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TRENDMACRO LIVE!

On the May FOMC

Wednesday, May 4, 2022

Donald Luskin

Powell needed to back off the ledge of ultra-hawkishness. He did.

The funds rate target was hiked by 50 bp, as markets had completely discounted.

Coming into this meeting we said it was urgently important that Chair Pro Tempore Jerome Powell and the FOMC back off their red-hot hawkishness driven by what is merely the appearance of inflation – an inflation the Fed didn't cause, and can't cure by anything except triggering a completely unnecessary recession (see "So Six Questions for Jerome Powell" May 2, 2022).

- *Powell's very first words in the post-meeting press conference* were not encouraging – and more than a little pompous. "I want to speak directly to the American people. Inflation is much too high…" Then "the labor market is much too tight." *Hard not to see that as a clear statement that he sees the Fed's dual mandate as out of whack on both sides, calling for tighter policy to both fight inflation and cool the labor market.*
- Then minutes later, Powell said "Additional 50 bp rate hikes should be on the table for upcoming meetings" – which we immediately understood as code to say that 75 bp hikes should not be.
- Of course reporters picked that up, and *the second question for Powell was whether 75 bp was on the table. We hoped he would be asked this – it's the key question. But we feared he'd say something generic – but implicitly hawkish – like "we aren't ruling anything out." He didn't. He said the opposite. He said 75 bp wasn't even discussed at the meeting. He ruled it out.*
- Confirming the truth of this, we note that there was not a repeat of the March FOMC dissent from James Bullard, the St. Louis Fed's over-the-top publicity-mad hawk who wasn't satisfied with a 25 bp lift-off (see "On the March FOMC" March 16, 2022).
- *This is what we were looking for, to put a bottom in for the stock market* (again, see "So Six Questions for Jerome Powell").

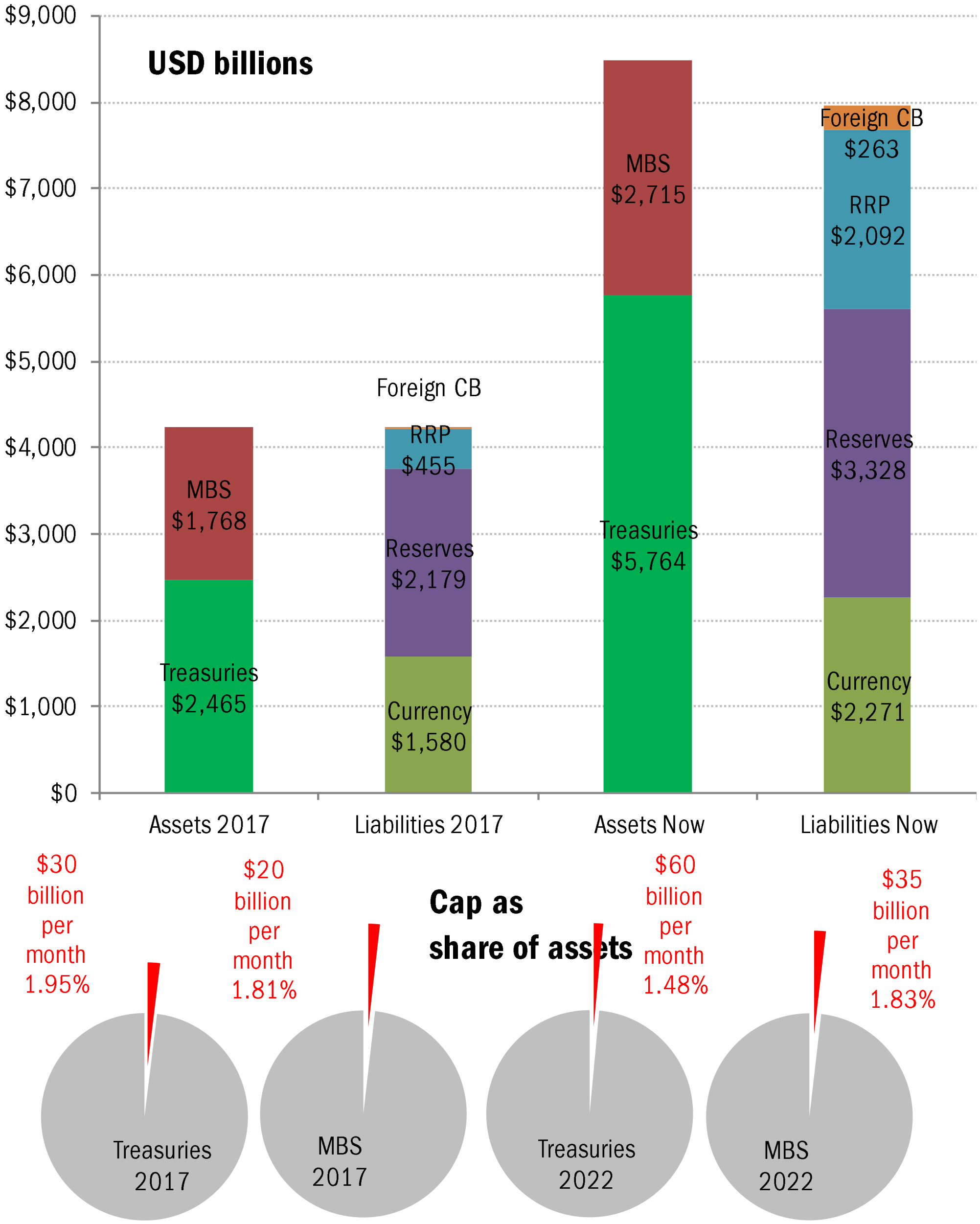
The text of today's FOMC statement made some dovish concessions, too, noting that "economic activity edged down in the first quarter" and that "COVID-related lockdowns in China are likely to exacerbate supply chain disruptions." Fair enough, but then the hawks tacked on this new sentence: "The Committee is highly attentive to inflation risks."

