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MACROCOSM

Was That Another Powell Bottom?

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Pro Tempore no longer, the confirmed Chair is politically free to reveal his inner dove.

On Thursday Fed Chair Pro Tempore Jerome Powell finally got to take "Pro Tempore" off his title – the Senate confirmed him for a second four-year term as Chair, by a vote of 80 to 19. It is amusing that both Elizabeth Warren (D-MA) and Rand Paul (R-KY) both voted nay.

- *Within just a few minutes, the stock market bottomed. As of this writing, the S&P 500 is more than 4% higher. At the worst Thursday, the loss from the top tick in January was 19.92%*.
- That's a mere 29 bp better than the 20.21% loss registered the last time Powell's chairmanship got enmeshed in political uncertainty in December 2018. His confirmation wasn't at risk then, but President Donald J. Trump was threatening to fire him. *Stocks bottomed when a tweet from Treasury Secretary Steven Mnuchin made it clear the crisis had passed* (see "Did Powell Just Cut a Deal?" December 23, 2018). *Suddenly, a new easing regime was just around the corner.*
- *So is this the all-clear for stocks? No, things are anything but clear. But Powell's confirmation, delayed for months by the drama of confirmation battles over progressive Fed Board of Governors candidates, liberates the Chair from the political necessity of taking the heat off the Biden administration by taking responsibility for having caused, and now having to cure, inflation.*
- We first pointed out this dynamic in December when Powell told Congress he would "retire" the word "transitory" to describe the present inflation episode (see "'Hawkish Powell'? Not a Chance." December 1, 2021). We said in January that when Powell was confirmed he would back off the Volcker-style "whatever it takes" talk on inflation-fighting (see "On the December Jobs Report" January 7, 2022).
- *But the world has changed* since we said that. Now the Russian invasion of Ukraine and the lockdown of major Chinese cities has created *a new second round of transitory scarcities leading to higher prices, and of course showing up in inflation statistics and consumer experiences*. We think the post-pandemic inflation was transitory – "was," past tense – with key elements of it, such as used cars, already decelerating or downright rolling over. The negative surprise is that there has been a baton-pass to new scarcities driven by entirely different causes. We think these new causes will also prove to be transitory. *But what happens when*

