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FED SHADOW

FOMC Preview: The Meh-stro

Monday, March 20, 2023

Donald Luskin

Greenspan knew what to do in a financial crisis. Powell knows how to cause one.

It shouldn't even be a close call for Wednesday's FOMC. Even without a banking crisis that will surely tighten financial conditions, *there's no reason for another rate hike*. Inflation by any measure has already peaked and is visibly on the way down (see "Data Insights: CPI/PPI" March 14, 2023). Indeed *the last few rate hikes have been superfluous* (see "What you're not hearing about the end of this Fed tightening cycle" November 18, 2022). They've already tightened financial conditions sufficiently to trigger this banking crisis which will in turn, again, tighten financial conditions more (see "It's Over For SVB – And the Fed" March 13, 2023).

- *Markets pretty much agree*, with only a 68% futures-implied probability of even a 25 bp rate hike, as of this writing. Less than two weeks ago, when Chair Jerome Powell testified before Congress that the FOMC may "increase the pace of rate hikes" based on "the totality of the data" (see "On Powell's Shocking Testimony" March 7, 2023), there was a similar probability of a *50 bp* hike (please see the chart on the next page). Silicon Valley Bank was in receivership three days later. You think maybe the totality of the data changed? But *the issue is what Powell thinks.*

Generative AI token: "Jerome Powell as an orchestra conductor, Spielberg style"

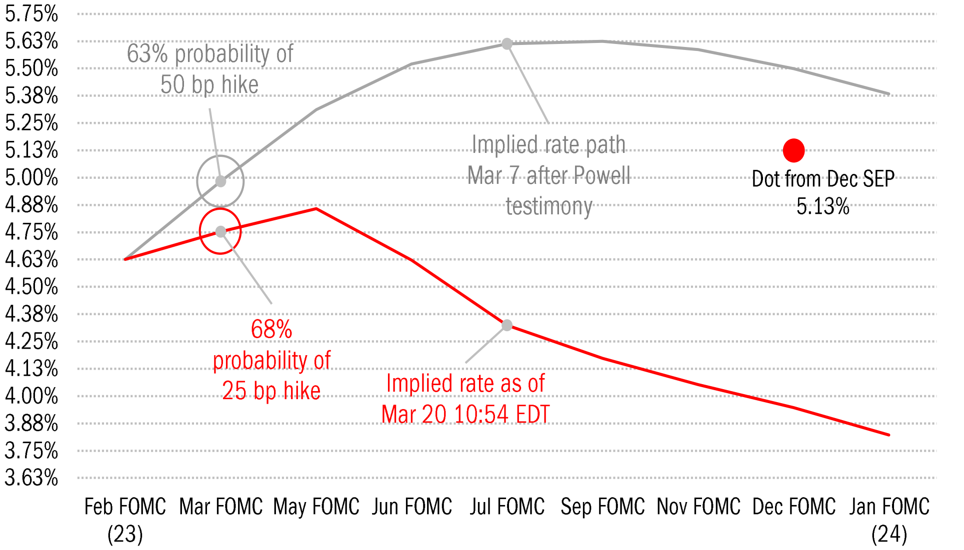
Source: Playground AI running Stable Diffusion 1.5

Update to strategic view

FEDERAL RESERVE, US MACRO: The scorched-earth policy tightening of the Powell Fed has precipitated a banking crisis that now demands a crisis response. Powell is a poor Fed chair in normal times, but he proved strong in the pandemic crisis. He styled inflation as a crisis to preserve credibility, but it never was – and now that has led to a real crisis. Can Powell address this crisis, given that he himself caused it? Volcker is a poor exemplar now – Greenspan should be Powell's model. The Maestro deftly handled the 1987 crash despite a backdrop of rising inflation, and, most similar to today's crisis dynamics, the LTCM collapse of 1998. Our bet is that Powell will pause Wednesday; this would be a modest upside surprise and would mark the end of this hiking cycle. With inflation falling anyway, that would launch a significant risk-back-on rally. Hiking in the name of showing confidence would be a mistake – confidence can only be restored by realistic action, not denial.

[Strategy dashboard]

Futures-implied funds rate, by FOMC meeting



Source: Bloomberg, TrendMacro calculations

Powell proved to be an able crisis manager in 2020 when the pandemic lockdowns began to shut down the global economy (see "On the Fed's Massive Intervention" March 23, 2020).

