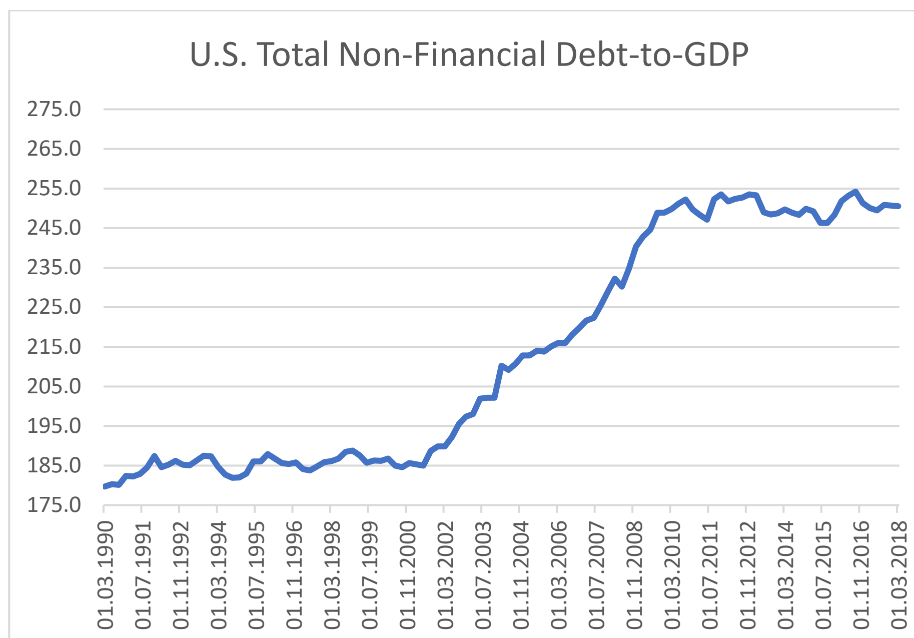
MACROLENS
Markets in High Resolution

Fed Memo: You Had ONE JOB

- Accusations that the Fed has been “blowing bubbles,” are not supported by the evidence
- Generally, debtors benefit if inflation outturns *are higher than assumed at the initation of the debt contract*. Creditors benefit if inflation outturns are lower (provided the implied increase in real debt service doesn’t push borrowers into default, in which case everyone loses).
- Persisent downside misses to the Fed’s inflation target are ipso facto evidence of a policy that has been *supportive of creditors not debtors*
- The widespread belief that inflation is understated in the official statistics is not relevant to this assessment of the policy stance
- *The risk ahead is rates, not the balance sheet*. The bulk of the tigtening effect from today’s balance sheet contraction was already absorbed in 2014 via shifts in market expectations

The Fed Has Erred to Tightness

Its often said that “you can’t solve a debt problem with more debt.” While the U.S. has what some might consider a lot of debt, U.S. total debt-to-GDP has in fact been stable since the global financial crisis. *The critisicm that the Fed has been fosterning excess debt accumulation via an overly-easy monetary policy is not borne out by the data*.



Source: BIS

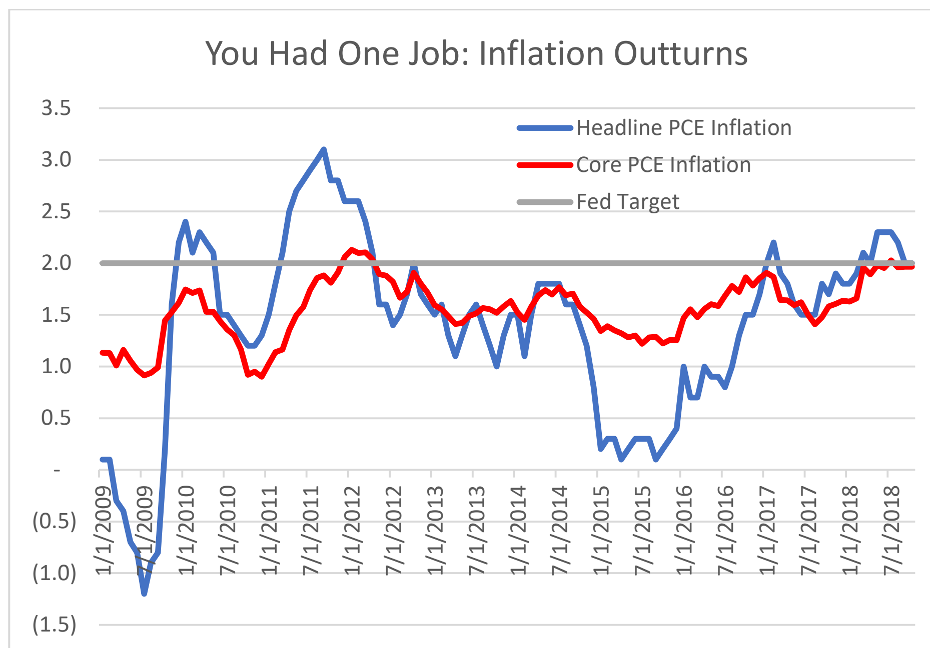
Given that it's been nearly eight years since the move to a formal 2% target, we can presume the bulk of today's outstanding debt was established with 2% core PCE inflation as an embedded assumption. i.e. creditors and debtors *set servicing and repayment terms around that assumption*.

