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The Powell Fed: Shackled to Neutral

- **Rate hikes are more powerful with a large balance sheet**
- The Fed blew by the neutral rate **and also depressed it** by signaling a 2% cap on growth
- Amateurish execution of the pivot to easing is **destroying the Fed's credibility**
- A chastened Fed could help raise the neutral rate

The Powell Fed is clumsily extracting itself from a series of errors in both execution and communication. They are emerging from the process with their credibility in tatters, but at policy setting that is "just about right." **That's very bullish!**

Not Your Father's 25bps

Let's begin with a logical but underappreciated fact about the Fed's hiking campaign: **a 25bp hike is more powerful than otherwise if the balance sheet is large**.

The Fed dumbed down its public rationale for QE by suggesting it worked through "lowering interest rates," despite abundant evidence in both theory and practice that **QE works through the liability side of the Fed balance sheet, not the asset side**. In layman's terms, it works by altering systemic liquidity and future expectations thereof, not by "lowering long rates" to goose economic activity.

10y Treasury Yield Generally Rose Coincident with QE Actions

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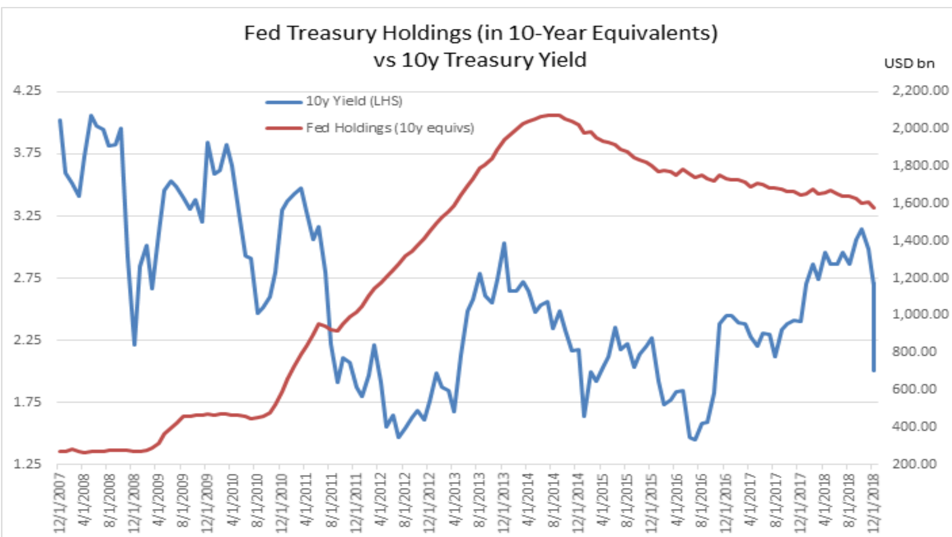
Columbia professor Michael Woodford's seminal (and readable) 2012 Jackson Hole paper on policy options at the zero lower bound concludes that **liability-side policy can be effective in conjunction with forward guidance** policies that render the opportunity cost of hording reserves non-zero.

As for asset-price manipulation as a policy tool, **Woodford dismisses the "portfolio-balance effect"** and confirms the classical logic that **asset prices trade at what the asset is estimated to be worth**. A Fed purchase of Treasury bonds does not, ceteris paribus, effect my estimation of the real value of expected cash flows the asset will produce.

However, Fed purchases of Treasuries are financed by the issuance of bank reserves. If that increased reserve issuance is coupled with effective forward guidance that raises inflation expectations, **QE should actually push Treasury yields higher** - which is in fact what has generally been observed (chart above).

More broadly, Treasury yields were slightly *higher* at end of QE than they were at the beginning and **yields are now *lower* today than when the Fed's duration holdings peaked in 2014**.



