Powell Stumbles Home

- The Fed has transitioned to “whites of the eyes” mode on inflation
- Today had Vice Chair Clarida’s fingerprints all over it (a good thing)
- Powell arrived in the right place but his missteps are not without cost
- The market’s obsession with the balance sheet is misplaced

Did anyone buy a slug of S&Ps on the Fed statement today and then spend the press conference fantasizing about a long wooden cane coming out from the side of the screen to yank Jay Powell off the podium? Umm, yeah, me neither…

Today’s FOMC was a watershed event. The Fed has shifted to a neutral policy stance with a “whites of the eyes of inflation” approach to assessing the need for further rate hikes. This is tremendously bullish for risk assets. We may have to see if its bullish enough to overcome a trade war, but it’s very bullish.

The FOMC statement alluded to a paradigm shift from “pause” to “done.” It wasn’t just that “further gradual increases” was dropped. It was HOW it was dropped.

Recall, in December:

> *The Committee judges that some further gradual increases in the target range for the federal funds rate will be consistent with sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee’s symmetric 2 percent objective over the medium term.*

Today however those conditions are simply assumed as “most likely outcomes:”

> *The Committee continues to view sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee’s symmetric 2 percent objective as the most likely outcomes.*

Yet despite that favorable backdrop the Fed is not even sure in which direction it might move next:

> *In light of global economic and financial developments and muted inflation pressures, the Committee will be patient as it determines what future adjustments to the target range for the federal funds rate may be appropriate to support these outcomes.*

We've just gone from "the Fed is on hold because they're afraid they've blown up to the economy" to "Fed is on hold even if they haven't blown up the economy." Sustained expansion will no longer bring further rate hikes. That's very bullish.

Furthermore, the Fed's patience is "in light of global economic and financial developments and muted inflation pressures" (end of qualifier). What's missing there? Any mention of employment conditions and above-trend growth! **The Fed is no longer playing traffic cop on GDP growth!**

This shift in approach reflects the growing influence of Vice Chair Richard Clarida. A supply-side optimist, Clarida has argued in a series of speeches that above-trend GDP growth in 2018 did not reduce economic slack because of, by his estimate, matching above trend increases in labor-supply and productivity. He's the Fed Chair Trump might've picked if Larry Kudlow had been at the White House at the time.

Respectful of the uncertainty around estimates of the neutral rate of unemployment, and bullish on the scope for strong growth to continue to pull labor supply back onto the market, Clarida has outlined a "show me" approach on inflation that the FOMC signed off on today.

That approach centers on indicators of inflation expectations – an area of economic research that's been Clarida's focus throughout his career. And market-based measures of inflation expectations made a critical appearance in Chairman Powell's prepared remarks, in anchoring the Fed's rationale for its policy shirt from "further gradual increases" to firmly in neutral:

> *In addition,* ***the case for raising rates has weakened somewhat. The traditional case for rate increases is to protect the economy from risks that arise when rates are too low for too long, particularly the risk of too-high inflation. Over the past few months, that risk appears to have diminished. Inflation readings have been muted, and the recent drop in oil prices is likely to push headline inflation lower still in coming months. Further, as we noted in our post-meeting statement, while survey-based measures of inflation expectations have been stable, financial market measures of inflation compensation have moved lower****. Similarly, the risk of financial imbalances appears to have receded, as a number of indicators that showed elevated levels of financial risk appetite last fall have moved closer to historical norms.*

Again, **this characterization of the reduced urgency to raise rates doesn't touch on US. growth or employment at all**. It's focused on indicators of inflation – all of which are benign.

Powell further laid out the "whites of the eyes" approach in response to a question about might trigger a return to monetary tightening. Powell answered:

> *"you know, it's really hard to speak about generalities, we'll be looking at everything, but I do think that muted inflation pressures… ahh, you know, I would want to see a need for further rate increases and for me a big part of that would be inflation. It wouldn't be the only thing but it would certainly be important."*

Where was this in December?!? Better late than never, of course. But the torturous route Powell took to get to the right place may not be without costs. The Fed will have difficulty shaking the unfair perception of political pliability (being right is preferable to being independently wrong) and has unnecessarily reinforced the notion of a "Powell Put." Keep in mind, there would be no need for a Powell put if not for the Powell foot – in mouth. The 12% collapse after the December FOMC need never have happened if they had just released today's statement six weeks ago.

In addition, Powell has managed to turn a mundane technical issue - the size and composition of the balance sheet - into a hot button for markets. In doing so, he risks feeding misplaced market narratives about monetary policy "feeding asset bubbles," thereby casting an unnecessary cloud of doubt over market efficiency, and tagging important signals like the yield curve and term premium as somehow "distorted."

As I explained recently in "QT is a Nothingburger," despite the obsession of some market commentators, the Fed's balance sheet reduction has had little bearing on liquidity conditions or asset markets. Rate hikes have "sterilized" or "neutralized" the balance sheet, rendering its size of little to no relevance for market liquidity conditions (chart below).

Today's market rally had nothing to do with the balance sheet announcement. It was the result of a watershed shift in the Fed's approach from "growth traffic cop" to awaiting the "whites of the eyes" of inflation.

Neutral Rate Estimate vs IEOR