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TRENDMACRO LIVE!

On the January FOMC, and The Briefest Word on DeepSeek

Wednesday, January 29, 2025

Donald Luskin

The FOMC took out the "progress on inflation" language. Powell built it back in.

Update to strategic view

FEDERAL RESERVE, US MACRO, US STOCKS: The FOMC statement took out the reference to progress on inflation, but Powell built it back in with his prepared remarks in the press conference…

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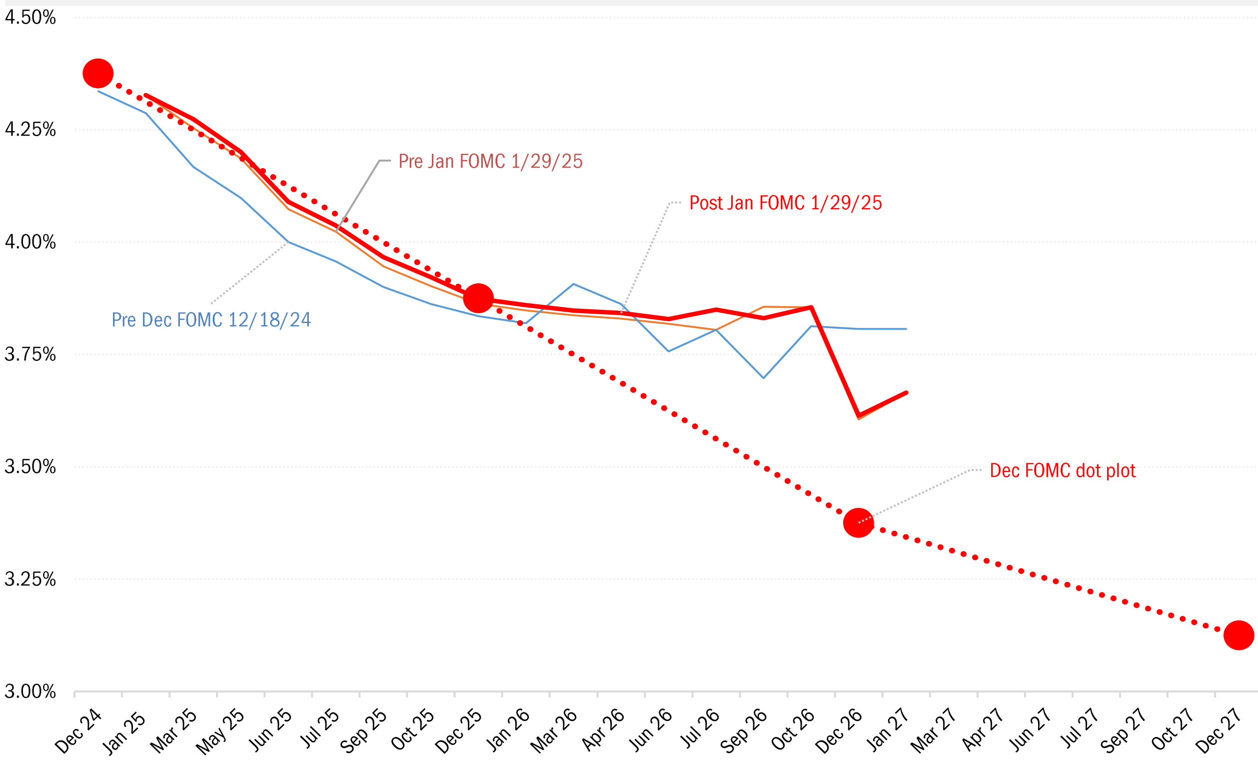
Not a lot of change at today's FOMC from the December meeting, when a "hawkish cut" triggered a risk-off panic. We said markets would "recover smartly," and they did (see "On the December FOMC" December 18, 2024). The supposedly shocking 50 bp upgrade to the year-end 2025 "dot plot", indicating only two rate cuts this year (rather than the four indicated previously), did nothing more than validate where the money-market curve had already been for weeks ahead of the meeting (please see the chart below). When the S&P 500 recovered and moved on to make new all-time highs, *that* validated our idea that *the Fed is about at the neutral policy rate already and no cuts are necessary to optimize growth potential*.

- *It's a mandate-consistent wonderful world, so why mess with it?* The unemployment rate is 4.1%. Sweet. Real GDP will likely print

Futures-implied effective funds rate versus "dot plots" of "appropriate policy path"



Source: FRB SEP, TrendMacro calculations tomorrow for Q4-2024 at about 3% at an annual rate, a third-in-a-row quarter at that level when the FOMC's "dot plots" believe that only 1.8% is possible. Inflation is quite literally back to target, with year-over-year market-based PCE at exactly 2.0%.