Why is this relevant? Because if it's the liability side, not the asset side, that drives QE's economic effects, then **QE was effectively unwound with the IOER hikes**. a

While the Fed thought it was sequencing "rate normalization" before "balance sheet unwind," **it was actually doing both simultaneously,** because the hikes in IOER were altering the monetary characteristics of the large pool of Fed liabilities in the system (technically, they were "sterilizing" them). IOER hikes had an economic effect quite apart from, *and in addition to*, the textbook effects on the marginal propensities to save, borrow, spend and invest. **The rate-hiking program was more powerful than they perceived**.

Note that **market pressure on the Fed was not alleviated in the least by their early termination of QE**. QT never mattered because the balance sheet had already been fully sterilized via IOER hikes. (Fed QT is a Nothingburger, 1/21/19)

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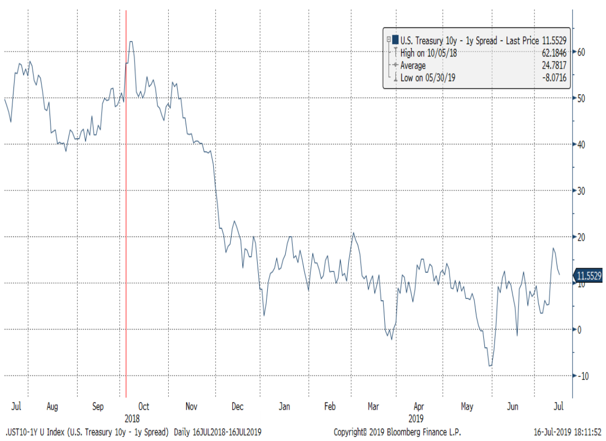
Blowing Through Neutral

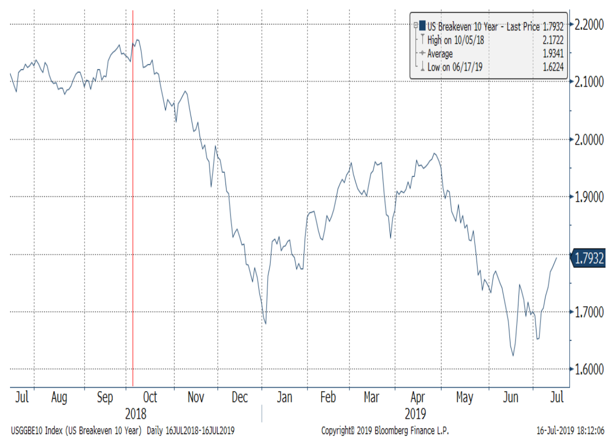
The Fed's next calibration error is wholly understandable, but their tardiness in correcting it is not: **they blew through neutral** - and it's been obvious for many months.

The market's response to Powell's now-famous quip that "we're a long way from neutral" was resounding: "NO YOU AREN'T." A wide array of market-based indicators started flashing "too tight" on the very day Powell made that intemperate remark:

U.S. 10y-1y Treasury Curve



U.S. 10y Inflation Breakeven



We can all only guess at the neutral, or "just right" interest rate which equilibrates savings and investment at target levels of inflation. To err in this estimation was human of Powell; to ignore the market's resounding verdict that he had erred was debilitatingly stubborn.

Furthermore, **the balance sheet itself was signaling they had exceeded the neutral rate**, when Fed Funds began running ABOVE IOER with a still-sizeable pool of $1.4T in excess reserves. While the Fed surmises that changes to liquidity coverage regulations have increased demand for reserves they seem largely oblivious – at least in public pronouncements – to the obvious fact that **the interest rate they pay on reserves is a critical determinant of demand for them**.

As the long experience in Japan illustrates, a large pool of excess reserves is of no economic consequence if the opportunity cost of holding them is perceived as negligible. As Woodford points out, the effectiveness of QE depends on the perception of a non-zero opportunity cost to holding reserves, which can be generated with effective forward guidance to prop up inflation expectations.

A high opportunity cost (i.e. excess risk-adjusted nominal returns on alternative assets) to holding reserves creates a "hot potato" effect. The system as a whole can't "get rid of" reserves – but it can spin them at increasing "velocity" by buying income-generating assets in circular fashion.

