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FED SHADOW

Jay Powell, Inflation Justice Warrior

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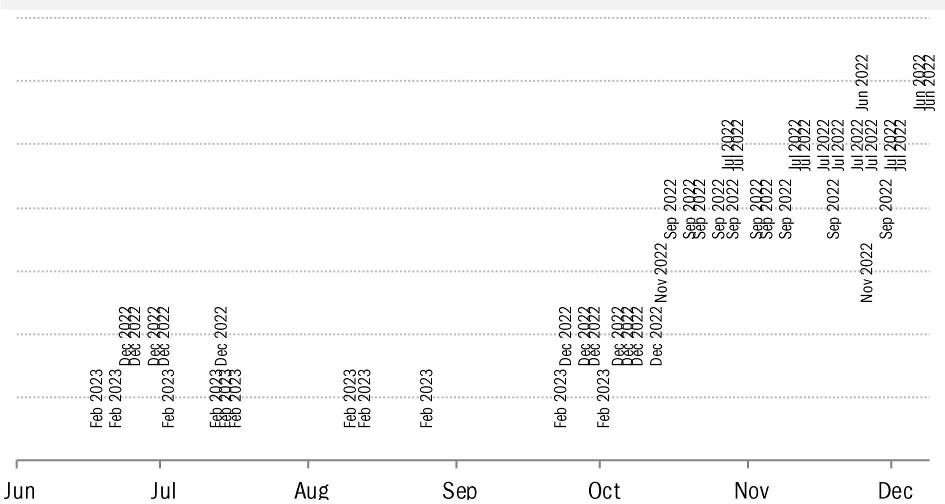
Donald Luskin

The FOMC will be a "struggle session." Powell will take blame for inflation he didn't create.

Tomorrow's FOMC meeting is going to be the trickiest in a long time.

- Having been renominated but not yet reconfirmed by the Senate, *Chair Jay Powell will be obliged to show how much his heart bleeds about inflation, even though he knows perfectly well that the current high rates are transitory* – as he (and we) have been saying all along, even though he (not we) got maneuvered into "retiring" the word last week (see "Video: What you're not hearing about the highest CPI in 39 years" December 10, 2021).
- *It is his political duty to pretend the Fed has a monetary policy solution to a problem of fiscal origins – thus deflecting blame from the damage to the supply side of the economy done by pandemic lockdowns and the reckless and unnecessary $1.9 trillion American Rescue Plan enacted in February* on a Democratic party-line vote just one month after Joseph R. Biden took office as president.
- For the Biden administration, at least, this is ideal. *Powell's both taking the blame and promising a solution deprives critics of the Build Back Better bill – particularly Senator Joseph Manchin (D-WV) – of the objection that trillions of additional government spending is risky when inflation is running hot*.

Futures-implied FOMC meeting of lift-off from near-zero funds rate



Source: Bloomberg, TrendMacro calculations

Update to strategic view

FEDERAL RESERVE, US MACRO: Powell's challenge tomorrow is to earn confirmation by the Senate by dutifully acting concerned about inflation. He must take the blame for it (which deflects from the Biden administration's spending agenda), and appear to "do something, even though he still believes correctly that it is transitory – all the while not crashing markets or the economy. His free option is to accelerate the pace of tapering asset purchases, now an irrelevant de-risking exercise. Market-implied expectations for lift-off have moved forward to the June FOMC. We expect inflation will cool by then and create an option for deferral. But based on the pace of labor market recovery across most groups, and reaccelerating growth after a disappointing Q3-2021, June lift-off would not necessarily be inappropriate. The curve expects only about five hikes this cycle, perhaps implying the return of "secular stagnation" – or, instead, a global savings glut that has moved the natural rate of interest lower.

