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

TRENDMACRO LIVE!

On the July FOMC

Wednesday, July 27, 2022

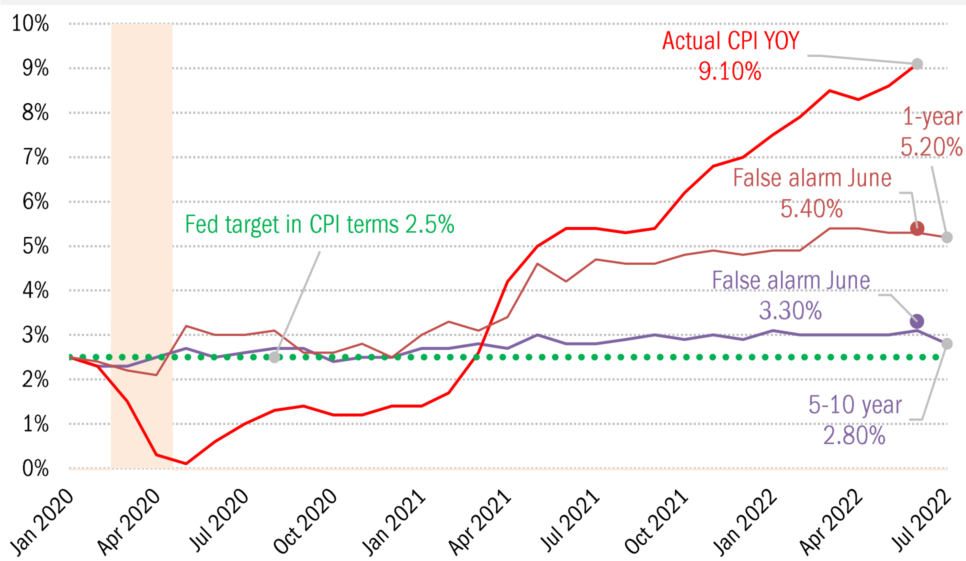
Donald Luskin

At least it wasn't 100 bp, and there were plenty of hints about a decelerating hiking path.

Today's July FOMC statement says "spending and production have softened" (in the June statement, "activity appears to have picked up"). June's reference to the inflation effects of lockdowns in China has been eliminated. *So why the 75 bp rate hike, identical to the policy move that in June seemed like emergency shock treatment? According to Chair Jerome Powell's opening remarks in the post-meeting press conference, it's because "the labor market is extremely tight."*

- We came into this meeting thinking that if there were any surprises at all, they would be on the dove-side (see "Walmart and the Fed" July 26, 2022). We thought there was a small chance the hike would be only 50 bp – *wrong*.
- Separately, we had thought there was a larger chance, but still only a chance, that Chair Jay Powell would signal that today's was the last large hike. That one appears to be about right. In the prepared remarks in the press conference, he said "ongoing increases in the target range for the federal funds rate will be appropriate," but that "it likely will become appropriate to slow the pace of increases" – *right*. At least directionally.

Actual CPI and University of Michigan consumer surveys



Source: Bloomberg, TrendMacro calculations

Update to strategic view

FEDERAL RESERVE, US MACRO: Today's hike in the funds rate to 2.375% brings us back to the too-tight level imposed at the infamous December 2018 FOMC, then as now, in the face of market turbulence and deteriorating macro conditions. The small market-implied probability for 100 bp today did not materialize, and as we expected, Powell made repeated hints that large hikes like today's and June's are likely over. He says it all depends on data (backward-looking inflation data to make forward-looking policy decisions, that is). He acknowledged low and falling inflation expectations only to the extent of taking credit for them. We expect that the two CPI reports before the next FOMC will be benign, and that September will end up bringing a hike of 25 bp at most. Already since the FOMC statement was issued, market-implied funds rate expectations have edged down while risk-markets have rallied.

