RUBRICS

Macro Overview

Ghosts of Central Bankers Past

Fixed Income Macro View

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Rubrics Fixed Income Macro View

19 December 2023

Volte-Face

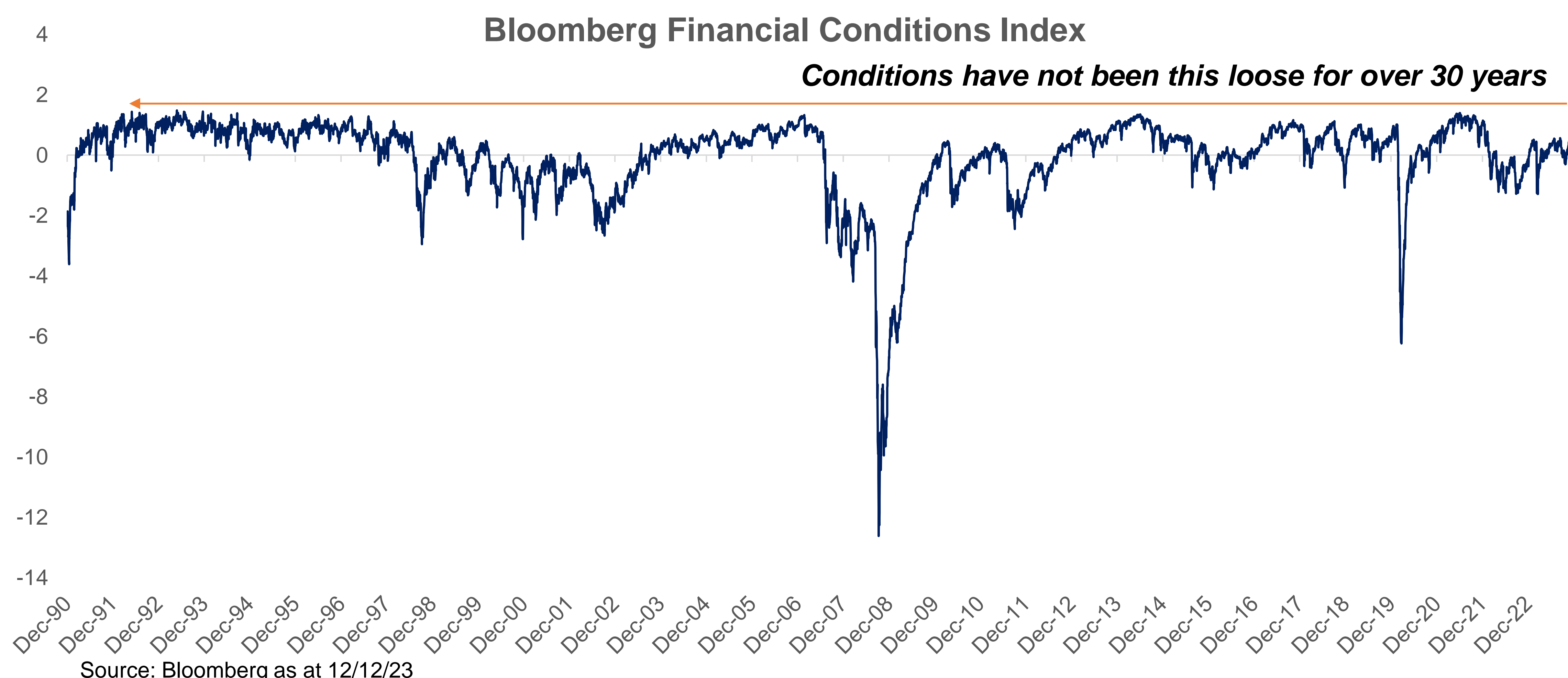
What has happened to the Fed's Monetary Policy outlook? The whole of Wall Street and even the Fed whisperers were left dumbfounded by Powell's complete shift in policy direction last week. Given the Fed's own outlook for inflation, depressingly not getting to target until 2026, it hardly made sense on the face of it for such aggressive action. While we have not always agreed with previous Fed decisions (slight understatement here), they have at least tended to provide a level of rationale. As we sit here today however, nearly a week on from Powell's Volte-Face, we are still scratching our heads as to what prompted the pronounced change in direction.

