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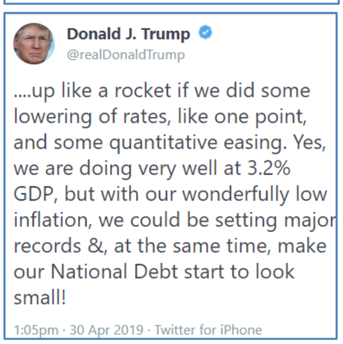
TRENDMACRO LIVE!

On the May FOMC

Wednesday, May 1, 2019

Donald Luskin

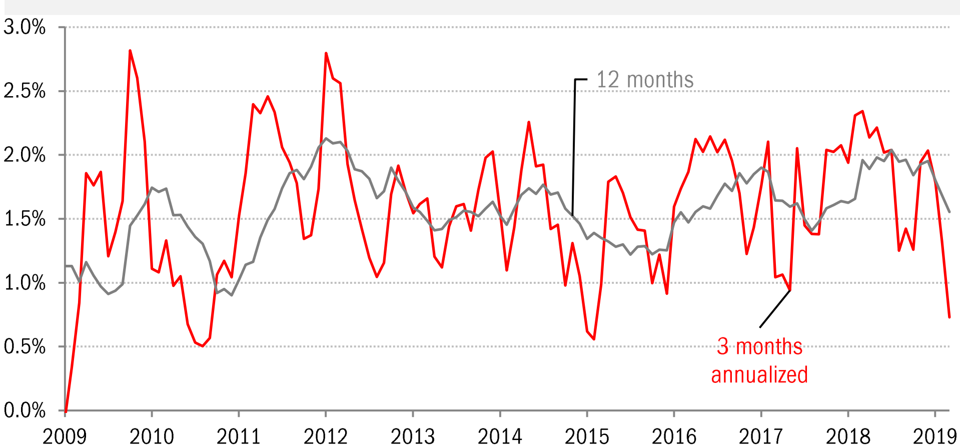
Trump is right, and if inflation stays "wonderfully low," even Powell will agree to cut rates.



The decision at the May FOMC meeting, to leave the funds rate unchanged, to lower the rate paid on excess and required reserves by 5 bp, and make no change to the tapering of normalization toward a $3.5 trillion asset portfolio – *despite the jump to 3%-plus real GDP growth in Q1-2019* – is in compliance with the Christmas Eve weekend deal to be "patient" that chair Jerome Powell struck with President Donald J. Trump (see "Did Powell Just Cut a Deal?" December 23, 2018). *Trump's two tweets posted yesterday while the FOMC was meeting, calling for a 1% rate cut and new quantitative easing, allow Powell to imagine that the world sees him as bravely defying Trump, even as he subserviently complies with the deal he made with him.*

Imagine the personal hell Powell has to live in. He has endured nine months of bullying from Trump, just when he thought he'd been appointed to the most fun job in the world, an unscrewable pooch. *The hell of it is that all the evidence indicates Trump has been correct all along on policy* (as we said from its

"Wonderfully low inflation" — Core PCE price index



Source: BEA, TrendMacro calculations

Update to strategic view

US FED, US MACRO: After Trump's call for a rate cut and new QE based on "wonderfully low inflation," the FOMC only reports "muted inflation pressures," the same language used in the prior meeting. The 5 bp cut in IOER is only a technical adjustment as the Fed learns to use this new policy tool. Trump's inflation argument is not out of the mainstream, yet because it is he who made it, Powell seems compelled to push back against it – though he remains "patient" in compliance with the deal he cut with Trump in December. Trump's call for a rate cut has already been reflected in the curve all year. If inflation remains this low, the consensus will come around to Trump's view and Powell will have little choice but to cut rates.

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very earliest days, for example see "Like It or Not, Trump is Right about the Fed" July 20, 2018). *Poor Powell. The only thing more humiliating than being bullied in public is when everyone knows the bully is right.*

- That puts Powell, and the FOMC too, for that matter, into a state of deep cognitive dissonance in which it becomes hard to tell to what extent policy decisions are made on the merits, and to what extent they are made to either comply with or be seen as defying Trump.
- Today's FOMC statement surely defied Trump's conception of "wonderfully low inflation." The committee says only that inflation "declined" and is "running below 2 percent." That's quite an understatement, considering that core PCE inflation is reported as 1.6% year-over-year, and just 0.7% on a three-month annualized basis (please see the chart on the previous page).
- Today's statement characterizes this as "muted inflation pressures," which is *exactly* the same language used in the March FOMC statement when the most current official data available had core PCE running at 1.9% year-over-year. At what point does the need to push-back against Trump's hectoring start to conflict with the Fed's own characterization of its 2 percent inflation target as "symmetrical," which you would think would have the committee worrying that inflation is too low now, whether or not it is a "wonderful" opportunity to stimulate the economy.
- In the prepared remarks in the post-meeting press conference, Powell conceded that the drop in core inflation was "unexpected." From there, he only repeated the usual mantra that the committee expects inflation to return – somehow, it supposedly has something or other to do with the labor market – to 2%.
- We've seen this kind of thing over and over. Consider the December 2018 statement. The committee justified a rate hike that Trump explicitly didn't want by claiming that "economic activity has been rising at a strong rate." In reality, real GDP growth in Q4-2018 was only 2.2%, tied for weakest quarter in seven. Then – once Powell had cut a deal with Trump and was forced to be "patient" whether he liked it or not – the January 2019 statement downgraded growth from "strong" to merely "solid." The March 2019 statement downgraded it further, saying it "slowed from its solid rate in the fourth quarter." Huh? Real GDP in Q1-2019 was 3.2%. So growth is "strong" when it's 2.2%, and then it "slowed" when it's 3.2%? That's how cognitive dissonance works. Powell doesn't want to be seen as being moved either by defiance of or compliance with Trump? Just make up numbers. In economics, that's easy.
- Trump's view of inflation is not an uncredible one to take, nor even particularly unusual. Plain-vanilla Fed-watchers have been talking this week about a parallel to the 1995-1996 mini-easing episode, justified at the time by a bout of weak inflation. We discussed this episode ourselves recently, noting that the Fed's easing then was just the right thing to do in light of the inversion of the funds rate/10-year curve – which we experienced at the end of last March (see "Video: What Jay Powell should be telling you about the inverted yield curve" April 1, 2019). As we pointed out, Powell himself