[Strategy dashboard]

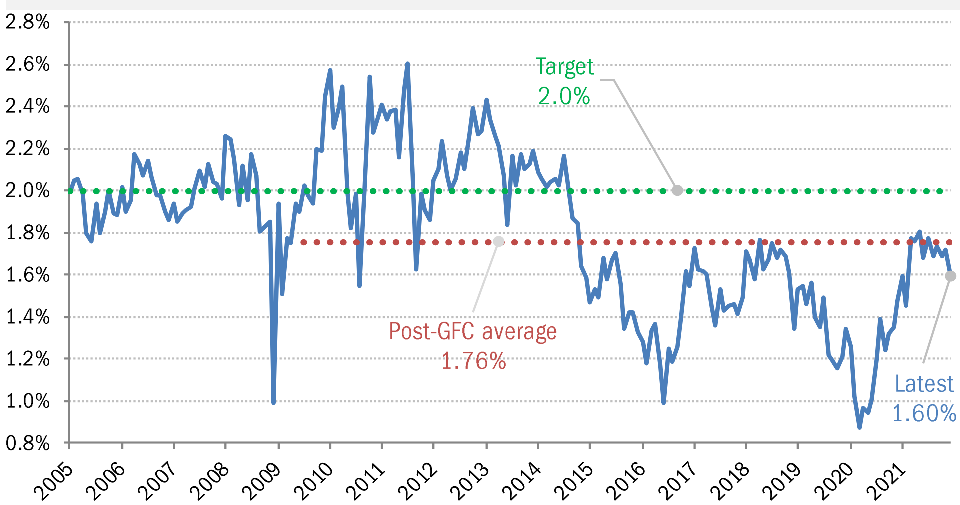
- *<u>The trick for Powell will be to appear as an earnest inflation justice warrior, while not taking it so far that it crashes the markets or the economy in the process.</u>* No doubt he will not have forgotten the December FOMC three years ago when he was still a rookie – when one last hike the market wasn't expecting and one off-hand remark about "automatic pilot" set off a panic (see "On the December FOMC" December 19, 2018) until he recanted (see "Did Powell Just Cut a Deal?" December 23, 2018).
- *<u>It is almost certain that an acceleration in the pace of tapering asset purchases will be announced tomorrow</u>*. Powell virtually promised as much in a question-and-answer session in the Senate two weeks ago (see "'Hawkish Powell'? Not a Chance." December 1, 2021). The option to do this was laid out clearly in the minutes of the November FOMC (see "Data Insights: FOMC Minutes" November 3, 2021):

  "Some participants suggested that reducing the pace of net asset purchases by more than $15 billion each month could be warranted so that the Committee would be in a better position to make adjustments to the target range for the federal funds rate, particularly in light of inflation pressures."

- It seems a stretch to exercise this option suddenly just because one more CPI report has come out and inflation got a little hotter (see "Data Insights: CPI" December 10, 2021). Perhaps one has to lose patience at some point, so why not now? Here's why not: because all the excess inflation remains concentrated in just three categories (motor fuels, motor vehicles and rents), and market-implied expectations have not only *not* gotten worse but, indeed, have gotten better, perhaps to a fault (please see the chart below). But no matter – this is political theater, not economics.

<u>The taper adjustment is a freebie for Powell</u>. It's a "do something" for him

Five-year five-years forward TIPS breakeven (downward adjusted 50 bp for PCE basis)



Source: Bloomberg, TrendMacro calculations

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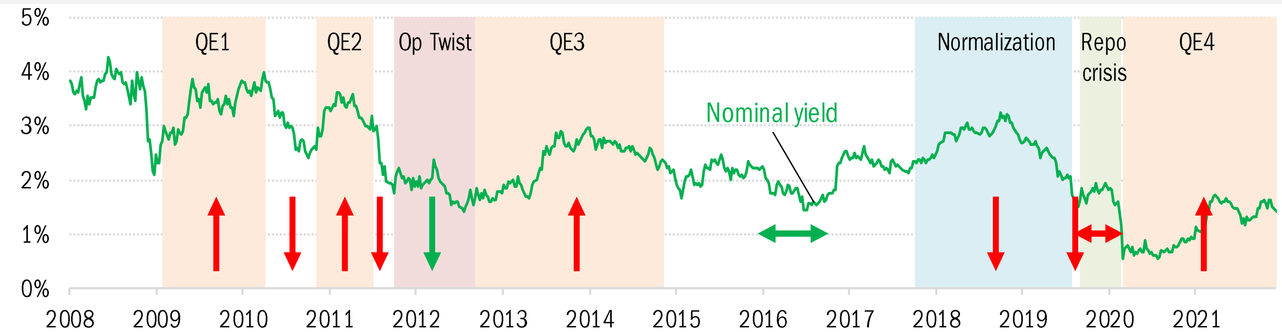
[About us]