A recent look back at history tells us the Fed have not been fans of sudden policy changes, even if they had good reason. In 2021 for example – with inflation running rampant above 5% the Federal Reserve was unwilling to change course due to insufficient advance warning in terms of policy communication. Today such concerns are no longer relevant it seems. What is even more surprising is that this sudden shift happened on the back of stronger than expected jobs and inflation data and was completely at odds with communication only 2 weeks prior.

Timeline of Recent Fed Communications

- Nov 1st Getting inflation to 2% 'has a long way to go'
- Nov 21st 'No indication of rate cuts at last meeting'
- Dec 1st 'Talks about rate cuts are premature'
- Dec 1st 'We are prepared to tighten policy further' if needed
- **Dec 13th Rates have peaked; 3 cuts coming in 2024**
- Dec 15th Fed 'Isn't really thanking about rate cuts' – Williams

Loosening Financial Conditions



Source: Bloomberg as at 12/12/23

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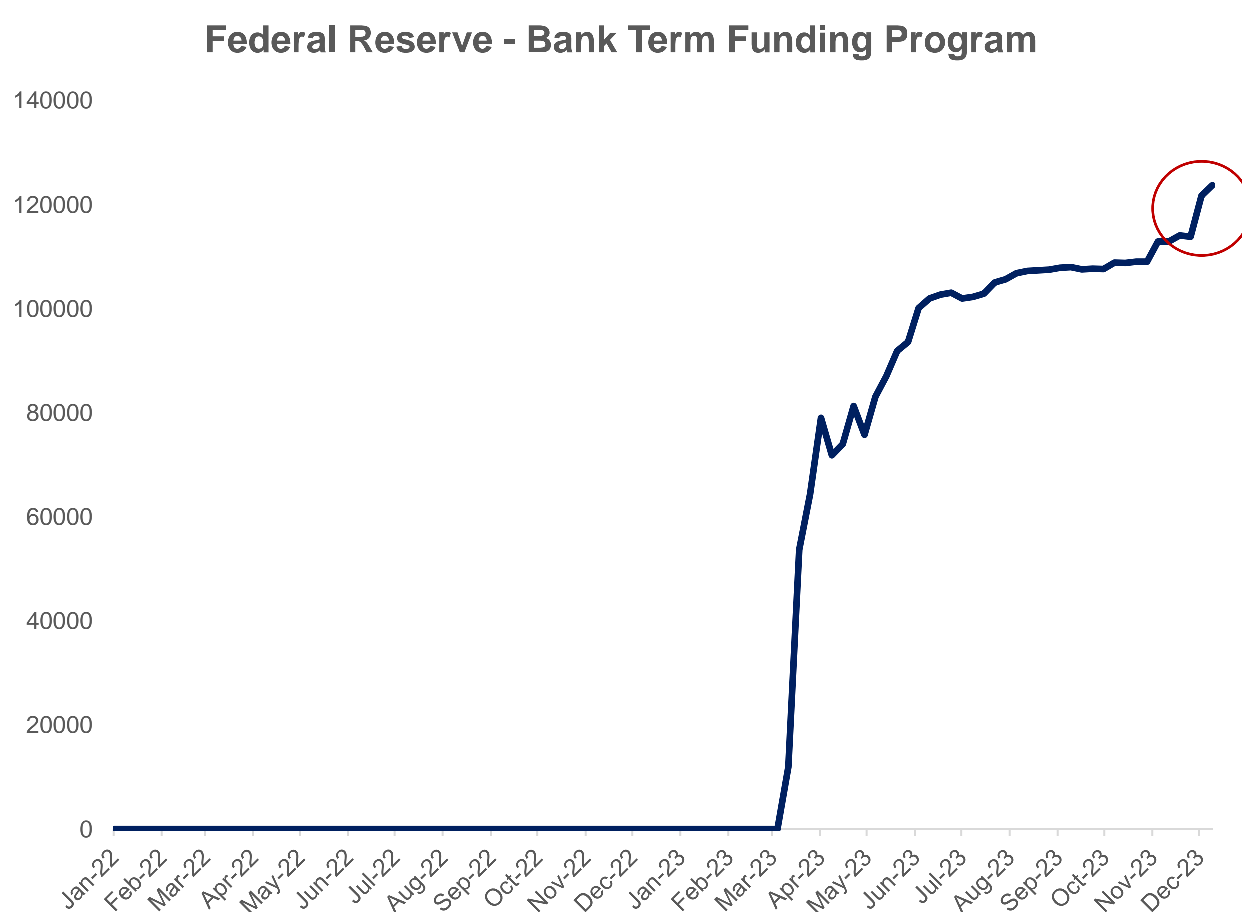
Why the Change of Heart?

