Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
Thomas Demas, Managing Director
Michael Warren, Energy Strategist

FED SHADOW

So Six Questions for Jerome Powell

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Donald Luskin

Prep for the Chair Pro Tempore on how to help stocks to put in a bottom Wednesday.

Question: Mr. Chairman, inflation expectations in markets and in surveys are completely consistent with your target of 2%. Why do you and your colleagues keep insisting that inflation is such a big problem that you need to do whatever it takes to solve it?

Powell: So that's Chairman *Pro Tempore*. I haven't been confirmed by the Senate yet.

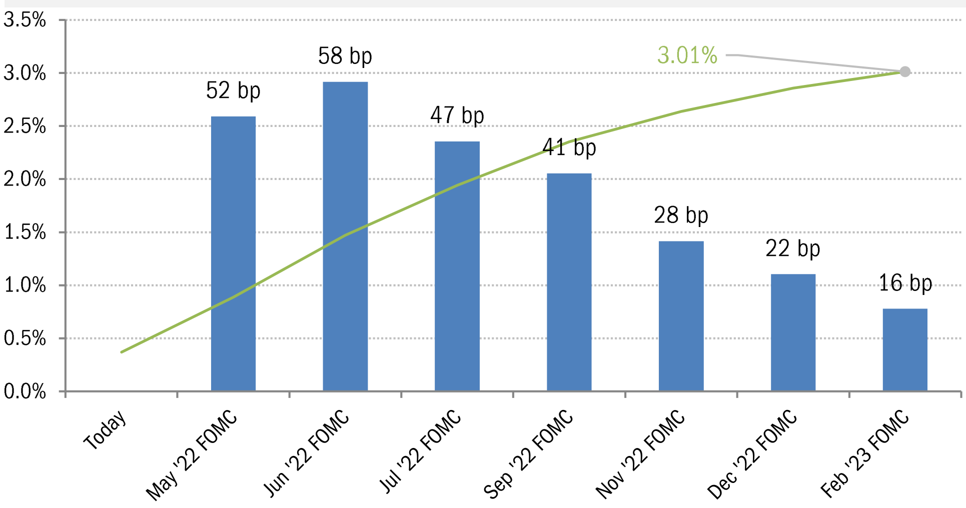
Question: Sorry, Mr. Chairman *Pro Tempore*. But what is the answer to my question?

Powell: So that *was* the answer to your question.

Question: Fixed income markets expect the funds rate to be at about 3% by year-end, and for that to be the end of the hiking cycle. The path to 3% is "expeditious" as you say, but 3% isn't a very high funds rate. Looks more like normalization of policy now that the economy is out of the pandemic, and not really like trying to fight inflation very hard.

Powell: So you noticed that…

Futures-implied — Path of fed funds rate — Rate hike at each FOMC meeting



Source: Bloomberg, TrendMacro calculations

Update to strategic view

FEDERAL RESERVE, US STOCKS, US BONDS, US MACRO: Powell has still not been confirmed as chair by the Senate, so overheated inflation-fighting rhetoric remains a political necessity. Inflation expectations are consistent with the Fed's 2% target. The rate-hike path implied by fixed income markets is steep but short, terminating at around only 3% at year-end, consistent with normalization, not tightening. New inflationary impulses coming from the Russian invasion of Ukraine and China lockdowns can't be addressed by policy. Balance sheet normalization will be cash-flow neutral as the Fed returns excess reserves to banks. If Powell emphasizes these simple facts on Wednesday, stocks can put in a bottom.

[Strategy dashboard]

Question: Gasoline and food prices have spiked world-wide because of the Russian invasion of Ukraine, which put stresses on energy and agricultural markets. And now lockdowns in China might prolong pressures on global manufacturing supply-chains. How will higher policy rates help with any of that?

Powell: So you seem to be suggesting that Milton Friedman was wrong when he said inflation is everywhere and always a monetary phenomenon. Well, I'm a lawyer, not an economist.

Question: How will the US Treasury fund our massive debts and deficits when the Fed stops reinvesting proceeds from maturities in its portfolio?

Powell: So I have a call in to Jamie Dimon to discuss that with him. I'm pretty sure when we return all those excess reserves he'll need some Treasury securities.

Question: But shouldn't we worry that the 10-year Treasury yield just touched 3%, the highest since late 2018?

Powell: So you mean when we were still in the longest economic expansion in US history?

Question: This all seems so sensible. So why all the scorched earth talk about inflation from you and your colleagues? Don't you think if you tone it down a bit at the FOMC on Wednesday the stock market might stop worrying that you're going to deliberately cause a recession, and finally put in a bottom for this correction?

Powell: So the answer to your second question is yes. Sorry, I forgot what the first question was.

Bottom line

Powell has still not been confirmed as chair by the Senate, so overheated inflation-fighting rhetoric remains a political necessity. Inflation expectations are consistent with the Fed's 2% target. The rate-hike path implied by fixed income markets is steep but short, terminating at around only 3% at year-end, consistent with normalization, not tightening. New inflationary impulses coming from the Russian invasion of Ukraine and China lockdowns can't be addressed by policy. Balance sheet normalization will be cash-flow neutral as the Fed returns excess reserves to banks. If Powell emphasizes these simple facts on Wednesday, stocks can put in a bottom.

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On the web at
trendmacro.com

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Donald Luskin
Chicago IL
214 550 2121
don@trendmacro.com

Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

Michael Warren
Houston TX
713 893 1377
mike@trendmacro.energy

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