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FED SHADOW

Is Quantitative Tightening Over?

Monday, January 29, 2024

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Powell says they're not talking about it. The FOMC minutes say they are. Does it matter?

A new narrative about Wednesday's January FOMC has emerged, so we're going to freshen up our earlier preview (see "FOMC Preview: Groupthink is Dead, Now It's Just Lies" January 19, 2024).

There's a lot of chatter among Fed-watchers that Chair Jerome Powell on Wednesday may hint that the end of the normalization of the Fed's balance sheet is coming into view – that is, the end of so-called "quantitative tightening."

We don't rule it out, and if he did it would be a useful reaffirmation of his dovish pivot at the December FOMC (see "On the December FOMC" December 13, 2023).

Unfortunately, what we have here is a failure to communicate. Yes, another one. Which is why that reaffirmation would be so useful.

The Fed has lost control of messaging at this point, and Wednesday will be an opportunity to get it back – at which point we'll see what the message really is.

We've already had hawkish New York Fed President John Williams falsely claim that rate cuts weren't discussed at the December meeting (see "It's Two! Two Feds in One!" December 15, 2023). But Powell said they were in the post-meeting press conference, and it was reaffirmed in the minutes of the meeting (see "Data Insights: FOMC Minutes" January 3, 2024).

- *Now we have the Chair himself fibbing about what was discussed in the December meeting.* At the post-meeting presser, Powell said [*our emphasis*],

  "We're, *we're not talking about altering the pace of QT* right now, just to get that out of the way."

- The minutes of the December FOMC contradict Powell, saying [*our emphasis*],

Update to strategic view

FEDERAL RESERVE, US MACRO, US STOCKS: A new narrative has emerged ahead of this week's FOMC – the slowing of so-called "quantitative tightening." Powell said it wasn't discussed at the December meeting, but the minutes of the meeting showed it was. He will now likely have to say "we are talking about talking about it." It doesn't matter, because though central bank asset purchases in times of emergency are a form of easing, running off those assets when the emergency is over is not a form of tightening. But it is nevertheless important to sentiment. The stock market and other risk-on indicia suggest the December pivot in the face of "immaculate disinflation" is still believed, despite contradiction by Fed officials other than Powell, and despite market-implied probability of a March cut falling back to where it was before the pivot. Other than an outright recantation, there is little the FOMC can do to damage sentiment. Reaffirmation won't be much of a surprise. We reiterate our call for the first rate cut to come in March.

> "Several participants remarked that the Committee's balance sheet plans indicated that it would slow and then stop the decline in the size of the balance sheet when reserve balances are somewhat above the level judged consistent with ample reserves. These participants suggested that *it would be appropriate for the Committee to begin to discuss the technical factors that would guide a decision to slow the pace of runoff* well before such a decision was reached in order to provide appropriate advance notice to the public."

- It was probably new Dallas Fed President Lorie Logan who provoked the discussion. She said in an early January speech [*our emphasis*],

  "Increased Treasury issuance and a less uncertain interest rate path have contributed to the rapid ON RRP [overnight reverse repurchase agreement] runoff by motivating money market funds to invest more in Treasury bills. …In my view, *we should slow the pace of runoff [of the Fed's balance sheet] as ON RRP balances approach a low level*. Normalizing the balance sheet more slowly can actually help get to a more efficient balance sheet in the long run by smoothing redistribution and reducing the likelihood that we'd have to stop prematurely."

The question of slowing so-called QT is more important for sentiment than for reality.

- Market perceptions aside, *we don't think it especially matters whether Fed balance sheet reduction continues or not*. We believe axiomatically that *large-scale asset purchases by a central bank in times of crisis are indeed a form of easing* because they relieve banks and other bondholders of duration risk at a time when risk-aversion is intense. *But when times are normal, reducing the balance sheet is not a form of tightening* because bondholders are no longer risk-averse, so having to take a little duration risk has little impact.
- *But sentiment matters to market behavior, of course.* The stock market has entered the "triumphal phase," the "blow-off top" we talked about mid-year (see "Video: What you're not hearing about the coming deflation" June 23, 2023).
- Stocks have now made new all-time highs (ex-dividend, that is – they had already done so on a total return basis on December 13, the day of the prior FOMC meeting). Q4-23 real gross domestic product growth reported at an astonishing 3.3% annual rate. Markets are now taking on board the reality of what we've been predicting for two years – it's being called *"immaculate disinflation," the rollover of inflation without even a soft landing*.
- Markets don't seem to care about the details. Stocks – and other risk-on indicia – have powered ahead even as the market-implied probability of the first cut in the fed funds rate at the March FOMC has fallen from well over 100% back to about 50%, not much better than it was before the pivot at the December FOMC. As of this

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writing, the probability for May is well over 100%, and perhaps the market doesn't really see a difference between March and May.

- Or perhaps it does, and the emerging narrative about slowing so-called QT has kept sentiment afloat. We have to entertain that idea, because we know from client calls that there is a widespread and deep belief that QT matters a lot. We disagree that it does, but we have to acknowledge that if market participants think it matters, then it matters at least to some extent and at least in the short term. *But it doesn't really matter.*
- *So it feels to us, on the one hand, that there's not all that much that Wednesday's FOMC is likely to do that could break sentiment at this point, short of a full-throated denial of the dovish December pivot – considering that markets have to such a large extent already given up on a March cut. Such a denial is unlikely, because it would be a humiliating reversal for Powell, seemingly bowing to insubordinate contradictions by his minions* (again, see "It's Two! Two Feds in One!" December 15, 2023, and see "FOMC Preview: Groupthink is Dead, Now It's Just Lies").
- *On so-called QT, we think he'll be asked about it, and will say something like, "So, we're not talking about it, but we're talking about talking about talking about it."*
- *While an outright denial of the pivot is unlikely, a reaffirmation of it would be useful, but only to a certain extent*. Again, it feels to us like markets have held onto their faith in the pivot anyway. So the asymmetry coming into the meeting is that a highly unlikely denial would be very damaging, a reaffirmation would be useful but not a surprise.
- And whatever the FOMC says on Wednesday, we still think the first rate cut will come at the March meeting. There are two very disinflationary/deflationary Consumer Price Index reports coming before then.

Bottom line

A new narrative has emerged ahead of this week's FOMC – the slowing of so-called "quantitative tightening." Powell said it wasn't discussed at the December meeting, but the minutes of the meeting showed it was. He will now likely have to say "we are talking about talking about it." It doesn't matter, because though central bank asset purchases in times of emergency are a form of easing, running off those assets when the emergency is over is not a form of tightening. But it is nevertheless important to sentiment. The stock market and other risk-on indicia suggest the December pivot in the face of "immaculate disinflation" is still believed, despite contradiction by Fed officials other than Powell, and despite market-implied probability of a March cut falling back to where it was before the pivot. Other than an outright recantation, there is little the FOMC can do to damage sentiment. Reaffirmation won't be much of a surprise. We reiterate our call for the first rate cut to come in March.