Why the sudden change in direction? In truth nobody knows, maybe not even Fed members like Williams. So what are the potential reasons:

1. The inflation outlook has improved (on a 3 month rolling bases), and if one ignores the Super Core CPI measure (which the Fed was so focused on only last month) it is now unnecessary to have rates so much higher than an r* of 2.75% (an approximate long run sustainable rate) with a weaker growth outlook for 2024.
2. The Fed has woken up to the lack of credit market activity. This would not be inconsistent with previous statements as they have mentioned a number of times the extent of corporate debt refunding required next year – potentially a major issue. As Rubrics have been pointing out, credit provision has been slowing for some time – mortgages, consumer credit and corporate borrowing have all declined considerably and are suffering under the weight of the highest Fed Funds in a generation.
3. The Fed has concluded that the current weakness and structural challenges of the Chinese and European economies will soon impact the outlook for the United States. Furthermore, with the fallout from the collapse of SVB not yet behind us (judging by the usage of emergency liquidity facilities) are they concerned about renewed stress on the banking system?
4. Hubris – The Fed believe they can thread the needle by engineering what would only be the 2nd soft landing in 43 years.
5. A more conspiratorial view - Powell might have received a proverbial 'phone call' from either his friends in the Private Equity world or the White House requesting a sudden change of direction in monetary policy.

