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Powell's "Shanghai Moment"

- A market bottom was sown with the public threats to fire Jay Powell
- Recounting the Fed's early-2016 China-induced U-turn was by far the most notable portion of Powell's appearance on Friday
- The confluence of rock-bottom sentiment towards China with a chastened Fed is déjà vu all over again
- I'm positioned for a "mini-2016" in coming months: flat USDCNH, long EM

This is a quick update to tie together the theme I laid out in "Powell on Thin Ice" (Dec. 20) and "Jay Powell: Scared Straight?" (Dec. 27) with the view on China that things are bad, but stimulus remains in the holster. As expressed in "Is China Imploding?" (Jan 3).

The market bottom was sown with the leaking to media outlets over the pre-Christmas weekend that consideration was being given to firing Fed Chair Jay Powell. While his poor performance at the December FOMC press conference may have been a proximate cause of such considerations, the tensions are much broader than that: Powell placed a speed-limit on GDP growth that was incompatible with the Administration's agenda (and a serious depressant to asset markets that had been priced for that agenda).

Despite the suggestions from Mnuchin and Mulvaney that the President realizes he can't fire Powell, the lack of an Executive tweet to that effect remains a glaring omission. It seems clear that a threat has been delivered and received. Might the combination of a bumbling press conference that sends global markets into a tailspin and not one, BUT TWO glaring verbal faux pas in rapid succession ("long way" and "auto pilot") potentially constitute "cause" for dismissal? Powell has been put on notice.

That said, I found his performance on Friday uninspiring. Fumbling with his notes, the Chair continues to display a lack of comfort with his role. While he scored points for telling us that Friday's robust wage data "does not raise concerns about too-high inflation," he left the impression of whistling past the graveyard while discussing China's economic outlook and the recent market turbulence.

Then came the capitulation:

> *As always there is no pre-set path for policy. In particular, with the muted inflation readings we see coming in we will be patient as we watch how the economy evolves. But we are*

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> *always prepared to shift the stance of monetary policy and to shift it substantially in order to achieve our goals of maximum employment and stable prices, and I'd like to point to a recent example when the committee did just that in early 2016.*
>
> *As many of you will recall in December 2015 when we lifted off the zero lower bound the median FOMC participant expected four rate increases for 2016. But very early in the year 2016 financial conditions tightened quite sharply and under Janet's leadership the committee nimbly, and I would say flexibly adjusted our expected rate path. We did eventually raise rates a full year later in December 2016. Meanwhile the economy weathered a soft patch in the first half of 2016 and then got back on track and gradual policy normalization resumed.*
>
> *Now no one knows whether this year will be like 2016, but what I do know is that we will be prepared to adjust policy quickly and flexibly, and to use all of our tools to support the economy should that be appropriate and to keep the expansion on track to keep the labor market strong and to keep inflation near 2%*

Interestingly, Powell misstates the history a bit here. While financial conditions did tighten sharply in 2016, they had been doing so fairly consistently since the Fed's stealth tightening began in 2014 (which I've detailed here). The problem in early 2016 was the tone-deafness the Fed exhibited at the "hike and 4-dots" December 2015 FOMC meeting – a mistake they recreated uncannily last month.

Also eerily similar is the cratering of sentiment towards the Chinese economy. The Apple profit warning may well serve as Powell's "Shanghai Moment." While I don't subscribe to the "Shanghai Accord" conspiracy per se, I do believe that during Janet Yellen's late-February 2016 visit to the Shanghai G20 something or someone scared the pantsuit off of her regarding the threat the Chinese economy and a potential RMB maxi-devaluation posed to global growth.

Since the global financial crisis *China has served as a significant amplifier of Fed policy*, with that effect growing stronger as China becomes ever-more reliant on easy credit conditions to avoid a bust. And until China's credit bubble bursts, the interplay between the Fed and China is bullish for risky assets.

Any Fed error in the direction too-tight liquidity threatens to tip China into credit or currency crisis, creating feedback on U.S. financial markets that quickly risks turning a minor monetary policy error into a dramatic one. The Chinese credit bubble is like an electric fence keeping the Fed from running into the traffic of too-tight monetary policy. The Apple profit shock perhaps provided a little jolt.

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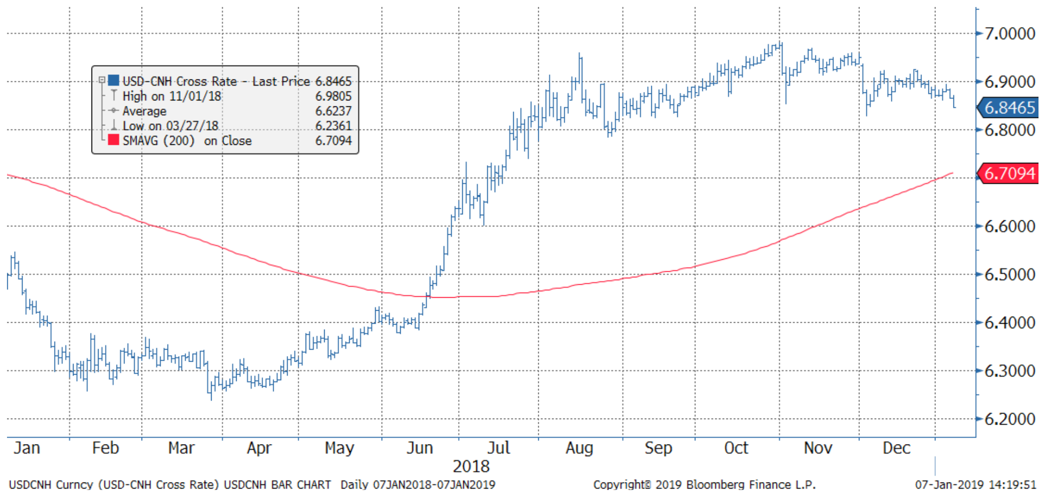
The Fed's capitulation dovetails nicely with the prospects for a trade deal ("Trade Update: China 25, Blame Canada and on to FOMC," Dec.13). Easier global liquidity conditions and an impending deal on March 1 bode well for the prospects of an actual stimulus from China – i.e. an acceleration of credit growth. All else is smoke and mirrors.

Confirming a potential trough in China sentiment on the back of the Fed's capitulation is a very toppy-looking USDCNH chart. 6.80 appears to be a key level at which Chinese authorities may choose to ease monetary policy a bit and/or release some pent-up outflow pressure bottled up by quotes on FX supply. Any break of 6.80 could trigger a short-term melt-up in global risk-assets.



To be sure, what we got from Powell was *capitulation without conviction*. The 2016 analogy portends a lengthy pause, but as Powell himself highlighted, it was a "pause that refreshes" as far as the Fed's ability to hike rates. Should China be able to stabilize economic expectations and U.S. growth remains steady enough to allow U.S. asset prices to retrace towards recent highs, Powell may well revert to playing the "growth traffic cop," bringing a renewal of political tensions between the White House and the Eccles Building. But that's probably an issue for the second half of 2019.

Conclusion: If the world looks and feels like early 2016, and the Chairman of the Fed tells us he is approaching things like they did in early 2016, shouldn't we trade the markets like its early 2016?