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FED SHADOW

Joint Session Overshadows FOMC Session

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Donald Luskin

March goes "live," and risk-tolerant markets don't care. The "natural interest rate" is rising.

First, a quick word about President Donald J. Trump's joint session address last night: It seems once again "the memo went out" – the expressions "softer tone" and "more presidential" were used universally in media reports. Not inaccurate, but much of Trump's address was just a rehash from stump speeches, often word-for-word – with the exception of a seeming opening to negotiate on "merit-based" immigration reform. We learned nothing new about the key economic initiatives that lie ahead.

- *What we did see was Trump consolidating his power and influence amidst a media environment that insists he is losing control. We saw nothing last night to diminish our enthusiasm for Trump accomplishing much of his pro-growth economic agenda.*
- It was a personal-best for Trump at out-playing the Democrats at their own game of identity politics. His over-the-top *homages* to several guests in attendance – all symbolizing his policy themes, but all "victims" in various ways, making them unassailable by sulky Democrats in the room, who looked small for not applauding.
- For all of Trump's "chaotic" style, he continues to draw strength from maneuvering Democrats into doubling down on candidate Hillary Clinton's lethal "deplorables" error. And when they stop making that error, their alternative will be to capitulate.

Now to the Fed: It needs explaining why, during about 90 minutes on Monday morning, market-based expectations for the probability a March FOMC rate hike jumped from 40% to 50% on no news at all, and closed yesterday at 80% – and yet markets have had substantially no reaction. Today's surge in stocks and the dollar, and the back-up in long-term yields, are all "Trump trades" in the wake of last night's address. The FOMC expectations changes were in the market long before any of them.

- We can find absolutely no event-based connection that explains Monday's initial jump in expectations. Apparently yesterday's continuation is due to remarks by New York Fed Chair William Dudley, which point in the right direction, but really strike us as no more dispositive than anything he ever says.
- *So we are agnostic on whether there will be a March hike. Call it 50/50.*

Update to strategic view

US FED, US MACRO, US BONDS: Trump's address to the joint session last night, while superficially "more presidential," was a masterpiece of identity-politics that leaves Democrats no alternatives but to double down on Clinton's "deplorables" error, or capitulate. Market-based expected probabilities for a March FOMC rate hike have jumped to 80% on Monday and Tuesday, during which there was no market reaction at all. We are agnostic on whether that hike will really happen. It doesn't matter anyway, because markets have become highly risk-tolerant, including tolerance to experiments by the Fed. That same risk-tolerance implies that the "natural rate of interest" is rising, so a Fed hike is appropriate, and would not represent a policy tightening at all.

[Strategy dashboard]

- *The important thing is that as March has become a "live" meeting, markets don't seem to particularly care. No tantrums.*
- One reason might be that for all the heightened expectations of a March hike, expectations for the long-term path of the funds rate haven't really changed much this week. Three years out, the curve is still expected less than two hikes per year. So this is all really just a matter of a slight front-end loading.
- *But we think the deeper reason is what we consider to be the governing dynamic of this moment in markets, and likely the governing dynamic for years to come – a global secular "turning" in social, cultural, political and investment attitudes in the direction of greater risk tolerance* (see, most recently, "From Executive Orders to Spontaneous Order" February 17, 2017).
- As an immediate effect, this turning means that markets will be more tolerant of the Fed experimenting with a slightly higher funds rate. It no longer demands that the Fed walk on eggshells.
- So don't be concerned that long-term yields are backing up today. That's not a tantrum. Again, it may not be causally related to the FOMC at all. For us, it's a reflection of the diminishing value of safe-haven assets in a world more tolerant of risk.
- Most important for thinking about the FOMC is that this turning implies the persistently low "natural interest rate" – the product of more than a decade of global risk aversion and savings-preference in the era of "secular stagnation" – is beginning to move higher. And as it does, it is perfectly appropriate for the funds rate to track it higher. In fact, we think that a version of this reasoning has become an unofficial "rule" at the Fed (see "Yellen Gives Conservatives Something to Cheer" February 17, 2017).
- *We urge clients to understand what within this framework a rate hike now would not be a tightening.*
- So long as the funds rate merely tracks the "natural rate," the Fed's policy posture – which is the degree (and direction) of difference between the funds rate and the "natural rate" – will not have changed at all.

Bottom line

Trump's address to the joint session last night, while superficially "more presidential," was a masterpiece of identity-politics that leaves Democrats no alternatives but to double down on Clinton's "deplorables" error, or capitulate. Market-based expected probabilities for a March FOMC rate hike have jumped to 80% on Monday and Tuesday, during which there was no market reaction at all. We are agnostic on whether that hike will really happen. It doesn't matter anyway, because markets have become highly risk-tolerant, including tolerance to experiments by the Fed. That same risk-tolerance implies that the "natural rate of interest" is rising, so a Fed hike is appropriate, and would not represent a policy tightening at all.

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