- We note in passing that since the market made those new all-time highs, this week's DeepSeek panic set in. But that's the intersection of valuations and innovation, and today – with President Donald Trump reportedly talking about tightening export controls on Nvidia – moves in the US rivalry with China. It has nothing to do with Fed policy.
- *It's early days, and we're not going to pretend to be experts, but we have to say intuitively that the DeepSeek story doesn't exactly have the ring of truth to our ears*. As our friend Scott Adams would say, "it's too on-the-nose" (see "TrendMacro conversation with Scott Adams on 'Reframe Your Brain'" September 6, 2023), and the media coverage of it is just too vague and too breathless. But even if it's all literally true, *should anyone be surprised that there would be advances in software?* And after all these decades of living with a panoply of technologies operating on some form of Moore's Law, *we should know from experience that collapsing prices are to be expected and embraced – they do not destroy a product market, but rather they expand it.*

But we digress. Today's FOMC statement had some language changes from December's, The immediate market reaction suggests they are hawkish. But we interpret them as generally affirming that we are in a mandate-consistent world.

> ~~Since earlier~~The unemployment rate has stabilized at a low level in ~~the year,~~ recent months, and labor market conditions ~~have generally eased, and the unemployment rate has moved up but remains low.~~remain solid.

- And…

> Inflation ~~has made progress toward the Committee's 2 percent objective but~~ remains somewhat elevated.

- Those with a hawkish turn of mind will be alarmed by the loss of the positive vibe in talking about "progress." But *the difficult part – that inflation "remains somewhat elevated" – is not new*. How does speaking about the glorious path by which it got to "remains somewhat elevated" help?
- Besides – in the prepared remarks at the post-FOMC press conference, Chair Jerome Powell built back in the language about progress! He referred to the edit in the statement as only a "language clean-up." He said, "It was not meant to send a signal."
- Coming into this meeting a number of clients were asking us about the possibility of rate *hikes* this year! Nothing here points to anything but keeping policy paused. As far as we're concerned, it can *stay* paused unless there's some clear shock that mandates a

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… characterizing it as a "language clean-up," not intended to "send a signal." He insists that policy is still restrictive but was evasive when asked whether it still would be with a single further cut. We think policy is already neutral, as evidenced by the generally mandate-consistent posture of the labor market, real growth and market-based PCE inflation. Stocks, having made new all-time highs after a correction in the wake of the hawkish December FOMC, confirm this. The subsequent DeepSeek correction is a separate matter. We are skeptical about the reporting on this purported breakthrough, but with decades of Moore's Law under our belt, we should expect technology breakthroughs that slash prices and expand the market. The two rate cuts this year forecasted by the "dot plots" remain a decent base case, but we suspect that as the year plays out the Fed's sense of the neutral rate will rise. It may well play out that we don't get, or need, both those cuts. We note that the Bank Term Funding Program is about to expire, and it did its post-SVB job so well, Powell didn't even mention it.

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change. But in the presser, *Chair Jerome Powell continued to insist that the Fed's posture is one of "policy restraint." He's telling us to keep expecting those two cuts this year.* *Whether they materialize is another matter, as his estimate of the neutral rate – which determines how restrictive he thinks policy is – is subject to change, and it's most likely going to be an upward change*.

- Powell was asked whether he still believes policy is "meaningfully restrictive." He said it is "meaningfully less restrictive" than it was before 100 bp of cuts. Pressed on whether policy would still be restrictive if there was one more cut, Powell only stammered out some characterizations of the labor market – and never answered the question.
- Later, when asked again, he said – and we thought there was some exasperation here – that policy is, indeed, "meaningfully above neutral." He was clear that no one really knows what the neutral rate is but pointed out that today's rates are well above any of the "longer run" estimates in the Summary of Economic Projections. He didn't mention that those estimates have been rising in every one of the last four quarters.
- As of this writing, the money-market curve has only slightly raised its estimates for the funds rate path in 2025. For year-end, the futures-implied funds rate is precisely aligned with the "dot plot" at 3-7/8% – two rate cuts (please see the chart on the first page). *We'll take the over.*

In the presser, many questions had to do with Trump and Trumponomics.

- Remember, at the December presser, when asked if the prospect of tariffs was influencing policy decisions, Chair Jerome Powell had said,

  "…this is not a question that's in front of us right now. …we don't know when we'll face that question."

- That was revealed as a lie (sorry – what else to call it?) when the minutes of the meeting were published three weeks later (see "Data Insights: FOMC Minutes" January 8, 2025, and "On the December Jobs Report, and How The Fed is Trumping Itself" January 10, 2025). They said [*our emphasis*],

  "…participants expected that inflation would continue to move toward 2 percent, although…the effects of potential changes in trade and immigration policy, suggested that the process could take longer than previously anticipated. …*A number of participants indicated that they incorporated placeholder assumptions to one degree or another into their projections*."

- *This time around, when asked, Powell said*:

  "…this is no different than any other change of policy by a new administration, and we will wait and see how it plays out."