Emergency Bank Funding Program Usage



Source: Bloomberg as at 12/12/23

Rising Bankruptcies

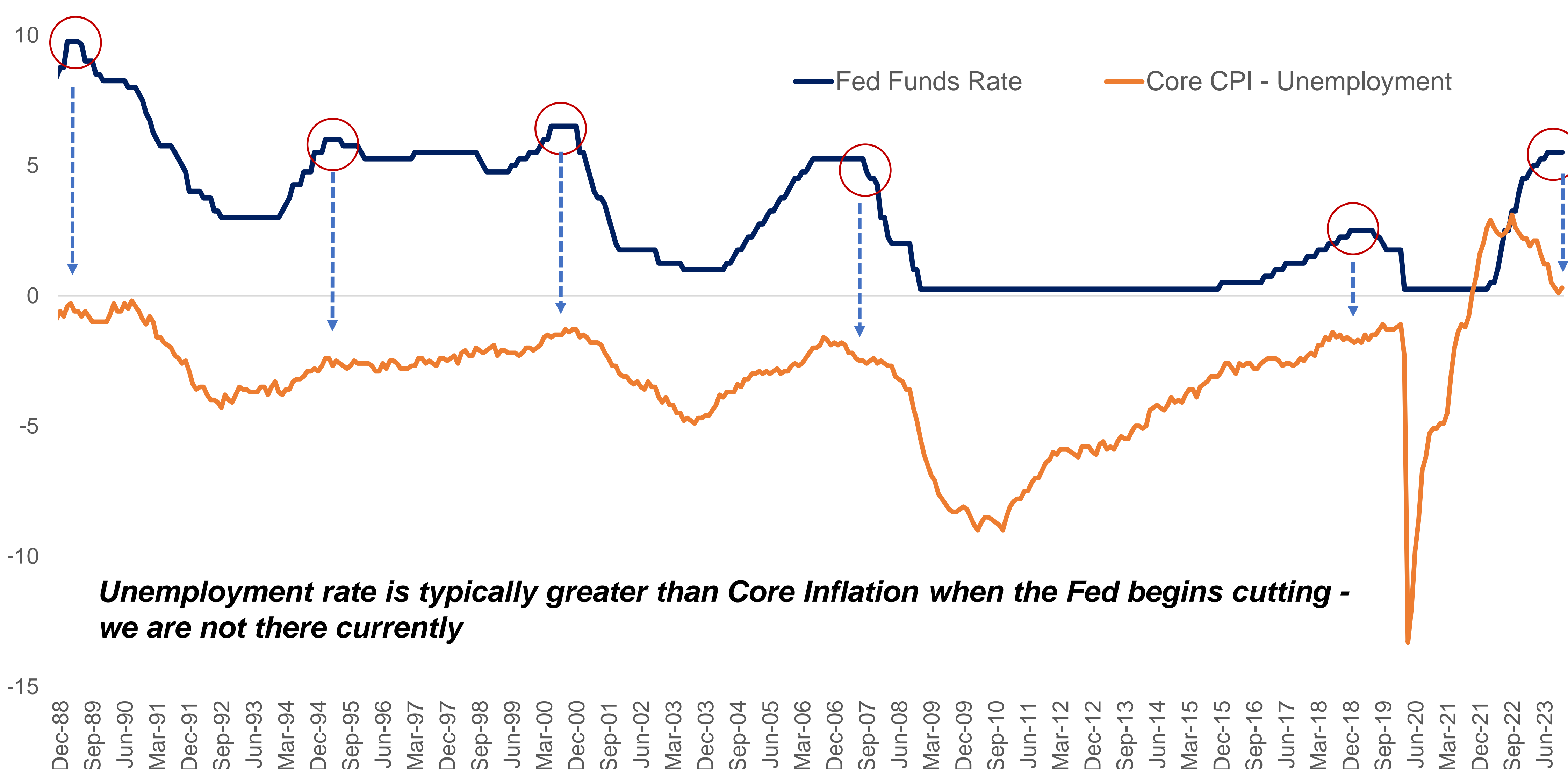
Source: FT as at 12/12/23

While any of these reasons, and many others, can be seen a credible there are still a number of key factors outstanding. The Fed does not simply change course like this, certainly not given the current economic data. Firstly there has been no credit event (that we are aware of). Secondly the labour market and wage growth are inconsistent with a 2% target. While the outlook for growth in 2024 is significantly less vigorous than the surprising strength of 2023, the financial markets have already eased financial conditions significantly since the Fed's insistence of "higher for longer" only a few short weeks ago.

The other incredibly important factor that comes to view with the easing of financial conditions is the surprisingly strong increase in market liquidity that has been driving the markets to stratospheric levels, unwinding all of 2022 tightening. Why ease financial conditions even more when the system is once again awash with liquidity? Such a sudden and dramatic action unquestionably raises further questions over longer term financial stability. A sudden shift in inflation higher again (which they have up to now been so keen to warn against) and another pivot in rates would drive rate volatility (MOVE) beyond even today's excessive levels. As history tells us, cutting rates when inflation is trending lower but is still elevated can be very dangerous (ask Arthur Burns). Former FOMC member Bill Dudley was the latest to weigh in suggesting a pivot at this stage was a 'pretty big gamble', i.e. recent dovishness increase the possibility of no landing at all, and that a resurgence of inflation would damage the Fed's credibility while requiring renewed tightening and a deeper recession.

Inflation and Unemployment in Previous Cutting Cycles

Core CPI minus Unemployment vs Fed Funds Rate



Source: Bloomberg as at 12/12/23

This of course is pure speculation, but perhaps something has really spooked the Fed - either an incoming credit event or a sharp downward revision to their own global growth outlook. Looking ahead 2024 will see a significant increase in corporate debt to be refinanced. The government bond market will have less liquidity from the Fed's Reverse Repo Programme to fund the massive deficits . We don't buy the White House story because anything that would delay inflation coming down (the weaker dollar has already supported higher commodity prices) will be a negative for Biden. Whatever the reason, it is unrealistic to assume that there wasn't something that changed the nature of everything the Fed had spoken about since the tragic mis-calculation of the 'transitory inflation' view. Not to mention the fact that only a day after Powell's explosive comments both the BOE and ECB, both with much worse growth outlooks to deal with, refused to shift away from fighting above trend inflation.

What does this mean for our outlook for the markets?

Recent price action has seen assets move higher in parabolic fashion from already lofty levels (thanks to trillions of dollars of support from central banks programmes themselves). However this leaves financial markets in a very precarious position. All of 2024's expectations have already been surpassed, including the most bullish outlooks – from the equity side. The rally in bonds at this stage can only be sustained by a continuation in the fall in inflation and growth – inconsistent in many ways with risk asset valuations today. We have significant headwinds coming in 2024 from the consumer, fiscal spending and liquidity programmes (RRP) with markets pricing of a once in a lifetime soft landing of extraordinary proportions. The Federal Reserve has taken an incredible gamble with its reputation – what they have done has a very low probably of working out given five thousand years of studied history (read The Price of Time by Edward Chancellor). Given what we currently know, we feel the reason for the surprising action was that the risk of not delivering the much-coveted soft landing is currently greater (and Powell's own immortal legacy is at stake) than the threat of a jump back towards inflation. One should trade these violent moves with great caution.

IMPORTANT INFORMATION

19 December 2023

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