that, we believe, satisfies demands for his political obeisance while entailing no penalty on economic growth. We've said it before and we'll say it again: *asset purchases are nothing more than a de-risking of market portfolios through maturity-transformation – a gigantic fixed-for-floating swap*. They fulfill the Fed's duty to be buyer of last resort in times of panic (such as Q1-2009 or Q2-2020). *Once they have saved the world, they have no further use and can be terminated without harm*. They have never been a means by which the Fed funds the federal debt; they have never been a helicopter drop of money; and if they were ever intended to lower long-term yields, well, they have failed at that every single time they were tried (please see the chart below).

Fed LSAPs versus 10-year Treasury yield Results: ↑ As advertised ↑ Not as advertised



Source: Bloomberg, TrendMacro calculations

- *Lift-off from a near-zero funds rate is a matter of potentially greater consequence – if the economy isn't ready for it when it happens. It would be insult on top of injury if it happens in the name of fighting inflation that turns out to be transitory, whether or not that particular word has been retired*.

While tapering and its imminent acceleration have been hashed out, market-implied expectations for lift-off have come forward in time all the way to the June FOMC (please see the chart on the first page). *Markets assume the Fed needs tapering to be done before lift-off can happen, so accelerating the taper brings closer the day of lift-off*. The transformation of expectations has been sudden. It was as recently as June that lift-off had come to be expected by the fed funds futures markets for the first time, at the February 2023 meeting (again, see the chart on the first page).

- June lift-off feels like it's just around the corner, but in fact it's *plenty of time for inflation to cool down and look a lot more transitory than it does now* – that's our expectation. If that happens, lift-off could be deferred back to where markets expected it just a few months ago.
- Inflation aside, *June 2022 lift-off might be fully justified by further economic expansion that creates a world in which it would not be tightening at all, merely tracking growth higher. In such a world the Fed would implicitly become too loose if it were to do nothing. Policy rates are a matter of context*.
- After all, the headline unemployment rate is already a mere 77 bp higher than it was before the pandemic. *As to the Fed's*

commitment that maximum employment be "inclusive," that gap is almost exactly the same across all ethnic groups except Asians, for whom it is worse, in part because there are now more Asians in the labor force than there were before the pandemic (as there are Hispanics). *Unemployment rates could be back to, or below, pre-pandemic levels as soon as the March jobs report if recent labor market trends continue* (see "On the November Jobs Report" December 3, 2021).