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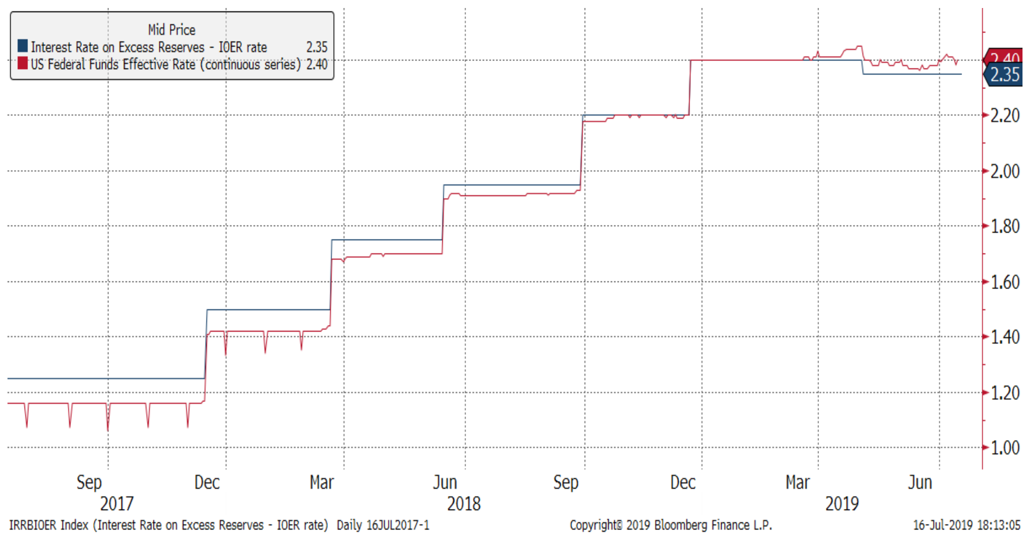
Effective Fed Funds rate vs. IOER



Raising IOER "sterilizes" the reserve pool by decreasing the opportunity cost of holding reserves. It **cools the hot potatoes**. Cool them enough and the velocity with which they "spin" will grind to a complete halt.

The fact that the Fed Funds rate trades above IOER with $1.4T in excess reserves in the system – orders of magnitude larger than anyone anticipated reserve scarcity would emerge – indicates that the pool of reserves is now "fully sterilized." **Banks are willing to hold $1.4T in excess reserves relative to other income-producing alternatives because the risk-adjusted interest rate is better – i.e. it is above "neutral."**

The Fed's Framework is a Depressant to the Neutral Rate

The shift in the U.S. macro policy backdrop to deregulation and tax cuts clearly raised the neutral interest rate, allowing the U.S. – almost uniquely within the developed world - to escape the zero lower bound.

But the Fed greeted the Administration's growth agenda with a stern refusal to sanction continued real GDP growth in excess of 2%. This is the essence of the Trump-Powell feud. (Powell on Thin Ice, 12/20/18).

If changes in fiscal and regulatory policy raised the neutral rate, then the Fed's steadfast refusal to allow those policies to bear fruit in the form of a period of "above-trend" GDP growth would be a counteractive depressant to it.

The Fed's Credibility is Shot

I predicted a rate cut at the June FOMC because it so clearly seemed to be the tactically smart play: get ahead of the curve, get markets off your back, and move while the window was open rather than risking subsequent events muddying the water. As it turns out, they decided to cut rates in June but not officially announce it until July!

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It's hard to overstate what a poor tactical this was. Nothing good could come of it. Either conditions might deteriorate, leaving them behind the curve and under pressure to cut by 50, or (as it turns out) conditions might improve, rendering the July cut difficult to justify.

While market-based measures of the policy stance more than justify a July cut, the Fed's stated framework does not. **They appear to be flying seat-of-the-pants** or worse, caving to political pressure.