We hope you will join us Tuesday, March 28, for a TrendMacro client Zoom conference call with Nick Timiraos, the *Wall Street Journal's* Fed-watcher (and official Powell-whisperer), to discuss his new book *Trillion Dollar Triage* that gives a blow-by-blow inside account of that remarkable time.

- But until greatness was thrust upon him, Powell had surely not distinguished himself as a Fed chair for non-crisis times. We hope no one has forgotten the sheer ineptitude of his rate-hiking cycle that ended at the calamitous December 2018 FOMC with his infamous statement that policy is "on automatic pilot" (see "It's Not 'Quantitative Tightening' – It's Powell" December 20, 2018).
- Unlike former chair Alan Greenspan, Powell is no Maestro. Powell is The Meh-stro.
- Having embarrassed himself again by continuing to label inflation "transitory" for too long (see "On the November FOMC" November 3, 2021), he maintained his crisis-era credibility by pivoting to the idea that inflation was not only *not* transitory, but itself a new crisis requiring the most dire solutions (see "On the June FOMC" June 15, 2022).
- But it's not. Just because it isn't transitory, that doesn't make it a crisis. *And Powell's treating it as such, with the fastest-ever rate hiking regime, is without doubt the proximate cause of a true crisis now.* Yes, Silicon Valley Bank exposed *itself* to losses from the sudden large back-up in yields that followed Powell's scorched-earth policy tightening. But arguably it never imagined the Fed would be so reckless.

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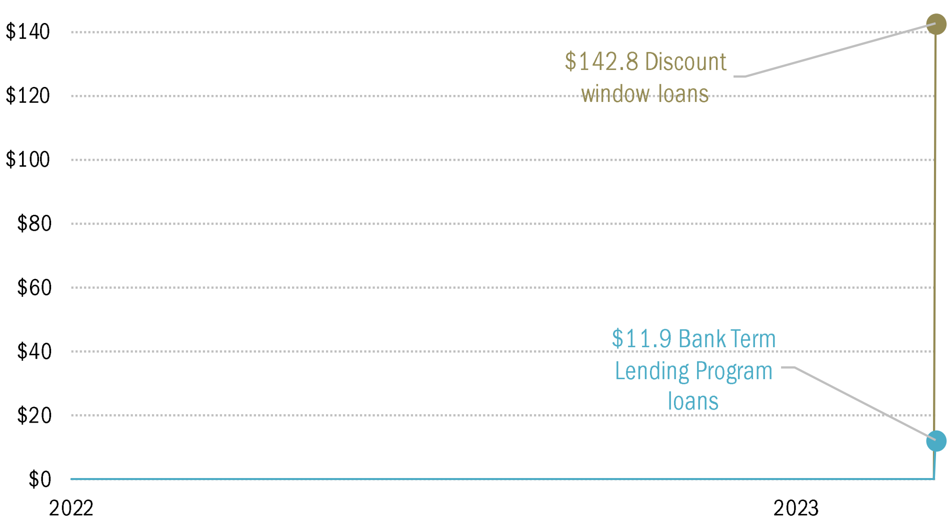
- And clearly *Powell suspected nothing until it was already too late* (not one word in that congressional testimony about any risk in the financial system). And the Bank Term Lending Program he set up would easily have saved SVB – if only it had been set up before it failed, rather than three days after.
- Since then, the Fed has been scrambling to contain a contagion of fear and, having done nothing in advance to make SVB mend its risky ways, is pressing other banks to drop into a defensive crouch. Much was made in the mainstream media last week about the rise in discount window borrowing by banks from zero to $142.8 billion (please see the chart below). But we know personally from banking sources that *the Fed is commanding banks to take these loans whether they need them or not* – much as it did with the Troubled Asset Relief Program in 2008.

Fed emergency lending programs (USD billions)



