Powell on Thin Ice

- Powell's press conference leaves no ambiguity as to what the Fed means by "data dependent:" they want slower GDP growth
- The centerpiece of Trump's domestic agenda is to push GDP growth to 3-4%
- Powell's message to markets: we expect to hike twice next year in order to push GDP growth back towards "trend" at 2.3% in 2019 and 2.0% in 2020
- The *best case* for risk assets is that the Fed somehow manages to pull off a soft landing after pushing a 3.5% economy back to 2% via brute force rate hikes
- A deceleration in GDP growth to 2% likely dooms Trumps chances for re-election
- Ergo, Powell is on thin ice

Buckle up, it's going to be a bumpy 2019. A Jay Powell firing is a real possibility, and a potentially monumental vol event that would put a meaningful top in the Dollar and create the mother of all buying opportunities in U.S. equities and EM assets.

The "correct" Fed Funds rate at any point in time is unknowable. And from the standpoint of Fed orthodoxy as we've come to know it, Powell's actions are defensible. Unfortunately for Jay Powell, he was appointed by a President who is anything but orthodox.

Powell's problem is the Fed's *framework* - a misguided model in which inflation is driven by the "output gap" based on static and uncertain estimates of "potential growth." Given their assessment of the economy being at "full employment," the framework tells the Fed it must now cap real GDP growth at 2% at all costs.

While Powell has inherited this framework, he must have understood when he accepted the post that it was in direct contradiction to the goals and agenda of the President who was appointing him. That Trump didn't make crystal clear to Powell his expectations in a Fed Chair is on him. (I'll discount the possibility that Powell agreed to support the Trump economic agenda but has gone rogue).

Here are the Fed's projections for long-run GDP growth – indicative of their estimate of "potential" GDP growth – dating back to mid-2016:

Jun-16	2.0
Sep-16	1.8

Dec-16	1.8
Mar-17	1.8
Jun-17	1.8
Sep-17	1.8
Dec-17	1.8
Mar-18	1.8
Jun-18	1.8
Sep-18	1.8
Dec-18	1.9

Notice anything? Me neither. Their reaction an aggressively pro-business platform including enactment of a generational tax cut and a significant program of deregulation is a big Blutarski. Zero, zip, nada.

This is not surprising given the intellectual leanings of the staff and much of the FOMC and institutional rigidities. We're not going to convince an Ivy League Keynesian that tax cuts have meaningful incentive effects that can expand the economy's supply potential.

But Trump's economic agenda has no hope of success without a Fed Chair who believes that, and is willing to force those beliefs on the FOMC. It requires an individual with some academic or market gravitas and a bull-in-a-china-shop management approach.

Instead, the President appointed an experienced manager with no academic or market credentials whatsoever. No knock on Jay Powell - his management of the Fed to date is perfectly consistent with his background, and his approach would be fine if he worked under an Administration content with a continuation of previous tax and regulatory policies.

But he doesn't. He works under an Administration that has predicated its re-election chances and its legacy on an accelerated pace of economic growth. *It's a bad fit*.

Because the optics of explicitly capping GDP growth are politically problematic, the Fed always remains coy about what it's doing. But Powell opened the kimono yesterday and it was not a pretty sight.

Here's what he said to justify the 4th rate hike of 2018 (against a Dec 2017 median projection of 3 hikes):

> *Now I will provide some additional context and detail, starting with a review of policy over the last year. Last December, the unemployment rate was 4.1 percent and inflation had been running just below 2 percent. FOMC participants and many other forecasters were*

predicting that growth in 2018 would be strong. This growth was predicted to push the unemployment rate down to near historic lows, and the increasingly tight labor market was expected to help push inflation up to 2 percent.

Given this outlook, Committee members judged that the appropriate way to sustain the expansion with inflation near 2 percent was to continue gradually withdrawing the extraordinary support for the economy that had been in place for almost 10 years. Thus, in December 2017, the median of the projections of FOMC participants pointed to three quarter-point interest rate increases in 2018, which would have left the target range for the federal funds rate at year-end at 2 to 2-1/4 percent, still below most estimates of the longer-run normal rate.

Early in 2018, it became clear that the economy was likely to be even stronger than we had expected, in part because the fiscal stimulus adopted near the start of the year was larger and more front-end loaded than most had anticipated. The signs of a more robust economy proved accurate, and the FOMC has now raised rates four times this year, counting today's action, one more time than anticipated in the median projection a year ago.

This illustrates the nature of data dependence that we always emphasize. In 2018, the economy was somewhat more robust than expected, and this led to a slightly faster pace of policy normalization than had been projected. When the economy has, instead, turned out weaker than expected, the Committee has slowed or paused the pace of rate increases--as we did in 2016. And when the economy has performed about as expected, the Committee has generally moved in line with the median projection--as we did in 2017.

Here are the median forecasts from the December 2017 and December 2018 SEPs:

	2017	2018
GDP:	2.5%	3.0%
U/R:	3.9%	3.5%
Core PCE:	1.9%	1.9%

Advocates of the Trump economic platform argue that it will allow the economy to grow at a somewhat faster pace without generating inflation. In 2018 the economy grew at a somewhat faster pace without generating inflation. Furthermore, we close 2018 with core PCE running at a 6-month annualized pace of 1.5% and breakeven inflation rates collapsing.

Given Powell's description of the reaction function it's difficult to avoid the conclusion that higher growth brings more rate hikes *irrespective of quiescent inflation*. If that's what data dependence means the markets seem not to like it much.

