Jay Powell: Scared Straight?

- Between an unambiguous thumbs-down from the markets and the thinly-veiled threats of his potential firing, Fed Chair Powell is likely to steer a more dovish course *even if the expected economic slowdown fails to fully materialize*.

- Messaging errors are easy to fix. It's not too late for the Fed to "take the victory" by declaring that normalization has been achieved, warranting an extended pause.

- QT is not the problem. U.S.-China trade is on course for another 6-month truce. *The bottom is likely in for U.S. equities*. *EM wins in 2019 even in an economic slowdown*.

- Powell's Jan 4 appearance with Yellen and Bernanke is a potential pothole for risk and a tone-setting event for 2019

A Dec. 26th "Fed Watch" blog from Tim Duy crystallizes the Fed's problem:

> *The Fed acted as expected and hiked rates last week. The data drove the decision; even with growth slowing, the pace of activity is expected to remain above the rate of potential growth, stoking inflationary pressures. In simple terms, the economy retains too much momentum heading into the economy (sic) for the Fed to hold back from pushing closer to their estimate of neutral.*

This is all standard Fed orthodoxy. The Fed sees the economy as operating at "full employment" and fears that continued real GDP growth "above potential" (as they estimate it at 1.9%) will risk an inflation outbreak. The required response in the Fed's view is known in the trade as "monetary offset" to the easing of fiscal policy. (The theory presumes that fiscal stimulus works via pushing out the aggregate demand curve, not the aggregate supply curve as believed by the designers of the Trump economic program).

Never mind that the "output gap" as model of the inflation process is highly debatable, the political problems stemming from such an approach should be obvious: the Fed is literally endeavoring to "offset" the President's signature economic policy.

Despite all the wailing and gnashing of teeth over President's Trump's supposed threats to the Fed's independence, the reality is that a *discretionary monetary policy is inherently political.* Any action the Fed takes will either be good for asset prices or bad for asset prices, good for the party in power, bad for the party in power, good for debtors, bad for creditors or vice versa.

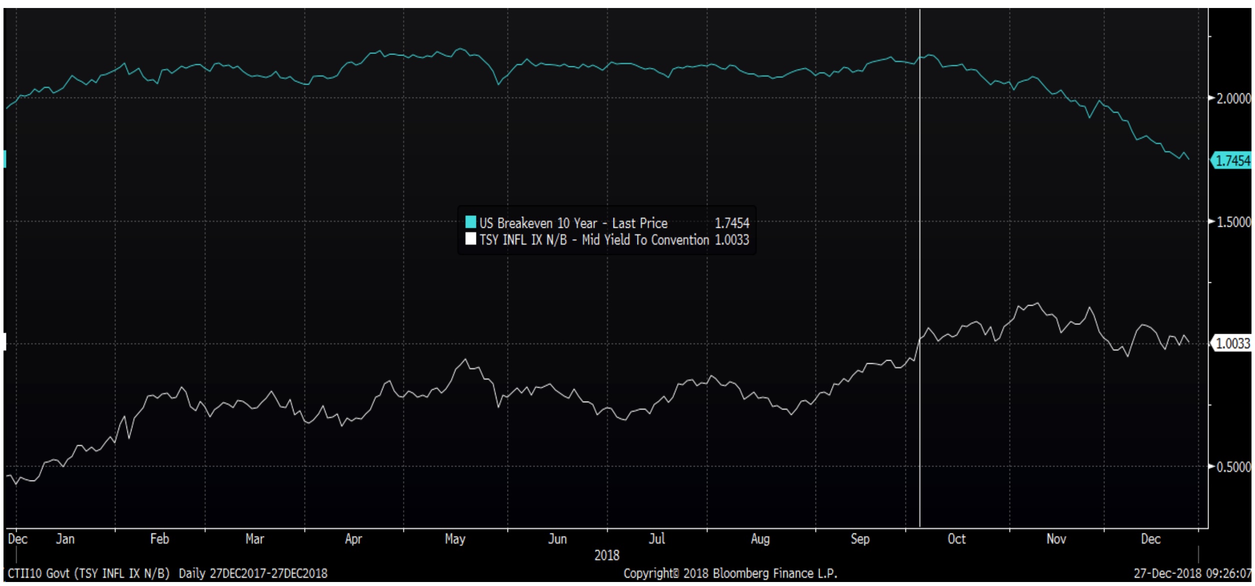
The Fed is permitted *operational* independence not because its actions are apolitical but because it's believed that isolation from short-term political pressure is conducive to better results. In other words, *the Fed's independence is predicated on getting policy broadly right*, which is why the Fed came under some political pressure after the debacle in 2008.

And there's the danger for Jay Powell and the FOMC: they damn well better be right. If we slide into recession while inflation decelerates (as indicators suggest is likely) after never having reached the 2% target, then the Fed should expect to catch some political heat. And as the 2020 election season approaches temperatures will rise considerably. "End the Fed" might replace "Lock Her Up" as a favorite rally chant if they're not careful.