Source: FRB, TrendMacro calculations

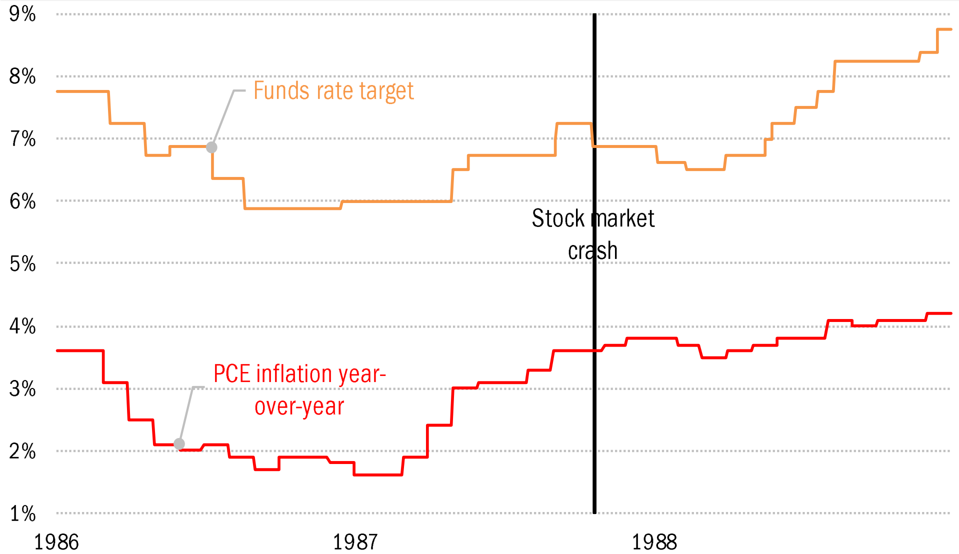
- *For a bank that doesn't need a discount window loan, that command is tantamount to a tax*. Such a bank would likely park the proceeds of the loan on the Fed's balance sheet in the form of so-called excess reserves (that's what our sources are doing). Thus the bank is borrowing from the Fed at the discount rate of 4.75%, and lending back to the Fed at the interest rate of overnight reserves at 4.65%.
- *At the same time, the same mainstream media that normally pander to the Fed are pointing fingers of blame*. *Bloomberg* reported that new examiners put in place a year ago by the San Francisco Fed flagged problems at SVB, but nothing was done. The *New York Times* reported that the joint Fed, Treasury and FDIC statement announcing a federal guarantee to all depositors was to include a sentence admitting to a regulatory failure – but supposedly Powell personally spiked it. Who knows whether any of that is true, or properly contextualized. But be that as it may…

- …coming into Wednesday's FOMC, *Powell and his Fed are in the difficult position* of having to keep up appearances despite being both complicit and oblivious. That inevitably throws one into cognitive dissonance and makes smart decision-making difficult.
- In other words, *we concede that Powell has been a good crisis manager. But this is the first time he's had to manage a crisis he caused*.
- It is incumbent on Powell to at least stop, if not reverse, the policies that brought us to this banking crisis. If the FOMC hikes rates again on Wednesday, it will be making matters worse. And when you're in a banking crisis, you really can't afford to make matters worse – or even be seen as possibly doing so.

We think it's time for Powell to stop styling himself as the new Paul Volcker, and instead ask himself how it was Maestro Alan Greenspan always seemed to know what to do in times like these.

- In his then-new job for only 11 weeks, he had to respond to the stock market crash of October 1987. He had assumed office in the midst of a rate-hiking cycle begun by Powell's idol Paul Volcker, and Greenspan's first official act was to contribute a hike of his own.
- Then inflation was rising. PCE inflation bottomed at 1.6% year-over-year in January 1987, and by the time Greenspan came on board, it had already risen to 3.6% in just seven months.
- Nevertheless, the day after the crash, he issued what, by modern standards, was an incredibly terse 30-word statement pledging, with no specifics whatsoever, "to support the economic and financial system." And he ended up cutting the funds rate three times, having just hiked it (please see the chart below).

Policy and inflation dynamics around the stock market crash of October 1987



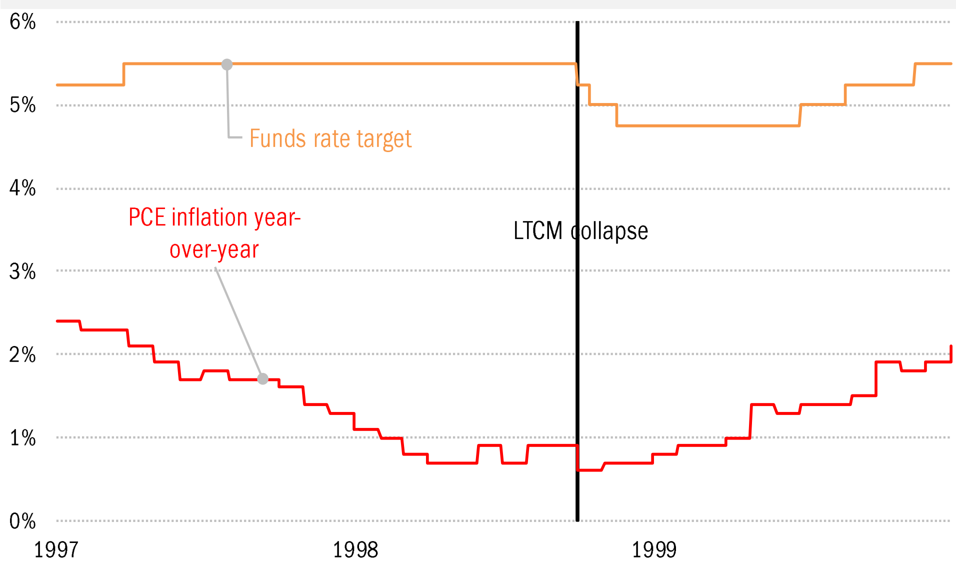
Source: BEA, FRB, TrendMacro calculations