As Milton Friedman explained, the Fed's "one job" is to avoid creating a nominal disturbance in that debtor-creditor relationship:

> *"The first and most important lesson that history teaches about what monetary policy can do – and it is a lesson of most profound importance – is that monetary policy can prevent money itself from being a major source of economic disturbance."*

From this perspective, assessing the stance of *past* monetary policy is simple: did the central bank do what it said it was going to do – i.e. did it hit its target?

The answer is no - the past decade was one of *persistent downside misses to the Fed's inflation target*. There is nothing about producing less inflation than you promised to that "encourages debt." Fed policy has unambiguously erred to the tight side.



Source: BEA

Potential Mismeasurement in Inflation Statistics Doesn't Change This Conclusion

Potential measurement error in the inflation statistics *is irrelevant to this assessment of the stance of Fed policy*. It may well be true that "actual inflation is 1-2% higher than reported inflation," as many contend. Debtors and creditors will have their own views on this issue *which will also be embedded into contracts*.

MACROLENS
Markets in High Resolution

For example, if the median market belief is that core PCE understates actual inflation by 1%, then the assumption embedded in the market-wide debt structure will be 2% core PCE + a "1% fudge factor" = 3% "actual inflation." To best balance the interests of debtors and creditors (and thereby foster economic stability) *the Fed still has to hit its statistical target*.

Any "fudge factor" in the inflation statistics can only be beneficial to debtors if the degree of mismeasurement is *increasing unexpectedly over time*. Otherwise, it will be accounted for in the establishment of contracts.

Don't Judge the Policy Stance from the Level of Rates

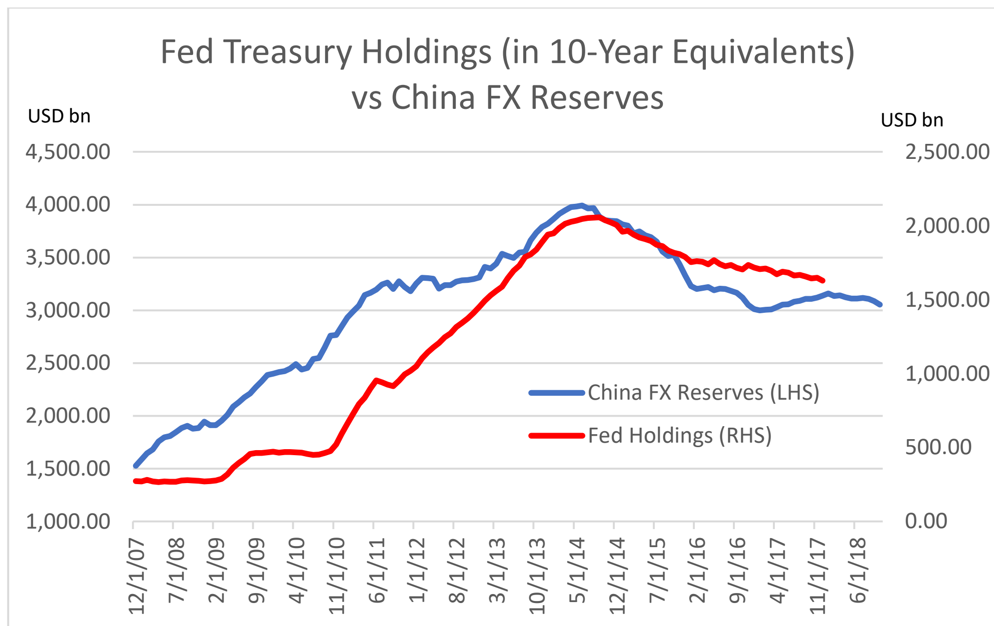
Also, let's not to fall into what one might call the Zero Hedge Trap: "the Fed did ZIRP/QE, ergo policy must be 'easy' and the Fed must be 'goosing asset prices.'"