Next, some telling Q&A:

> *Q: Chairman Powell, you talked a little bit earlier about the ability to be patient. And so, as you think about your next policy moves, are you inclined to go at the current recent pace to a slightly different destination that's laid out in the projections today? Or does the current environment of restrained inflation maybe allow you to space out your next few moves and take more time to get there?*
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> *MR. POWELL: So as background, I would just point to 2018 being a very strong year and the committee looking forward to 2019 and still having what amounts to a positive forecast. We still are forecasting individually growth a bit above its longer-run potential; 2.3 percent is what we're forecasting. We're forecasting that growth will be strong enough that unemployment will drop still further and inflation will remain right near our target. So I'd say that's a reasonably positive forecast.*
>
> *Going forward, you know, I will be looking in particular to see whether incoming data tell us that we're, in fact, on that path, that development of the economy is in line with that expectation. That will be the main thing.*

The deceleration to 2.3% GDP growth is something Powell feels *needs to happen* to avoid an economic overheating. A 2-hike median dot for 2019 suggests the median committee member believes two more hikes *will be required to elicit the desire deceleration in economic growth*.

The logic here is clear: if growth slows towards 2% on its own, perhaps the Fed will deliver fewer than 2 hikes. If growth does not slow towards 2% on its own they will keep hiking until it does.

Obviously, this precludes any possibility of a 3% growth rate - a foundational goal of the Trump Presidency. See the problem?

Then, a great zinger from Binyan Applebaum of the New York Times:

> *Q: You're about to undershoot your inflation target for the seventh straight year. Your new forecasts say that you're going to undershoot it for the eighth straight year. Should we interpret the dot plot as suggesting that some members of your committee believe that policy should be in a restrictive range by the end of next year? And if so, can you help us to understand why people would be advocating restrictive monetary policy at a time of persistent inflation undershoots?*
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> *MR. POWELL: Well, as a committee, we do not desire inflation undershoots. And you're right, inflation has continued to surprise to the downside, not by a lot, though. I think we're very*

> *close to 2 percent. And, you know, we do believe it's a symmetric – it's a symmetric goal for us, inflation is symmetric around 2 percent. And that's how we're going to look at it. We're not trying to be under 2 percent. We're trying to be symmetrically around 2 percent. And I don't – you know, I've never said that I feel like we've achieved that goal yet. The only way to achieve inflation symmetrically around 2 percent is to have inflation symmetrically around 2 percent. And we've been close to that, but we haven't gotten there yet and we have not declared victory on that. So that remains to be accomplished.*
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> *Q: Just following up ..., I guess if you haven't achieved 2 percent inflation and you don't see an overshoot, which would be sort of implied by a symmetrically target, what's the point in raising rates again at all?*
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> *MR. POWELL: So, again, I go back to the health of the economy. If you look at 2018, as I mentioned, this is the best year since the financial crisis. You have growth well above trend, you've got unemployment dropping, you've got inflation moving up to 2 percent. And we also have a positive forecast as I mentioned. And in that context, we think this move was appropriate for what is a very healthy economy.*
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> *Policy at this point does not need to be accommodative. It can move to neutral. It seems appropriate that it be neutral. We're now at the bottom end of range of estimates of neutral, so that's the basis upon which we made the decision.*

If you're maybe, finally, just barely getting to your 2% inflation target and you claim that policy needs to be neutral (at which point they expect a stable inflation rate) then *you do NOT have a symmetrical inflation target*. You have a 2% cap. Welcome to ECB-land.

And what happened to all the talk of inflation-target symmetry anyway? Shouldn't the oft-stated desire for inflation symmetry have provided room to let the economy run? Even if one held a strong belief that GDP growth above 2% would put upward pressure on inflation, doesn't a sub-2% inflation rate and a pledge to symmetry allow you some flexibility to find out? Hmmm…

What makes Powell's performance yesterday all the more disappointing is that *he knows there is a better approach*. In fact, he laid it out for us in August at Jackson Hole in his "shifting stars" speech that, that while widely hailed at the time for its humble respect for the uncertainty inherent in policymaking, now rings sadly hollow.

Here is Powell on "Shifting Stars and the 'New Economy' of the Late 1990's:"

> *The labor market looked to be tight and getting tighter in real time, but in retrospect, we estimate that there was slack in the labor market in 1996 and early 1997, and the labor market only tightened appreciably through 1998 (figure 4). Greenspan was also right that the*

> *potential growth rate had shifted up. With hindsight, we recognize today that higher potential growth could accommodate the very strong growth that actually materialized, let alone the moderate growth policymakers were forecasting.*[12]
>
> *The FOMC thus avoided the Great-Inflation-era mistake of overemphasizing imprecise estimates of the stars. Under Chairman Greenspan's leadership, the Committee converged on a risk-management strategy that can be distilled into a simple request: Let's wait one more meeting; if there are clearer signs of inflation, we will commence tightening.*[13] *Meeting after meeting, the Committee held off on rate increases while believing that signs of rising inflation would soon appear. And meeting after meeting, inflation gradually declined.*

WHERE WAS THIS APPROACH YESTERDAY?!?

Chairman Powell has revealed an awareness of the type of open-minded and flexible policy course that an aggressive shift in structural economic policies calls for. Sadly, he yesterday revealed either an unwillingness or inability to follow such a course. He's a business manager in a role that cries out for new thinking and bold leadership.

While removal of a recently-installed Fed chair seems drastic, the policy path Chairman Powell laid out yesterday poses a significant threat to President Trump's re-election prospects.

Barring a quick, public and credible mea culpa from Powell, I suspect that Administration officials will be game-planning options. Given the lack of statutory guidance on the matter there seems little to stop the President from stripping Powell of his Chairmanship.

This is a non-tail risk for asset markets. If it happens, sell Dollars, sell long-duration Treasuries, and once you get confirmation that Clarida is taking over the Chair buy equity and EM risk aggressively.