After a double-shot across his bow in the form of a violent market meltdown and credible threats of his impending firing (as yet un-denied by the principal), Jay Powell is surely a savvy enough operator to understand that a change of course is called for. The justifying rationale for signaling an extended pause will be easy enough to find. In fact, [Vice Chair Clarida effectively laid it out in a Nov. 27 speech].

The Fed Has Been the Problem

Market-based indicators strongly suggest that what we have here is a nominal problem, not a real problem. In the context of the current debate it's not a tariff problem. It's a Fed problem.



The chart disaggregates the U.S. 10y Treasury yield into its nominal (inflation break-even) and real (TIPS yield) components, with the vertical line marking Chairman Powell's October 3rd "long way from neutral" faux pas. If you're looking for someone to blame for the market carnage, think of the blue line as "Powell's job" and the white line as "Trump's job." The entire decline in 10-year yields has been in nominal space. Asset markets have a nominal problem, not a real one.

The good news is that nominal problems are much easier to fix than real problems. We just need the Fed to stop making mistakes. And the public floating of a "fire Powell" trial balloon, as unseemly as some may have found it, works in that direction.

It's a Messaging Problem Which is Still Fixable

The risk to the bullish view is that the Fed mistake is already baked and they've set us on a course for recession. Perhaps the additional 25bps in December was somehow the "straw that broke the camel's back."

I discount this. The market seemed fine with the September rate hike until Powell made his forward guidance faux pas in early October. Ditto for the 25 bps at December FOMC – the market didn't really freak out until Powell's disconcerting press conference performance, replete with a nervous demeanor and tone-deaf messaging.

The Fed's problem has been in its messaging of a growth-unfriendly policy posture for 2019. Messaging errors are easy to fix – just say different things! And the pivot is easily justifiable - simply reinforce Powell's "star uncertainty" to declare "close enough to neutral for government work," and begin to signal an extended pause until they can reasonably forecast above-target inflation.

QT is Not the Problem

If they fix the message they can leave QT in place. QT is not the problem. There are two strong theoretical arguments for this assessment and one irrefutable empirical one.

The efficacy of QE is predicated on shifting expectations. As Paul Krugman pointed out in his seminal work on the subject, "it doesn't matter how much money you print unless you credibly promise higher inflation." In this light (as I described recently) *the effect of the Fed's QE policies have long since come and gone*. QE worked to increase inflation expectations when instituted, but when the Fed in 2014 failed to live up to its "credible commitment to irresponsibility" by beginning its exit with inflation still below target, any residual effects on nominal growth expectations dissipated.

Furthermore, the liquidity generated via Fed asset purchases – namely excess reserves – has been aggressively sterilized via rate hikes. The entire point of raising IOER is to disincentivize the market from putting that liquidity to work. On "the way in" the Fed bought a 2.5% asset (let's say) and issued an asset (reserves) yielding a handful of basis points. On :"the way out" the Fed sells back that 2.5% asset and "buys" an asset (reserves) now yielding 2.375%. Wouldn't such "swaps" logically be more powerful on the way in than the way out?

Lastly, an empirical observation: if QE worked by "pushing investors out the risk curve" we would have seen yields fall upon QE announcements, but history shows the opposite: QE announcements were generally met with risk rallies and bond sell-offs – strong evidence that the effect on monetary liquidity and expectations dominates any effect on asset market flows. And obviously, if QT was somehow forcing investors out of riskier assets into Treasuries the means of inducement would be higher Treasury yields, which of course are not in evidence.

Lastly, the news flow on U.S.-China trade continues to support our contention that the March 1 negotiation deadline is likely to bring an extended pause in the escalation of tensions.

Conclusion: The market sell-off has been driven by a Fed messaging error that is eminently fixable. *EM assets are particularly well-placed in that they will respond positively to any dovish shift by the Fed, whether of the U.S.-bullish variety (standing down in the face of continued robust economic growth) or the U.S.-bearish variety (standing down in response to slower growth)*. EM only loses from here if the Fed goes on a deflationary suicide mission.

I downplay that risk, but must acknowledge it has not been entirely eliminated. I could be over-estimating Jay Powell's level of competence or under-estimating some possible Machievellian motivations. In this regard, *I do not like the looks of his next scheduled appearance* – a January 4 joint interview with Bernanke and Yellen.

If this turns into some kind of "defense of the institution against political interference" all hell will break loose in the markets. Positioning itself as some kind of economic "adult in the room" might have its political and cultural attractions to Fed Chairs past and present, but it would put the Fed as an institution at extreme political risk and prove extraordinarily unsettling for markets.

For now I'm playing things as if we've bottomed in risk assets. But I'll be buckled in tightly on January 4th for what will a tone-setting event for 2019.