- *<u>Inflation wasn't the top priority then. Indeed, PCE inflation would continue to rise as high as 4.9% by May 1989 – not much lower than it is today at 4.5%. For The Maestro, saving the world was more important.</u>*

<u>We think a closer analogy is Greenspan's handling of the Long Term Capital Management crisis of September 1998</u>. The details are very different, but in a general way LTCM's problems were very much like Silicon Valley Bank's. Both held money-good positions that were squeezed to the breaking point on a mark-to-market basis – LTCM couldn't make its margin calls, and SVB couldn't meet its depositor withdrawals. In neither case was it like the Great Financial Crisis of 2008-2009, in which assets were both impaired and toxically structured, imperiling the entire ecosystem of borrowers and lenders.

- Going into the LTCM crisis, the funds rate had been steady at 5-1/2% for 18 months (Greenspan having last hiked it by 25 bp on March 25, 1997, citing, in a very Powell-like way, "persisting strength in demand, which is progressively increasing the risk of inflationary imbalances").
- We suppose it worked – but to a fault. Personal Consumption Expenditures inflation peaked at 2.4% in December 1996. It had already fallen to 2.1% when Greenspan hiked – and fell all the way to a mere 0.6% by September 1998 when LTCM blew up.
- So with inflation not a visible threat – quite the opposite – Greenspan was able to immediately respond to the LTCM crisis by cutting the funds rate 25 bp on September 29 (please see the chart below). With coyness rather than 1987's brevity, Greenspan cited "recent changes in the global economy and adjustments in U.S. financial markets." The rate cut, he said, was "consistent with

Policy and inflation dynamics around the stock market crash of October 1987



Source: BEA, FRB, TrendMacro calculations keeping inflation low."

- Another 25 bp cut came on October 15, 1998 to address "caution by lenders and unsettled conditions in financial markets." With PCE inflation only at 0.7%, this was done "in the context of contained inflation."
- The last LTCM-driven 25 bp cut came on November 17, 1998, because "unusual strains remain." This was said to be "consistent with…keeping inflationary pressures subdued." An easy call with PCE inflation still at 0.7%.
- *To be sure, today Powell does not have the luxury of a below-target inflation rate. Greenspan didn't either in 1987, but he did in 1998.*
- But for Powell today and Greenspan in 1998, inflation is more than a potential policy constraint. *It is a reflection of the financial conditions* that are relevant to the crises faced by the two Fed chairs. No, *more* than a reflection, *more* than a mere part of Powell's "totality." *Inflation, in the LTCM episode and now, is causal to the crises.*
- At 5.4% today, PCE inflation is down from 7.0% last June. So in absolute terms, it has fallen from peak now about as much as it had by September 1998. *In both cases, then and now, the Fed was deliberately trying to tighten financial conditions to lower inflation. This time the Fed's efforts are working in harmony – indeed, they are redundant – with the contraction in the money supply driven by the cessation of pandemic era stimulus* (see "Surprises of 2023 Volume 1: From Inflation to Deflation" January 3, 2023). *So should we be surprised that there are blow-ups in the banking system? There always are.*
- And as the old saying goes, that's where hiking regimes end. Or at least they are supposed to. At least they did under The Maestro.

Powell's contemporaries at other major central banks don't seem to be any more skilled. The blow-ups started last fall when the UK gilts market blew up after the Bank of England became the first major central bank to lift off from zero, and announced it would reverse its quantitative easing program with outright bond sales (see "It's Starting to Feel a Lot Like Brexit" September 28, 2022). They resumed QE for a while, but they're still hiking. The European Central Bank just keeps hiking, as though the Credit Suisse fiasco at its back door is of no consequence (with Mario Draghi at the helm, we had "whatever it takes," and now with Christine LaGarde it's just "…whatever." So far, the Bank of Canada is the only one with the good sense to pause.