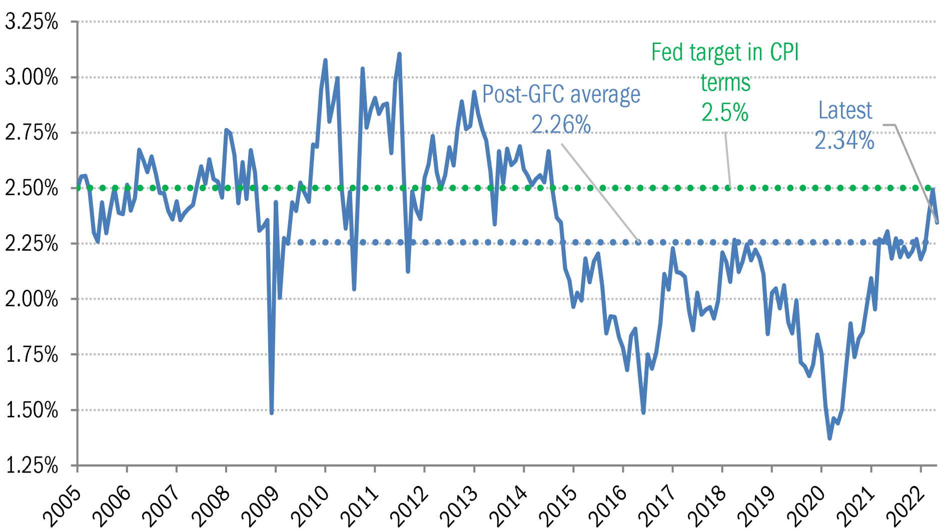
Update to strategic view

FEDERAL RESERVE, US MACRO, US STOCKS: Powell was confirmed on Thursday, and US stocks bottomed just minutes later, and as of this writing are more than 4% higher. The almost 20% bear market experienced this year is similar to the one in late 2018 the last time Powell faced a political crisis. Now confirmed, he can dial back the politically necessary ultra-hawkish rhetoric. An interview on Thursday showed no evidence of that, but it seems it was made before the confirmation vote. Powell's current thought process implicitly assumes that inflation is permanent unless the Fed slows the demand side of the economy. This is a doom-loop with China's lockdowns and the war in Ukraine already slowing growth, but creating scarcities driving higher statistical inflation at the same time – inflation that will happen no matter what the Fed does. The S&P 500 equity risk premium got almost back to its post-GFC mean at the lows on Thursday. There are lots of risks out there, and Powell's conversion is not proven. But it's a sensible time to at least start reallocating back towards risk and growth.

there are two transitory inflations back-to-back – in aggregate is inflation still transitory?

- We would say "yes" – because *when a cause is transitory, the effect is transitory*, and that would remain true even when you have two causes producing the same effect.
- Be that as it may, a prolonged consumer experience of inflation, from whatever cause, can lead to higher inflation expectations which themselves lead to higher inflation in a self-fulfilling prophecy, as consumers rush to buy before prices rise further, pushing prices higher by doing so. *After a brief hint at a jump in expectations implied by the TIPS markets last month, expectations have reverted to the tame levels seen throughout this inflation episode, and for that matter, consistently since 2014* (please see the chart below, and see "Video: What you're not hearing about inflation's dead canary in the coal mine" April 25, 2022).

5-year TIPS breakeven spread, five years forward



Source: Bloomberg, TrendMacro calculations

- It's not just TIPS. The University of Michigan's consumer surveys show one-year inflation expectations well below the past year's inflation experience – 5.4% to 8.7%. And long-term expectations remain pegged at a fairly typical historical level of 3%. Even among Republican respondents to the survey, the ones with the stronger motive to make a big deal about inflation while a Democrat is in the White House, long-term inflation expectations are just 3.5% (and that's down from 3.8% the prior month – please see the chart on the following page).
- *But what matters here is what Powell thinks*, and whether – as we once predicted – he will really move away from his present ultra-hawkish posture once confirmed.
- It's too soon to know. He was interviewed on Thursday, the same day he was confirmed, on the PBS show *Marketplace*. But there's nothing in the interview to suggest he knew about his confirmation at the time it was taped.

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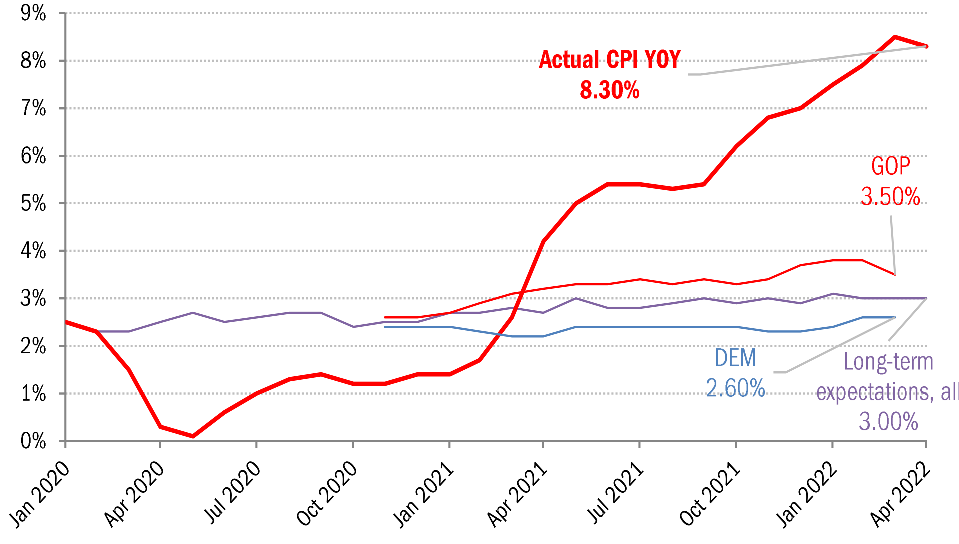
[About us]

