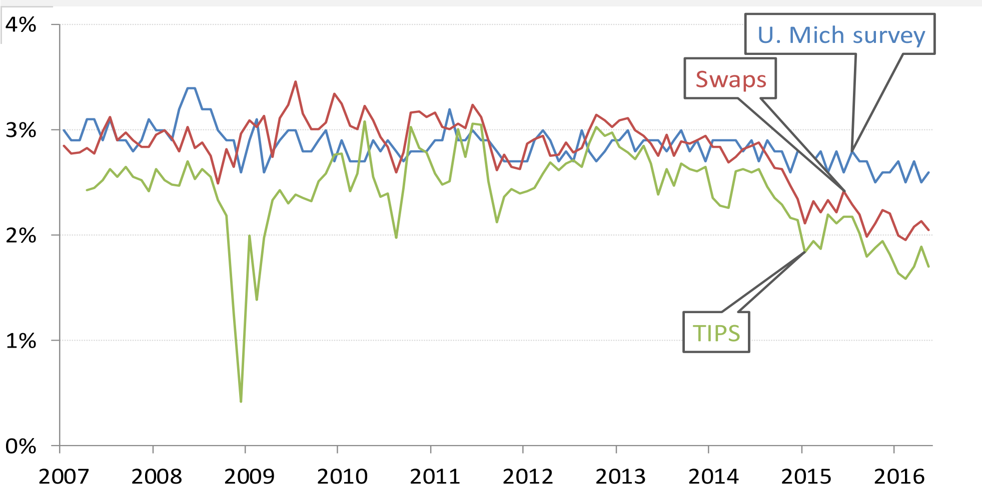
Has it really been only 52 days? On March 29, Fed Chair Janet Yellen suddenly inserted the word "uncertainty" into the title of her speech to the Economic Club of New York, highlighting a new-found respect for the unknown in her policy framework. She citied risks from too-low oil prices and China's exchange rate policies, and alarmingly low long-term market-based inflation expectations (see "Yellen Adds 'Uncertainty'" March 30, 2016). To be sure, the first two of those three risks have receded in intensity (but hardly gone away entirely) – but the third is as worrisome as ever (please see the chart below). And now we could add to the list of

Update to strategic view

US FED, US MACRO: Mere weeks after Yellen confessed "uncertainty" after a disastrous liftoff, suddenly Fed officials see "at least" two rate hikes in 2016, perhaps starting in June – and the April FOMC minutes can be read the same way. We don't believe it will happen. We still think no hike until December, and probably not even then. There's no good reason for it, and lots of good reasons against it. And once burned, twice shy. But if we're wrong, then the Fed will have revealed itself to be stuck on stupid, and markets will unravel very fast and very hard.

[Strategy dashboard]

Long-term steady-state inflation expectations



Source: Bloomberg, TrendMacro calculations known unknowns the highly unusual upcoming presidential election with Donald Trump as the presumptive GOP candidate (see "Trump's the One" May 4, 2016), and the United Kingdom's potentially world-historical upcoming referendum on "Brexit."

Precisely because of the massive cognitive dissonance of it all, markets have understandably reacted strongly to officials' statements about "at least" two more rate hikes in 2016, and minutes that say "Most participants judged that if incoming data were consistent with economic growth picking up in the second quarter… it likely would be appropriate for the Committee to increase the target range for the federal funds rate in June." *So much for "uncertainty." Apparently now all it takes is a couple weeks of slightly better data, and we're hiking.*

- *Call us contrarian, or just plain ornery, but we don't believe it.*
- When the FOMC sits down in that big marble conference room on June 15, one woman is going to have to make one decision, no matter what anyone else is saying or wishing. We think that so soon after being chastised by markets following liftoff, Janet Yellen won't risk another hike – especially with an election coming up.
- This is revealed subtly in a passage from the April FOMC minutes that none of the media accounts have mentioned:

  The public appeared to have interpreted Federal Reserve communications following the March FOMC meeting as indicating that achieving the Committee's economic objectives would likely require a somewhat more gradual pace of increases in the federal funds rate than anticipated earlier. The shift in policy expectations… seemed to contribute to the improved tone in global financial markets.