As Friedman showed:

> *"low interest rates are a sign that monetary policy* ***has been*** *tight – in the sense that the quantity of money has grown slowly; high interest rates are a sign that monetary policy* ***has been*** *easy."*

Obviously, if the Fed sharply contracts liquidity, causing a cascade of defaults and an economic downturn, we're going to end up with a lower rate structure. The U.S. in the 1930's and Japan over the past few decades show that a persistence of a very low rate structure is more likely indicative of a tight policy stance than an easy one. You can't judge the stance of policy by the level of interest rates or the mere existence of a QE program.

Something Happened in 2014



Source: PBoC, U.S. Federal Reserve (data available only through Dec 2017).

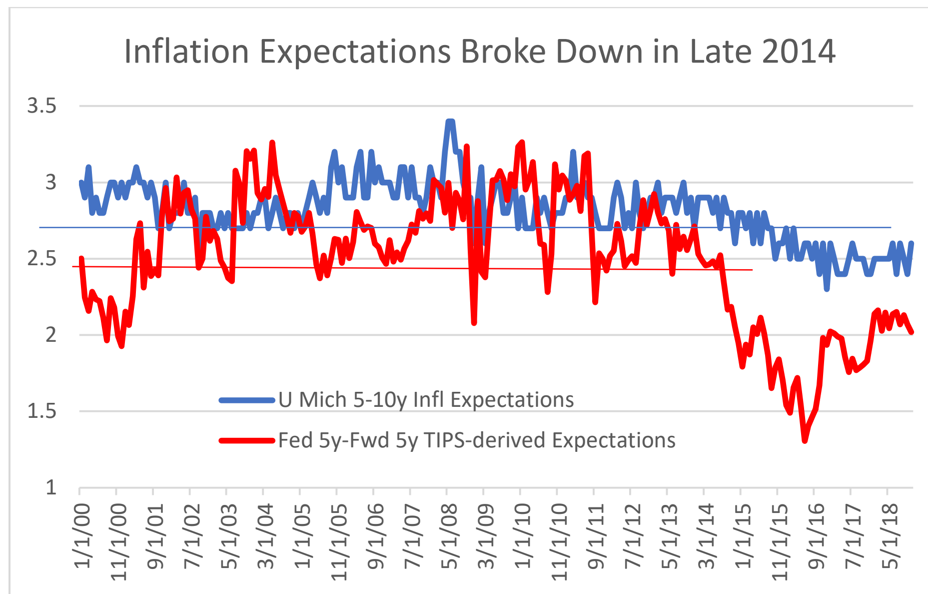
The chart above is interesting from a couple of perspectives:

- In terms of "Dollar duration" as measured in 10-year equivalents – indicative of the amount of duration risk the Fed has taken out of the market - *the Fed balance sheet has actually been shrinking since mid-2014*. (Though the picture looks similar including MBS, we exclude them here to illustrate "active" duration management absent market-based swings in MBS duration).

- China's FX reserves peaked concurrently with the Fed balance sheet. While causality can be tough to decipher with China buffeted by both global and home-grown liquidity pressures, I favor the view that causality runs predominantly from Fed control of Dollar liquidity conditions through the exchange rate to Chinese FX reserves.