Actual inflation and University of Michigan survey long-term expectations (6 to 10 years)



Source: BLS, University of Michigan, TrendMacro calculations

- With that in mind, he spoke extensively about how he sees the Fed's role in reducing the current inflation. We do not normally make quotations at length, but this one is important in order to understand his thought process:

  "…so the problem, what causes inflation, is that demand and supply are out of whack. There's too much demand. For example, in the labor market, there's more demand for workers than there are people to take the jobs, right now, by a substantial margin. And, because of that, wages are moving up at levels that are unsustainably high and not consistent with low inflation. And so what we need to do is we need to get demand down, give supply a chance to recover and get those to align. So how might we do that? Right now, in the labor market, there are two job openings for every unemployed person. It's historically high-level. So in principle, and I'm not saying this will be easy to do, in principle, you could moderate demand, reduce demand to the point where job openings move down substantially, and the labor market gets much closer to being in balance. And that would affect … wages would still be moving up at healthy levels. They wouldn't have to go down, but ultimately they would be at levels that would be consistent with 2% inflation."

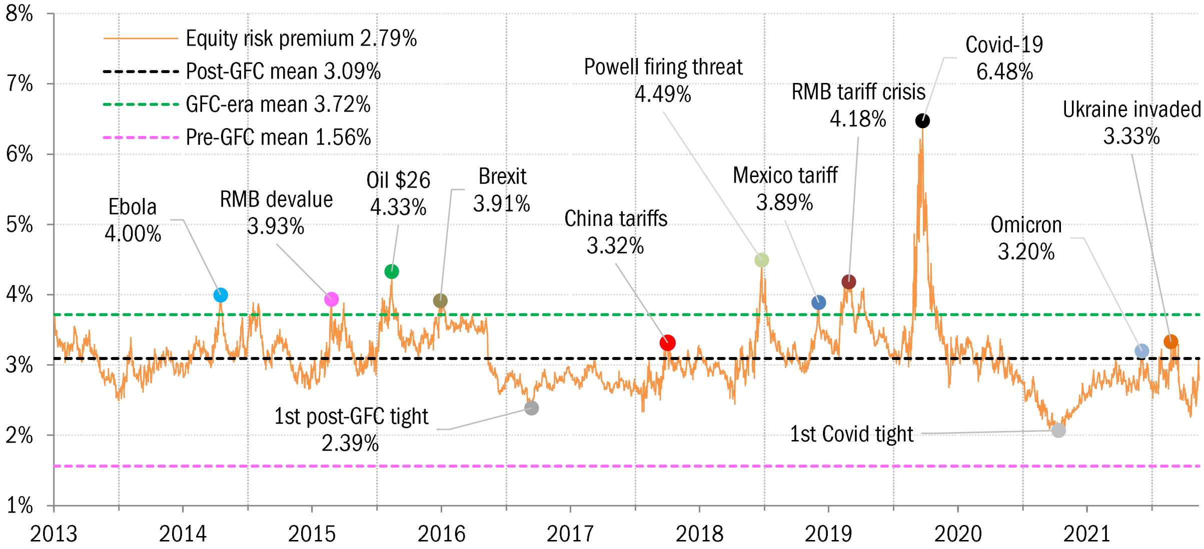
- *This is so wrong on so many levels we hardly know where to begin*.
- *At the outset he says "There's too much demand." But if "demand and supply are out of whack," why not say "There's too little supply"?*
- Probably because if you have a hammer, the world is a nail. All the Fed can do in a hurry is put a dent in demand by slowing the economy, perhaps throwing it into recession.