- The Fed has persistently claimed "data dependence," but the growth data looks decidedly less bad in July than it did in June. If a cut wasn't warranted in June on this basis, it isn't in July.
- They ditched the "transitory" mantra in favor of increased angst over below-target inflation, only to see strong prints on core PCE (3m annualized at 2.0%) and core CPI (3.6% annualized rate in June) leave the first half inflation slowdown looking – you guessed it – "transitory."
- Risks around U.S.-China trade are certainly not worse, with the tentative Osaka truce reducing the odds of near-term escalation.
- No one is worried actually worried about the debt limit but the Fed itself but, as luck would have it, that may be sorted out prior to July FOMC as well.
- Where was the obsession over global growth when they hiked in December? The U.S. is the most insular large economy on the planet. Incremental changes in "global growth" are largely irrelevant.

The idea that a rate cut was not warranted in June but is warranted in July is indefensible.

The Mea Culpa

We all know why the Fed is actually cutting rates: because they overshot. Powell did sneak an acknowledgement of such into day 2 of his "Humphrey-Hawkins" testimony last week:

> *"**We're learning that interest rates -- that the neutral interest rate -- is lower than we had thought** and I think we're learning that the natural rate of unemployment is lower than we thought," he said. "**So monetary policy hasn't been as accommodative as we had thought.**"*

Powell's reluctance to be more open about this – to simply own up to the error – is all the more curious given that his Jackson Hole address last year was a well-received call for institutional humility about the degree of knowledge surrounding r* and u*!

Perhaps Chair Powell is afraid of owning up to the mistake because some had publicly predicted he was making one?

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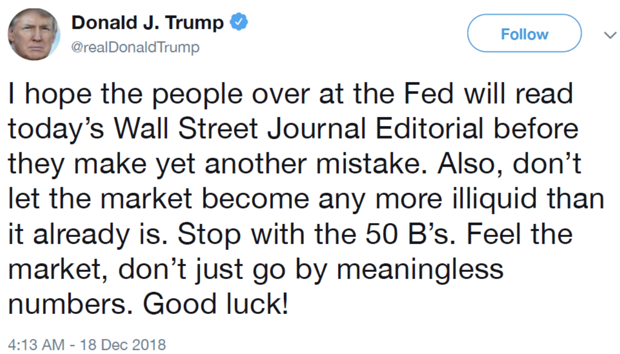
Donald J. Trump
@realDonaldTrump

I hope the people over at the Fed will read today’s Wall Street Journal Editorial before they make yet another mistake. Also, don’t let the market become any more illiquid than it already is. Stop with the 50 B’s. Feel the market, don’t just go by meaningless numbers. Good luck!

4:13 AM - 18 Dec 2018

If so, **he has done serious damage to the Fed’s credibility by resorting to an obvious snow job to make the case for a rate cut instead of simply stating the truth that they over-tightened.**

<u>A Chastened Fed at the Neutral Rate: It Doesn’t Get Much Better for Markets</u>

The Fed is rattled, its credibility at a low. As an institution, it would probably love to just disappear into the bureaucratic woodwork for a while. And if one or two rate cuts puts the Fed back into a neutral posture, the woodwork would be the perfect place for them!

The Fed’s determination to hike rates until they slowed the economy to 2% was akin to the market being short a call on GDP growth at 2%. The Fed is now relinquishing that call option, because **a rate hike between now and November 2020 is nearly inconceivable regardless of the data flow**. In this manner, a chastened Fed might itself push the neutral rate slightly higher in that it **restores the right-hand side of the GDP growth distribution**.

For the foreseeable future, monetary policy is likely to be “stuck at neutral.”

<u>Conclusions</u>

- The Fed mis-calibrated the power of IOER hikes on a large balance sheet
- The Fed overshot the neutral interest rate
- They’ve justified the pivot to cuts with a laundry list of non-credible excuses
- 25-50 bps of rate cuts and a chastened Fed should put us right around the neutral rate
- Monetary policy “stuck at neutral” points to **a low-vol bullish grind for risk assets**