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Recommended Reading

The Fed Should Dump Its Interest-Rate Target
Bill Dudley
Bloomberg
April 30, 2019

When Reagan Went to China
Tunku Varadarajan
Wall Street Journal
April 30, 2019

Xi Jinping shows his love of Game of Thrones but warns reality must not mirror fantasy
South China Morning Post
April 28, 2019

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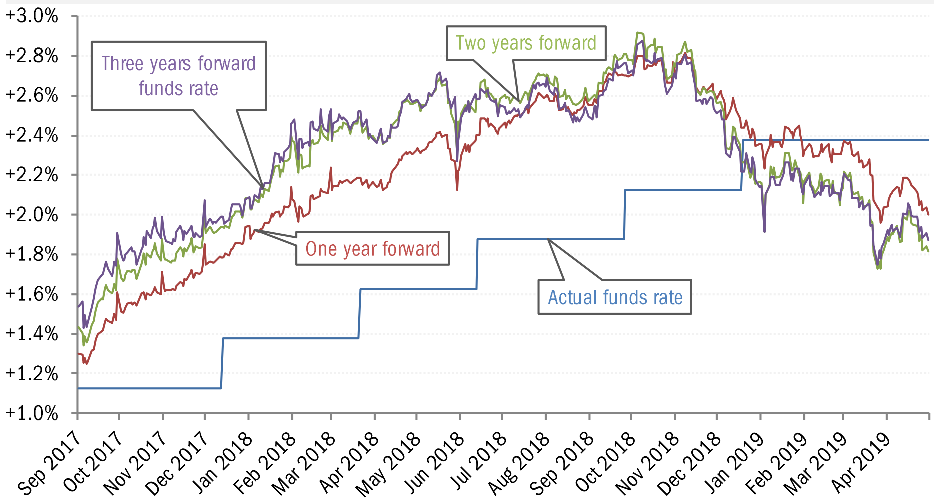
admitted last July that such an inversion means “your policy is tighter than you think.”

- *If inflation continues to run as low as it has in Q1-2019, there is no question in our mind that the consensus will shift more aggressively toward a call for rate cuts. As Trump’s single voice becomes a smaller and smaller share of a growing chorus, we would expect Powell to have to bow to the inevitable.*
- Setting aside the specific rationale of “wonderfully low inflation,” there’s nothing so out-there about Trump calling for a rate cut, either. The whole money-market curve is calling for a rate cut – or two – and has been all year (please see the chart below). The only thing special about Trump saying it is that he’s not the OIS forward curve, he’s President of the United States.

Fed funds rate



Source: FRB, Bloomberg, TrendMacro calculations

- *As to today’s 5 bp cut in “IOER” – the interest rate paid by the Fed on required and excess reserves – that shouldn’t be seen as an attempt to ease policy.* The Fed is experimenting with where to set IOER in relation to the target range for the funds rate – the idea is for funds, on average, to trade in the middle of the range. For years, IOER was set at the top of the range, and funds tended to trade above-middle as a result. At last June’s and last September’s FOMC meetings, the Board of Governors opted to move IOER down within the range by 5 bp each time, and yet funds are still trading a bit above-middle.
- As we have said so many times, in the new world of a large asset portfolio in which the Fed pays interest on the deposits that fund it – that’s what IOER is – there will be a lot of learning-by-doing to get perfect control of rate targets (see “Video: What Jay Powell isn’t going to tell you about the Fed’s balance sheet” March 19, 2019). That’s all this is.
- So don’t think Trump will take any satisfaction from seeming to get a 5 bp down-payment on his 100 bp rate-cut demand. And don’t think Powell will think that he’s given Trump anything. In his

prepared remarks in the post-meeting press conference, he was careful to explain the 5 bp cut much as we just did – calling it only a "technical fix."

- Let us conclude by pointing out the most important of the language changes in today's FOMC statement (see "Data Insights: Federal Reserve" May 1, 2019). FOMC statements when Janet Yellen was chair always referred to her as "chair," not "chairman." When Powell took the gavel, he was "chairman." Today he has become the genderless "chair." We let ourselves imagine he thinks Trump will be annoyed by that little gesture of political correctness. We're pretty sure that if Trump even notices, he might take some measure of satisfaction that Powell has been reduced to such gestures.

Bottom line

After Trump's call for a rate cut and new QE based on "wonderfully low inflation," the FOMC only reports "muted inflation pressures," the same language used in the prior meeting. The 5 bp cut in IOER is only a technical adjustment as the Fed learns to use this new policy tool. Trump's inflation argument is not out of the mainstream, yet because it is he who made it, Powell seems compelled to push back against it – though he remains "patient" in compliance with the deal he cut with Trump in December. Trump's call for a rate cut has already been reflected in the curve all year. If inflation remains this low, the consensus will come around to Trump's view and Powell will have little choice but to cut rates.