- *In other words, the Fed is aware that the improvements so eagerly cited this week by Dudley, Williams and Lockhart are due to the Fed's move toward the dovish. Why, then, would improvements caused by dovishness now justify a move toward the hawkish? Wouldn't that only reverse those improvements?*
- As but one possible example, arguably US dollar weakness this year has been the result of the Fed's move toward dovishness. That weakness has taken pressure off China's exchange rates versus the non-USD world (see "More Anbang For the Buck" April 13, 2016), and thus helped ameliorate one of the key risks Yellen cited in her "uncertainty" speech. How would it help to move back toward the hawkish, possibly strengthening USD – and RMB along with it – throwing China right back into the untenable position of having a too-strong currency getting stronger still?

At the same time, there is absolutely no pressure on the Fed to make any policy changes – other than frantic calls from lobbyists hired by the banking industry and AARP. *In reality everything is perfect, mandate-wise.* Unemployment is 5%. Year-over-year core PCE inflation is 1.6% – there are thou happy too. To the extent that either of those key indicators of

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On the web at
trendmacro.com

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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

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success at achieving the Fed's dual mandate are imperfect at all, they are imperfect in a direction that argues for *easing*, not *tightening*.

- Vice Chairman Stanley Fischer admitted as much yesterday, whether he realizes it or not.
- In a speech celebrating the career of Michael Woodford, Fischer lovingly recited a paean to the great founding father of monetary theory, Knut Wicksell – the originator of the concept of the "natural rate" of interest. According to Wicksell, as quoted by Fischer, when a central bank sets its policy rate below the natural rate, inflation ensues; above it, deflation.
- Fischer quotes Wicksell's formula for how central banks should determine policy. They should not try to figure out what the natural rate is. "The procedure should rather be simply as follows: So long as prices remain unaltered, the banks' rate of interest is to remain unaltered. If prices rise, the rate of interest is to be raised."
- *In other words, when you see too much inflation, raise the policy rate. When you see too little, lower it.*
- *So what inflation do we see now?* To be sure, Wednesday's CPI report was attention-getting, at least in that headline inflation for the single month of April ran at an annual rate of 5%. *But come on!* A massive sudden recovery in oil prices will do that (see "Oil's Bull Market in a Month" March 15, 2016). It's only one month anyway, but even ignoring that, take oil out and all you have is 2.3% -- and that's pretty much entirely due to "owner's equivalent rent" at 3.7% (see "Data Insights: CPI/PPI" March 17, 2016).
- *Get a grip, people!* Again, today year-over-year core PCE inflation is running at 1.6%. The most alarming thing you can say about that, the Fed's favorite inflation measure, is that over the last three months, it is 2.1% (as of March; April data has not been released).
- And again, long-term steady-state inflation expectations in markets and surveys are at or near the lowest in the history of the data, showing almost no change at all despite oil's dramatic recovery since mid-February (again, please see the chart on the first page).
- And even if you want to turn a blind eye to all that and judge future inflation by the present labor market, the most recent jobs report wasn't especially strong, was it (see "On the April Jobs Report" May 6, 2016)?
- *So by Wicksell's own policy prescription – which Fischer himself chose to celebrate yesterday – there is no reason in the objective evidence to hike rates.*

We can understand why the chaos industry – the financial media and Wall Street – would try to get investors excited about the manifestly ridiculous idea of the Fed raising rates "at least" two times in 2016, perhaps starting in June. We can understand why publicity-seeking regional Fed presidents would be complicit. *But we can't see why the Fed would actually do it. There's no good reason to, and some good reasons not to. There's an election coming – and presumably if Yellen wants to put her thumb on the scale at all, it would be in such a way as to keep the economy as strong as possible for fellow Democrat Hillary Clinton. And once burned, twice shy.*

We continue to think there will be no hike until December at the soonest, and probably not even then.

We're giving the Fed a lot of credit here. We're assuming it's not stuck on stupid. But if it hikes in June, or even uses the June FOMC to warn that two hikes are coming in the back half of 2016, then it is stuck on stupid – and markets will come unraveled very hard when they realize it in full.

Bottom line

Mere weeks after Yellen confessed "uncertainty" after a disastrous liftoff, suddenly Fed officials see "at least" two rate hikes in 2016, perhaps starting in June – and the April FOMC minutes can be read the same way. We don't believe it will happen. We still think no hike until December, and probably not even then. There's no good reason for it, and lots of good reasons against it. And once burned, twice shy. But if we're wrong, then the Fed will have revealed itself to be stuck on stupid, and markets will unravel very fast and very hard.