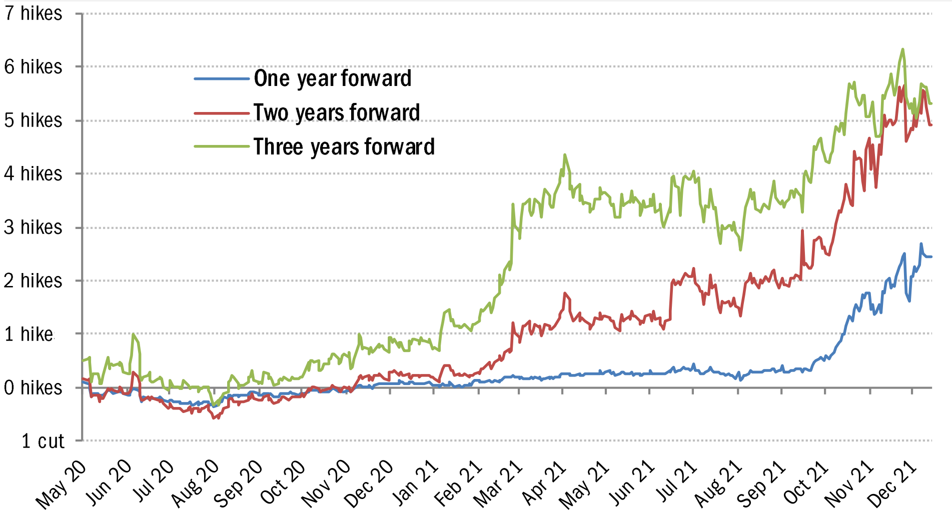
- If there is to be a sticking point in the labor market, it will most likely be labor force participation, still 2.5 million persons below the pre-pandemic level (all whites and African Americans, by the way).
- Of course, there are other metrics of growth besides the labor market. For example, US real gross domestic product, even with a disappointing Q3-2021, is already 1.3% above its pre-pandemic high in Q4-2019. The V-shaped recovery we predicted at the worst of the pandemic lockdowns (see "On the March Jobs Report, and Being in Recession (Whatever that Means)" April 3, 2020) has long been accomplished – we're in an expansion, now.
- Indeed, it amounts to a post-war boom. Q3-2021 was dented by the case-wave associated with the arrival of the Delta variant, and the fear associated with it. Fear has substantially subsided, and it looks as though – as we predicted (see "Video: What you're not hearing about the Omicron variant" November 28, 2021) – the Omicron variant is not going to drive an encore of that in Q4-2021. As of this writing, the Atlanta Fed's real-time "GDP Now" estimate for Q4-2021 is at 8.7%
- *By the time the June 2022 FOMC rolls around we think inflation will have proved to be "transitory" after all*. If, as we think, its roots were not monetary, then as supply/demand mismatches sort themselves out, we might actually observe some degree of deflation – not in the technical sense of that word, but rather price declines that reverse what will have turned out to be temporary increases.
- In either version of that scenario, *Powell would have an option to defer lift-off as an insurance policy for the sake of protecting growth*. We can't read his mind, but we think that would be an ideal outcome for him, and likely it's his personal base case. *But for all the reasons we just cited with respect to jobs and growth, inflation or no inflation, lift-off then will likely be entirely appropriate, or at least harmless.*
- *And for that matter, the curve already expects it – any damage is already done.*

What might come next? At the moment, *while lift-off timing expectations have heightened, it seems the coming hiking cycle is expected to be both front-end loaded and ultimately limited (please see the chart on the next page). Even with lift-off in June, only five rate hikes are implied over two years. No further hikes are expected in the third year out.*

What is Mr. Market trying to say here?

- That *inflation is, in fact, transitory* – so rate hikes can cease quickly without a more stringent tightening cycle? We could sign on to that.

OIS forward curve-implied number of rates hikes



Source: Bloomberg, TrendMacro calculations

- That *the economy will never need a funds rate higher than 1.375%*? Back to "secular stagnation" in the post-pandemic world? Nope… we still think we're in for years of booming growth.
- Maybe that the vast stock of savings created by the US and governments around the world during the pandemic amounts to topping up what former Fed Chair Ben Bernanke used to call the "global savings glut." If that's the case, *the natural rate of interest – the hypothetical rate that would be produced by markets in the absence of central banks, already low for two decades – will be even lower in the future*, and will act as a ceiling on policy rates. It's not convenient for central bankers to have policy rates close to the zero-bound. But that's probably going to be a characteristic of the paradoxical post-pandemic world – *simultaneously booming growth and a low natural interest rate*.

Bottom line

Powell's challenge tomorrow is to earn confirmation by the Senate by dutifully acting concerned about inflation. He must take the blame for it (which deflects from the Biden administration's spending agenda), and appear to "do something, even though he still believes correctly that it is transitory – all the while not crashing markets or the economy. His free option is to accelerate the pace of tapering asset purchases, now an irrelevant de-risking exercise. Market-implied expectations for lift-off have moved forward to the June FOMC. We expect inflation will cool by then and create an option for deferral. But based on the pace of labor market recovery across most groups, and reaccelerating growth after a disappointing Q3-2021, June lift-off would not necessarily be inappropriate. The curve expects only about five hikes this cycle, perhaps implying the return of "secular stagnation" – or, instead, a global savings glut that has moved the natural rate of interest lower.