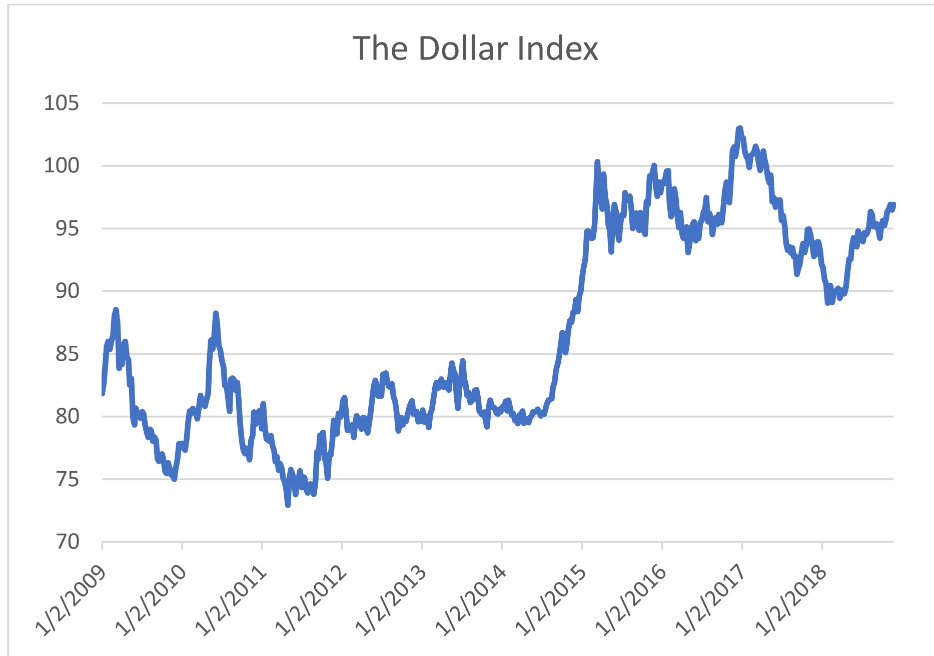
- Causality aside, given the key role Chinese reserve accumulation played "liquidity recycling" during the 2000-2014 period, it is abundantly clear that *a significant tightening of global liquidity conditions began in mid-2014*.

The 2014 tightening can be seen clearly in the breakdown of inflation expectations, indicating the market's loss of confidence in the Fed's willingness to uphold the 2% inflation commitment upon which so many debt-servicing assumptions were predicated:

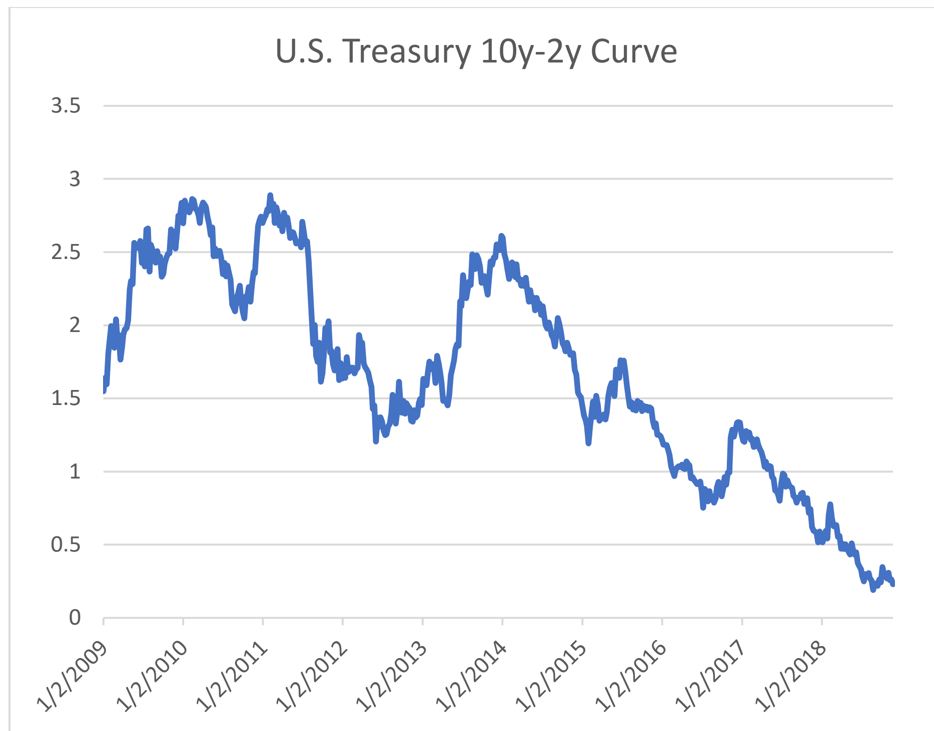


Source: Federal Reserve, University of Michigan

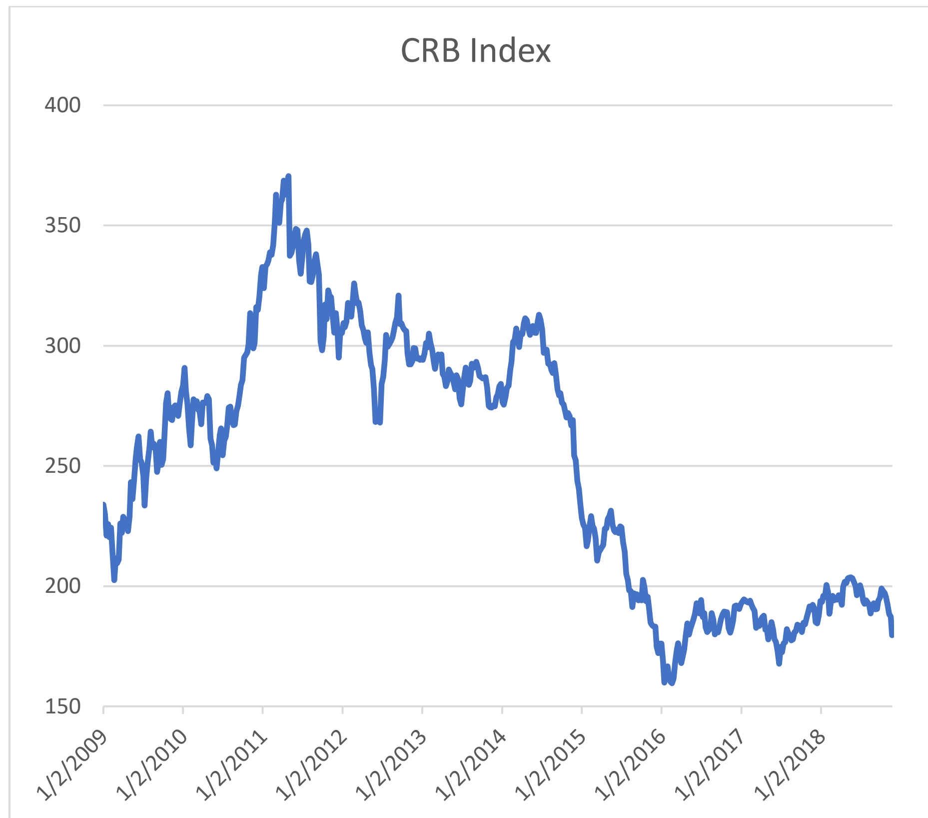
The tightening of liquidity conditions is also clearly visible in the U.S. Dollar, the Treasury yield curve and commodity prices:



Source: ICE



Source: Bloomberg



Source: Bloomberg

These metrics also suggest that the Fed's dovish turn in 2016 *only partially reversed the 2014-15 tightening of monetary policy.*

While deregulation and tax cuts have likely served to increase the natural rate of interest – providing the Fed some additional room to rise rates without committing a deflationary error – *the policy stance was already leaning towards tightness before the Fed even embarked on its recent rate-hiking campaign*. This why markets are so hyper-sensitive to the prospect of continued rate-hikes.

The Risk is Rate Hikes, Not the Balance Sheet

Lastly, despite heightened anxiety in the market over the Fed's balance sheet contraction, the risk of a Fed tightening mistake now stems primarily from interest rate hikes – *not the balance sheet reduction*.

Recall the critical importance of expectations in driving QE efficacy:

- As Paul Krugman has famously put it, QE requires "a credible commitment to be irresponsible," by which he meant a commitment to maintaining the easy-liquidity policies until the expected result – i.e. higher inflation – was actually realized.

- The initiation of QE involves an embedded forward-guidance commitment to the maintenance of easy-liquidity policies.

- *The Bernanke Fed broke that commitment in 2014* by beginning to exit QE while inflation was still running below target.

If expectations are a critical driver of the potency of QE then it follows that *the bulk of the tightening impulse from balance sheet contraction was already absorbed by markets in 2014* via the dramatic drop in confidence in the Fed's willingness to hit its inflation target. The excess liquidity created by QE was effectively rendered "dead man walking" in 2014. Its gradual withdrawal today is largely a monetary formality.

Conclusion

The Fed's scope for avoiding a deflationary error with continued rate hikes is limited by the fact that the policy stance had already been leaning towards tightness since 2014.

Should the December FOMC meeting produce a "dovish hike" via a downshift in the pace of rate hikes in 2019 as we expect, equity and credit markets should bottom out into 2019, regardless of developments with the Fed balance sheet or U.S.-China trade policy.