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FED SHADOW

A Turn Signal for the Fed's Off-ramp on the Road to Rate Hikes

Monday, January 31, 2022

Donald Luskin

When perma-hawk Esther George suggests an alternative to rate hikes, you should listen.

The sound of sanity is emanating from the most unlikely precinct of the Fed – *Kansas City President Esther George*. This congenital perma-hawk, who never met a rate hike she didn't like nor a central bank balance sheet she didn't think was too big nor an inflation level she didn't think was too fearsome, *is the first Fed spokesperson to point to exactly the off-ramp we predicted they would take on the road to the aggressive hiking campaign* *Wall Street now expects*: *specifically, to back off rate hikes and substitute, instead, allowing the Fed's balance sheet to run off by non-reinvestment of maturities* (see "War on Two Fronts: Ukraine and Inflation" January 24, 2022).

We thought this was coming at Wednesday's FOMC, when the committee took the unusual step of publishing an attention-getting separate document on balance sheet run-off (see "On the January FOMC" January 26, 2022).

Now it's official. From a speech George made yesterday in Indianapolis (*emphasis added*):

> "I expect it will be important to consider the interaction between reductions in the size of the balance sheet and increases in the policy rate. What we do on the balance sheet will likely affect the path of policy rates and vice versa. For example, more aggressive action on the balance sheet could allow for a shallower path for the policy rate. Alternatively, combining a relatively steep path of rate increases with relatively modest reductions in the balance sheet could flatten the yield curve and distort incentives for private sector intermediation, especially for community banks, or risk greater economic and financial fragility by prompting reach-for-yield behavior from long-duration investors."

We continue to believe – more than ever – that the present high inflation is transitory (see, most recently, "Video: What you're not hearing about Jay Powell, Mission Accomplished!" January 27, 2022), even if the FOMC has been forced to abandon the word itself (see "On the December FOMC" December 15, 2021). So we believe it would be a mistake for the Fed to risk any economic opportunity cost at all by raising rates in order to squelch it – because it's in the process of already squelching itself. *But inflation is the new Covid – a politicized mania of fear in which we're talking ourselves into causing a recession in a clumsy attempt to rein in a*

Update to strategic view

FEDERAL RESERVE: Perma-hawk Kansas City Fed President George gave a speech today calling for Fed balance sheet run-off as a substitute for rate-hikes. We predicted the Fed would take this view as a means of catering to the present intense and politicized concern with inflation, while doing no economic harm. Last week's FOMC published a special statement drawing attention to balance sheet run-off, and now the most inflation-phobic Fed spokesperson has endorsed it. As a "do something" about inflation, balance sheet run-off is a harmless placebo to administer while the disease resolves itself. It spares us from administering what amounts to economic chemotherapy that is more dangerous than the disease.

[Strategy dashboard]

disease that is less deadly than the proposed treatment. But in such a cognitive environment, once must be seen as "doing something."

- *Our prediction has been that the Fed would "do something" by administering what amounts to a placebo – running off the balance sheet, something that makes no difference whatsoever to consumers, the economy, the banking system or the US Treasury* (see "Video: What you're not hearing about the Fed's 'quantitative tightening'" January 7, 2022). But it will surely quell inflation fears, because almost no one knows it's a placebo in this "blind" trial.
- *The special statement at the FOMC, and now George's speech – all the more significant because of her perma-hawk bona fides – is the proof that they're going to do that, rather than administer what amounts to economic chemotherapy (that is, a treatment you hope will eliminate the disease before it eliminates you).*
- You see, this isn't a "double blind" trial. The patient doesn't know that balance sheet run-off is a placebo. But we're convinced more than ever now that Doctor Fed does.
- *This is very good news.*

Bottom line

Perma-hawk Kansas City Fed President George gave a speech today calling for Fed balance sheet run-off as a substitute for rate-hikes. We predicted the Fed would take this view as a means of catering to the present intense and politicized concern with inflation, while doing no economic harm. Last week's FOMC published a special statement drawing attention to balance sheet run-off, and now the most inflation-phobic Fed spokesperson has endorsed it. As a "do something" about inflation, balance sheet run-off is a harmless placebo to administer while the disease resolves itself. It spares us from administering what amounts to economic chemotherapy that is more dangerous than the disease.

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