Update to strategic view

FEDERAL RESERVE, US MACRO, US STOCKS: A 50 bp hike, as fully expected. But Powell had to back away from recent excessive hawkishness, and he did. This is what we were looking for to put a bottom in for stocks. He confirmed that additional 50 bp rate hikes are on the table, but that 75 bp hikes hadn't even been discussed. This is confirmed by no dissent from Bullard. The written statement acknowledged weaker growth, and risks from China's lockdowns, a recognition that the fullest hawkish approach is not appropriate. Asset sales will begin in June, but with a dovish surprise – run-off will begin at only half-speed, with the full caps not coming into effect for three months. Powell conceded that if inflation visibly decelerates, anticipated 50 bp hikes would become 25 bp hikes.

[Strategy dashboard]

Fed securities holdings, their funding, and run-off caps – at onset of 2017 run-off, and now



Source: FRB, TrendMacro calculations

And now the more-than-hints in the minutes of the March meeting (see "Data Insights: FOMC Minutes" April 6, 2022) are official. Described in a separate statement today, *shrinkage of the Fed's securities holdings begins on June 1, achieved exclusively through non-reinvestment of Treasury maturities and MBS pre-pays – not outright sales – capped at $60 billion per month and $35 billion, respectively* (please see the charts on the previous page, and see "Video: What you're not hearing about the Fed's aggressive balance sheet normalization plan" April 7, 2022).

- *We think it's something of a concession to the doves – or at least*

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to the cautious hawks – that there is a surprise here versus the hints in the March minutes: the run-off will begin at only half the pace, with the full caps not coming into effect for three months.

The headlines all over the place today about "tightening" are directionally correct, but miss the nuance that policy has been too loose for a while now, given the robust expansion of the economy in the wake of the 2020 pandemic depression. *By the numbers alone, we continue to see the expected path of rates as a slightly overdue normalization of policy, considering how near we are to "inclusive maximum employment" – and even if inflation were not a consideration* (see "Video: What you're not hearing about the coming Fed tightening cycle" February 18, 2022).

- *We don't think inflation should be a consideration*. We're way out of consensus in our fervent belief that the post-pandemic price bump is already rolling over – but now there's another price bump that has taken the baton, driven by risk premia energy and food prices arising from the Ukraine crisis. Yes, that's a double back-to-back price bump, but it's not "inflation" – its scarcity – and it's still totally transitory (if we may dare to use that forbidden word). Some confirmation: after a flare-up for a couple days two weeks ago, inflation expectations are more than perfectly anchored (see "Video: What you're not hearing about inflation's dead canary in the coal mine" April 25, 2022).
- *Powell revealed that he is still open to the idea that inflation will prove to be transitory. In response to a question, he said rate hikes would likely continue, marching policy back toward normal, under any inflation scenario – but if inflation visibly rolls over, the rate hikes "would be 25 bp instead of 50 bp."*
- *To be clear, we are betting that inflation will indeed prove to be transitory, and that this will end up meaning that the expectations in the curve now for where the funds rate will go this year will have to be dialed back to some extent.*
- To be sure, reasonable people can argue about whether the Fed should be tightening amidst a military crisis at the borders of Europe, the world's largest economy – especially following the first quarter of US contraction since the pandemic depression in mid-2020 (see "Data Insights: GDP" April 28, 2022). But hopefully we can agree, at least, that today's funds rate target range between 0.75% and 1% is still very accommodative in the grand scheme of things, surely accommodative enough for anything but an outright crisis.
- Similarly, we don't see the gradual run-off of the Fed's assets amounting to any substantial degree of policy tightening. *The run-off is perfectly cash-flow neutral, because every penny that the Fed fails to re-invest in Treasuries or MBS goes back to the banking system by the release of excess reserves and reverse repurchase agreements. It is not entirely risk-neutral, because those deposits by the banking system are the least-risky investments in the world – better than full faith and credit, overnight commitment and floating rate – so however those funds are redeployed will mean banks are taking a little more risk than they were. But considering that we are*

hardly in a crisis environment of risk-aversion as we were in 2009 or 2020 – at the launch of the Fed's asset purchase programs – that probably doesn't make any real-world difference in the ability of the private sector to bear risk going forward.

- So, by extension, the rate of the run-off doesn't matter much, either. We've heard concerns that the dollar caps on monthly run-off are far larger than they were in 2017, the prior (and only other) time the Fed undertook to shrink its balance sheet. But as a share of the Fed's asset portfolio, the monthly caps are actually smaller now than last time (again, see the charts on page 2, and "Video: What you're not hearing about the Fed's aggressive balance sheet normalization plan" April 7, 2022).

Bottom line

A 50 bp hike, as fully expected. But Powell had to back away from recent excessive hawkishness, and he did. This is what we were looking for to put a bottom in for stocks. He confirmed that additional 50 bp rate hikes are on the table, but that 75 bp hikes hadn't even been discussed. This is confirmed by no dissent from Bullard. The written statement acknowledged weaker growth, and risks from China's lockdowns, a recognition that the fullest hawkish approach is not appropriate. Asset sales will begin in June, but with a dovish surprise – run-off will begin at only half-speed, with the full caps not coming into effect for three months. Powell conceded that if inflation visibly decelerates, anticipated 50 bp hikes would become 25 bp hikes.