- To be sure, the Fed can encourage growth in supply by encouraging capital formation with low rates. But that takes more patience than the politics of the moment can live with.
- And – *Good Lord!* – at this point do we really have to hear Phillips Curve nonsense about wage growth "at levels that would be consistent with 2% inflation"? Less that two years ago the Powell Fed officially jettisoned all that claptrap (see "Powell at Jackson Hole, and the Inflation Makeup Strategy" August 27, 2020)
- *All that said, the deepest sin in Powell's construction is the implicit assumption that demand and supply are "out of whack" permanently, unless the Fed does something. If, as we believe, demand and supply are getting more "in whack" every day as we get further and further from the worldwide pandemic lockdowns and their associated stimulus programs, inflation will indeed be transitory.*
- *All the Fed has to do is shut up and wait – inflation will subside, exactly as market-implied and survey expectations say it will, and the Fed can claim credit.*
- That's true even if it takes somewhat longer while the Ukraine situation plays out, and China re-opens its large cities as its Omicron case-wave continues to subside.
- In the meantime, Powell's framework is a doom-loop (see "The Fed/China Doom Loop" May 10, 2022). As China's lockdowns and the war in Ukraine create scarcities that lead to higher statistical inflation, they also slow global growth. *It doesn't help – it only hurts – to have the Fed act to slow growth even more, considering that statistical inflation is going to be high at least for a while, no matter what the Fed does*.
- *To be clear, we are not worried that a mere normalization of Fed policy rates will trigger a recession.* As Powell admitted in the *Marketplace* interview, such normalization is overdue. He said, "…it probably would have been better for us to have raised rates a little sooner." We didn't shed a tear, though presumably we were supposed to, when he added, "…we did the best we could."

So now we wait for clues – to see if Powell, or his many proxies, start dialing back the rhetoric a little bit. *In some sense they already did at the April FOMC, with one rate hike already coming out of the market's expectations framework since then* (see "On the May FOMC" May 4, 2022). *But as the Marketplace interview shows, it's still too hot, and asymmetrically so – there's pretty much nowhere it can go here but cooler.*

- But again, the world has changed since we first looked forward to a post-confirmation Fed tone change. There are now other risks.
- Given all those risks, we wish that the S&P 500 equity risk premium were presenting a more outstanding value case for equities. *Even intra-day on Thursday, the ERP didn't quite make it all the way back up to the post-Global Financial Crisis mean* (please see the chart on the following page, presenting for the first time the ERP with intraday highs and lows). The ERP was very much wider in December 2018, the last time Powell had a political crisis that led to a more dovish outlook.

S&P 500 Equity Risk Premium (forward earnings yield minus 30-year Treasury yield)



Source: Bloomberg, TrendMacro calculations

- But as we get further from the Global Financial Crisis and the pandemic lockdowns, is seems that the ERP is getting systematically narrower (see "Regime Change for the Equity Risk Premium?" April 19, 2021). *This is a bad thing for investors looking for bonus returns earned by exploiting transient panics – but it speaks well for a gradual restoration of risk tolerance. Indeed, much of it due to the back up in long-term Treasury yields, which itself shows a restoration of risk tolerance.*
- If that's right, it means we have to be less demanding for high-risk premia in times of turmoil – provided we think the turmoil will be resolved.
- *This isn't the perfect set-up we had in December 2018. But all considered it's probably a sensible time to begin reallocating back toward risk and toward growth.*

Bottom line

Powell was confirmed on Thursday, and US stocks bottomed just minutes later, and as of this writing are more than 4% higher. The almost 20% bear market experienced this year is similar to the one in late 2018 the last time Powell faced a political crisis. Now confirmed, he can dial back the politically necessary ultra-hawkish rhetoric. An interview on Thursday showed no evidence of that, but it seems it was made before the confirmation vote. Powell's current thought process implicitly assumes that inflation is permanent unless the Fed slows the demand side of the economy. This is a doom-loop with China's lockdowns and the war in Ukraine already slowing growth, but creating scarcities driving higher statistical inflation at the same time – inflation that will happen no matter what the Fed does. The S&P 500 equity risk premium got almost back to its post-GFC mean at the lows on Thursday. There are lots of risks out there, and Powell's conversion is not proven. But it's a sensible time to at least start reallocating back towards risk and growth.