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TRENDMACRO LIVE!

On the January FOMC

Wednesday, January 26, 2022

Donald Luskin

Ouch. Is balance sheet run-off "running in the background" the new "automatic pilot"?

At 2:48 pm in the post-FOMC press conference, Chair Jerome Powell made a gaffe. Markets didn't like it – stocks erasing the day's gains and yields backing up sharply. *Talking about the run-off of the Fed's balance sheet by not reinvesting maturity proceeds, he said "it will just run in the background."* Poor choice of words – all too close to his characterization of the same thing at the December 2018 presser as *being "on automatic pilot."* Not bad policy necessarily, but it's really stupid for a Fed Chair to suggest that anything about policy is not under very careful and mindful control (see "It's Not 'Quantitative Tightening' – It's Powell" December 20, 2018).

- *Ironically, at this moment, we see this gaffe as a feature, not a bug* – indeed, it's one we expected (see "War on Two Fronts: Ukraine and Inflation" January 24, 2022).
- *Balance sheet run-off by non-reinvestment of maturities is not tightening at all. It doesn't contract the money supply, fail to fund Treasury issuance, reduce liquidity in the banking system, or anything else: it's purely symbolic* (see "Video: What you're not hearing about the Fed's 'quantitative tightening'" January 7, 2022).
- *What better – most harmless – way to be seen as "doing something" about inflation.*
- To be sure, today's FOMC statement dropped the long-standing criteria for lift-off from near-zero policy rates, saying instead it will be "soon" (see "Data Insights: FOMC Minutes" January 5, 2022).
- *But the Fed released at the same time an entirely separate statement talking about the balance sheet run-off, as though to draw special attention to it.* That statement began by saying that the funds rate will remain the primary instrument of policy. It suggested that run-off won't happen until after lift-off. *But nevertheless we see run-off being positioned as something important, deserving its own statement – and therefore as an element of policy adjustment which, when deployed, would create scope for less deployment of rate hikes.*
- *This is way too Machiavellian, but we could even go so far as to imagine that Powell deliberately made his "running in the background" gaffe in order to draw attention to run-off as a tool.*
- All that said, we had hoped for more. We had hoped for more hints that there will be off-ramps by which the Fed can exit its recent hawkish rhetorical posture.

Update to strategic view

FEDERAL RESERVE, US MACRO, US STOCKS, US BONDS: Stocks gave up the day's gains and long-term yields backed up when Powell said run-off of the balance sheet "will just run in the background," an echo of his "on automatic pilot" characterization at the December 2015 meeting. Discussing it in a separate statement released today, the Fed is trying to draw attention to this alternate policy tool, so we can't rule out that Powell's seeming gaffe was deliberate. The regular FOMC statement dropped longstanding contingencies for lift-off, saying it will be "soon." Emphasizing run-off blunts the risk of a headlong hiking campaign by offering a harm-free policy tool that can substitute for hikes while appearing to "do something" about inflation, buying time until it proves to be transitory. Powell acknowledged economic impact from the large number of Omicron infections. By the March meeting, those will have produced two very weak jobs reports. We would have liked more solid clues today, but reiterate our outside-the-box call for no lift-off in March.

[Strategy dashboard]

- Nothing about "international risks" in the FOMC statement. The only macroeconomic concession was to note *"the recent sharp rise in COVID-19 cases."* But rather than seeing this as sidelining something like 5 million workers and consumers from participating in any and all dimensions of economic activity, multiples of the numbers sidelined by severe storms, the statement only said it related to "sectors most adversely affected by the pandemic" (see "War on Two Fronts: Ukraine and Inflation" January 24, 2022).
- *In the prepared remarks for the post-meeting presser, Powell characterized the matter more appropriately*: "activity more broadly may also be affected as many workers are unable to report for work because of illness, quarantines, or caregiving needs."
- *We think that when the Fed meets in March, it will have January and February jobs reports in* hand – and we expect both will show payroll contractions, or at best very anemic growth (again, see "War on Two Fronts: Ukraine and Inflation").
- *And by March Powell will have been confirmed by the Senate for another four years as Chair – he'll be beyond politics at that point, and will be able to appear significantly less obsessed with inflation*.
- *And make no mistake about it. For all the brave talk about inflation-fighting, the reality is that Powell and the FOMC still believe it is transitory*. In today's statement, the word "transitory" is absent again, of course. But the language explaining that it is, nevertheless, transitory is still there, word for word: "Supply and demand imbalances related to the pandemic and the reopening of the economy have continued to contribute to elevated levels of inflation."
- With all this in mind, can we stick with our outside-the-box call that lift-off won't happen in March? We would have liked to have more solid indications. But our call is based in part of contingent events – two terrible jobs reports, moderating inflation statistics – that haven't occurred yet. So of course after this FOMC we have to lower the level of our conviction a bit – but no lift-off in March is still our call.

Bottom line

Stocks gave up the day's gains and long-term yields backed up when Powell said run-off of the balance sheet "will just run in the background," an echo of his "on automatic pilot" characterization at the December 2015 meeting. Discussing it in a separate statement released today, the Fed is trying to draw attention to this alternate policy tool, so we can't rule out that Powell's seeming gaffe was deliberate. The regular FOMC statement dropped longstanding contingencies for lift-off, saying it will be "soon." Emphasizing run-off blunts the risk of a headlong hiking campaign by offering a harm-free policy tool that can substitute for hikes while appearing to "do something" about inflation, buying time until it proves to be transitory. Powell acknowledged economic impact from the large number of Omicron infections. By the March meeting, those will have produced two very weak jobs reports. We would have liked more solid clues today, but reiterate our outside-the-box call for no lift-off in March.

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