- The Fed's Bank Term Lending Program is smart – even if it is too late for Silicon Valley Bank. *Many clients have asked us whether the BTLF is the same as quantitative easing*.
- Only in the largest sense that both de-risk the banking system. Traditional QE – Large Scale Asset Purchases – do so by taking all the risk of holding long-term securities off the balance sheet of the banking system. That was valuable in the Global Financial Crisis and again in the pandemic lockdown crisis because the banking system could bear no marginal risk; and it has proven valuable all over again in the post-pandemic period in that much – though not

enough – of the mark-to-market losses in those securities is on the Fed's balance sheet, not the banking system's.

- But BTLP doesn't actually buy securities from banks, so they continue to bear any risks of owning them – except that now the Fed will loan against those assets at par, rather than at the depreciated mark-to-market value, in order to help banks meet the liquidity demands of deposit flight.
- It's not free. Banks pay the Fed the 1-year index swap rate plus 10 bp, which is something like 4.7%. This replaces deposits on which Chase, say, is paying almost nothing, or at best, 3-month CD's on which it is paying 4%.
- The deposits into First Republic Bank by a consortium of large banks is smart, too. And it's slightly reminiscent of the bail-in of Long Term Capital Management similarly facilitated by a consortium. But they shouldn't have had to do it (the Fed was created 110 years ago to do exactly that itself).
- And last night the Fed, in concert with other central banks, announced it is spinning up its trusty swap-lines to assure dollar liquidity overseas. Snore.

But as we've said before, first, foremost and finally banking crises and their resolution are matters of confidence (again, see "It's Over For SVB – And the Fed"). *Powell has the power to bolster or shatter confidence Wednesday, by what he does and what he says and how he says it.*

- *Powell must pause. No hike.*
- *Even a pause would be something of a surprise, though. A cut would be better. It would be a shock to expectations in the direction of goodness.*
- *He must say "whatever it takes" – or the equivalent.*
- *It is imperative that he pivot away from his mono-focus on inflation, and address the crisis at hand.*
- *Of course he can note that inflation is still a priority – but for the moment, it can't be the first priority.*
- *Ideally, he will note that we are in the lucky situation of seeing inflation already coming off peak, where at this point our only real problem is that, in a perfect world, we'd like to see it return to target more rapidly.*
- *But he must not continue to be the man with a headache who wants it to go away more rapidly – so he chugs the whole bottle of aspirin and poisons himself.*
- *He can say that when the crisis is past, we'll look at where inflation is then and act appropriately.*
- *What he must not do is fall for the false narrative that he must show confidence by going ahead and hiking – that pausing would be a show of weakness*. No. Greenspan proved twice that you inspire confidence by being honest – we're in a crisis, and we have to handle it, rather than pretending we are not.

We really have no way of handicapping it. But we're in the handicapping business, so *we will put a stake in the ground here and say the Fed will* *pause on Wednesday*.

- That, by the way, is tantamount to announcing the end of this hiking cycle – because inflation, we believe, will be back at the Fed's target within six months anyway.
- *The end of this hiking cycle would restore confidence in both the banking system and the Fed. Followed by a cessation of inflation worries, that would surely launch a risk-back-on rally of significant proportions.*
- Strangely, we would end up being right when we said the hike at the February FOMC was the last one (see "On the February FOMC" February 1, 2023).

Bottom line

The scorched-earth policy tightening of the Powell Fed has precipitated a banking crisis that now demands a crisis response. Powell is a poor Fed chair in normal times, but he proved strong in the pandemic crisis. He styled inflation as a crisis to preserve credibility, but it never was – and now that has led to a real crisis. Can Powell address this crisis, given that he himself caused it? Volcker is a poor exemplar now – Greenspan should be Powell's model. The Maestro deftly handled the 1987 crash despite a backdrop of rising inflation, and, most similar to today's crisis dynamics, the LTCM collapse of 1998. Our bet is that Powell will pause Wednesday; this would be a modest upside surprise and would mark the end of this hiking cycle. With inflation falling anyway, that would launch a significant risk-back-on rally. Hiking in the name of showing confidence would be a mistake – confidence can only be restored by realistic action, not denial.