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- That doesn't mean the rate hikes are over, at least not as of current thinking. More than once Powell appealed to the Summary of Economic Projections at the June FOMC calling for a year-end funds rate from 3.0% to 3.5%. That implies anywhere from 25 bp to 50 bp at the three meetings remaining in 2022.
- It was all very heavily hedged. Powell said the FOMC will be offering "less clear guidance" in the future – which is truly a howler, considering how both unclear and unreliable guidance has been so far. He said "we'll be deciding meeting by meeting" depending on "incoming data," noting as we have that there will be two more CPI reports coming out before the September FOMC (all to the good, but how depressing that the Fed is setting policy that acts with a forward lag based on backward-looking data).
- We do think the next two CPI reports will be *very* dovish. But the way the Powell Fed has reacted to incoming data this year has not been encouraging.
- Recall that at the last FOMC, the committee stampeded itself into a 75 bp hike, when 50 bp had been the strong prevailing expectation just days before (see "On the June FOMC" June 15, 2022). The committee's panic was triggered, in part, by the University of Michigan's long-term inflation survey showing a 30 bp uptick, from 3.0% to 3.3%, a new cycle high (please see the chart on the previous page). In June's post-meeting press conference, Powell called that "eye-catching," and warned that it might be revised. It was – to just 3.1%, where it had been as recently as January. And now another month's data is in, and expectations have fallen to 2.8%, a level not seen for a year.
- *So not only was June's emergency 75 bp rate hike predicated on data that has been revised away, but now the data has moved even lower than where it started, and yet we get another 75 bp. So what's the policy rule here: "hike 75 bp when expectations rise and also hike 75 bp when expectations fall"?*
- In today's presser, Powell mindlessly repeated his familiar trope about the risks of "entrenched inflation expectations" – seemingly oblivious to the reality that their entrenchment is a feature now, not a bug, because they are entrenched low and getting lower.
- Oh – today he did acknowledge low inflation expectations to the extent of taking credit for them ("the market believes we are serious about inflation"). Sigh – why isn't that enough for "mission accomplished"?

For what it's worth, as of this writing with Powell just having stopped talking, risk markets are responding positively. The fed funds futures markets have taken 6 bp (a quarter of a 25 bp hike) out of the expected September funds rate (implying now 2.907%, down from 2.955%. The cycle peak funds rate this morning was at the February 2023 FOMC, at 3.406%. That's now off by 11.3 bp, (half a rate hike), at 3.289%. Indeed the cycle peak has now moved to December 2022, at 3.293%. So *what this morning was the peak is now the first FOMC with a possibility of a rate cut.*

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trendmacro.com

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Donald Luskin
Dallas TX
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

[About us]

We'll take the small win here. But still... with this 75 bp hike to a mid-point of 2.375% for the federal funds rate, it feels ominously like something more than a coincidence that 2.375% was exactly the same rate that proved to be intolerably restrictive the last time we tried it – at the infamous December 2018 FOMC (see "It's Not 'Quantitative Tightening' – It's Powell" December 20, 2018).

- An important difference, then and now, is that in 2018 the hike was not entirely expected by markets, which made it worse. This one was *more* than totally expected – indeed there was a 12% futures-implied probability that the hike would be 100 bp. That said, *both* then and now, markets were turbulent and the macroeconomic outlook was deteriorating (see, most recently, "Data Insights: A Few of Our Favorite Things" July 27, 2022). After December 2018, there were five FOMC meetings with no rate changes, and then three cuts (ending at 1.625%, where the funds rate remained until the pandemic, and where it was this morning until today's hike).
- For that matter, today's move is similar to the December 2015 FOMC (see "On the December FOMC" December 16, 2015), when then-Chair Janet Yellen lifted off from a zero policy rate that had been in place for seven years, despite similar market turbulence and a deteriorating macro outlook. Her next seven moves were to do nothing – there wasn't another hike for a year. (see "Data Insights: Federal Reserve" July 27, 2022).
- Like those two rate hikes made against the better judgment of Mr. Market (and Mr. Macro), *we think this one will be the last, certainly the last big one*. Maybe 25 bp in September – after two more CPI reports are in hand, both of which we expect will be very benign – but that's it (see "Walmart and the Fed" July 26, 2022).
- The question, now as then, is how much or how little economic damage and market volatility will it take to get Powell's attention.

Bottom line

Today's hike in the funds rate to 2.375% brings us back to the too-tight level imposed at the infamous December 2018 FOMC, then as now, in the face of market turbulence and deteriorating macro conditions. The small market-implied probability for 100 bp today did not materialize, and as we expected, Powell made repeated hints that large hikes like today's and June's are likely over. He says it all depends on data (backward-looking inflation data to make forward-looking policy decisions, that is). He acknowledged low and falling inflation expectations only to the extent of taking credit for them. We expect that the two CPI reports before the next FOMC will be benign, and that September will end up bringing a hike of 25 bp at most. Already since the FOMC statement was issued, market-implied funds rate expectations have edged down while risk-markets have rallied.