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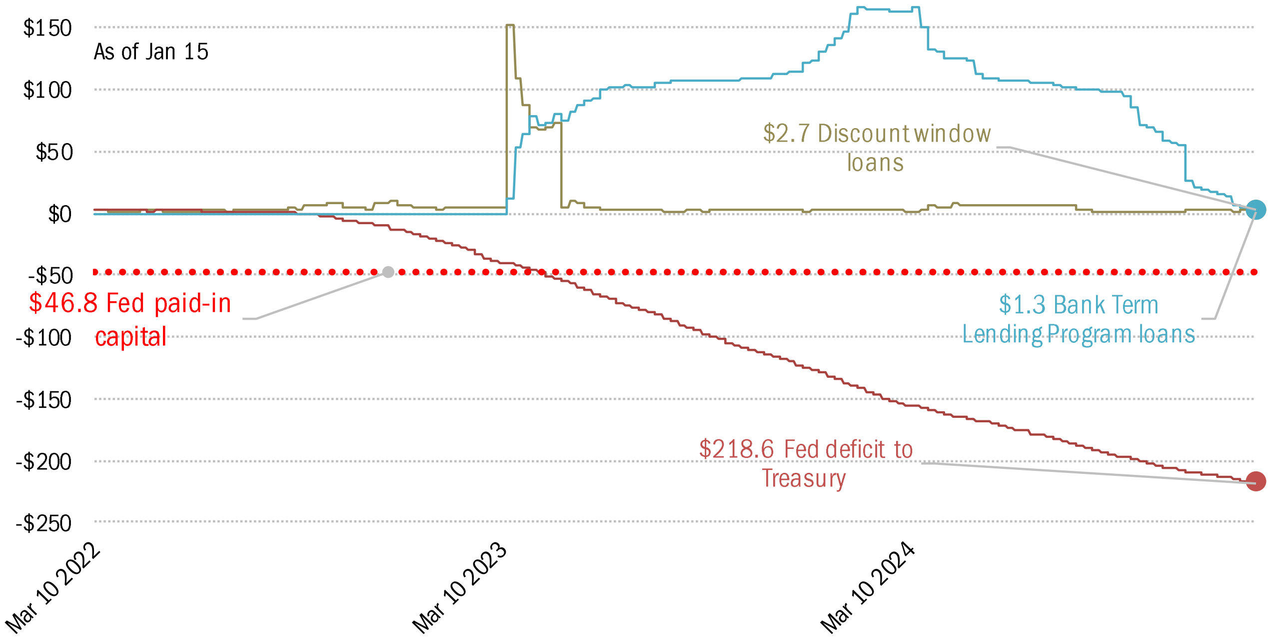
- *<u>Which is to say, he repeated December's lie.</u>*

Of course there was the inevitable question about how Powell would react if Trump were to browbeat him to cut rates. Powell said, in essence, he would not allow himself to be influenced. We will say no more on this, as we think it is utterly irrelevant to policy – it's just Trump-porn, and there's plenty of that already without our amplifying it.

Oddly, Powell didn't say anything about the imminent demise on March 11 of the Bank Term Funding Program, announced right after the Silicon Valley Bank failure almost two years ago. The program was designed to allow banks with underwater long-term Treasury securities to pledge them to the Fed and receive cash at their par value – we said at the time that the program, if it had been in place a week earlier, would have saved SVB (see "It's Over For SVB – And the Fed" March 13, 2023). And we said it would prevent the SVB failure from becoming a systemic "Lehman moment." That was totally correct, with bank lending now having recovered to new all-time highs (see "One Year On, Bank Credit Finally Shakes Off Silicon Valley Bank" March 26, 2024, and every Thursday, "Data Insights: High Frequency Post-Virus Recovery Monitor").

- The BTFP has gracefully wound down, with only $1.3 billion in loans outstanding, down from over $160 billion a year ago (please see the chart below). There has been no significant rise in Discount Window lending to compensate, so *<u>it would appear the crisis has passed, and BTFP can uneventfully go away</u>*.

Bank relief and cumulative Fed losses on Federal Reserve balance sheet (USD billions)



Source: FRB, TrendMacro calculations

- *That said, the Federal Reserve System itself continues to hold underwater Treasury securities and suffer from negative net interest margins*, the accumulated loss from which is now almost $220 billion (again, please see the chart below). If the Fed were a bank that the Fed regulated, it would be in receivership (see "The Fed is Silicon Valley Bank" April 17, 2023).

Bottom line

The FOMC statement took out the reference to progress on inflation, but Powell built it back in with his prepared remarks in the press conference, characterizing it as a "language clean-up," not intended to "send a signal." He insists that policy is still restrictive, but was evasive when asked whether it still would be with a single further cut. We think policy is already neutral, as evidenced by the generally mandate-consistent posture of the labor market, real growth and market-based PCE inflation. Stocks, having made new all-time highs after a correction in the wake of the hawkish December FOMC, confirm this. The subsequent DeepSeek correction is a separate matter. We are skeptical about the reporting on this purported breakthrough, but with decades of Moore's Law under our belt, we should expect technology breakthroughs that slash prices and expand the market. The two rate cuts this year forecasted by the "dot plots" remain a decent base case, but we suspect that as the year plays out the Fed's sense of the neutral rate will rise. It may well play out that we don't get, or need, both those cuts. We note that the Bank Term Funding Program is about to expire, and it did its post-SVB job so well, Powell didn't even mention it.