RUBRICS

Macro Overview

The Fed's Gordian Knot

Fixed Income Macro View

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1st May 2024

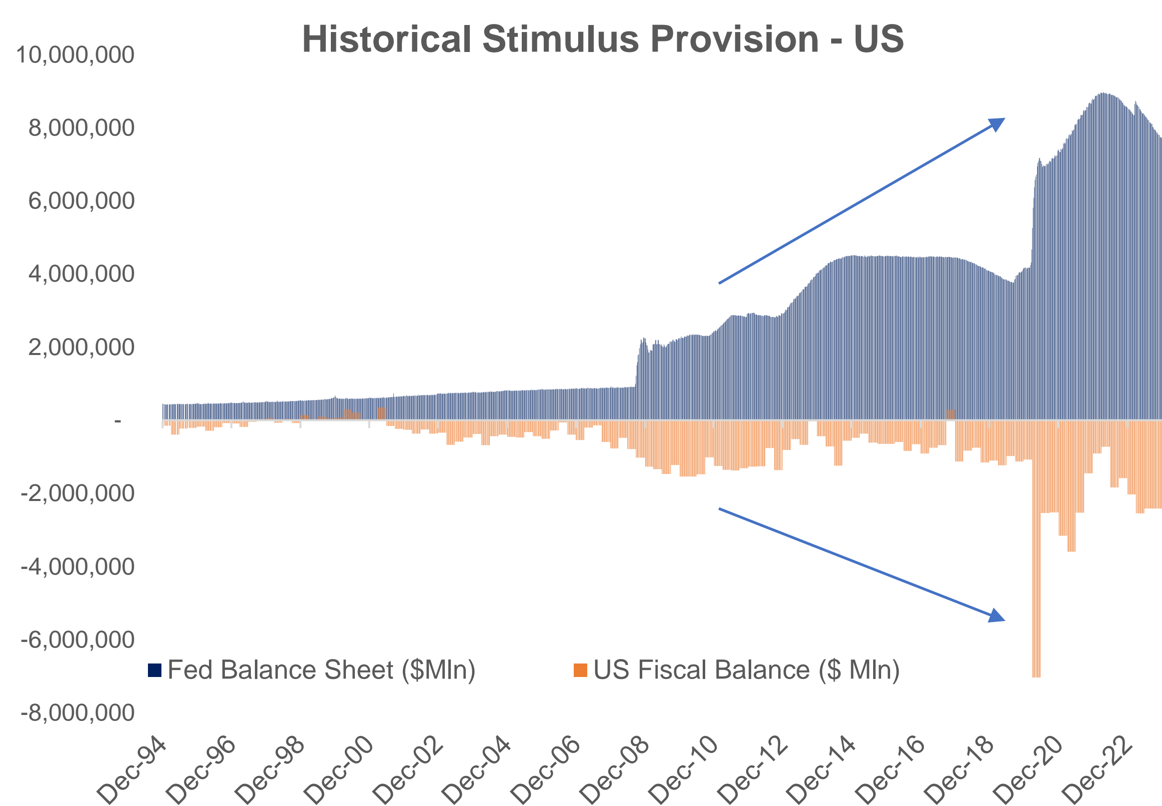
Fed's Gordian Knot

One of the key events that caused the outburst of inflation in the 1970's was Nixon's dropping of the gold standard. Countries were redeeming their dollars for gold at an ever-increasing rate, tightening monetary conditions in the face of an explosion in US government spending. Something had to give and it duly did. While perhaps not quite as momentous, the Fed and Treasury's MMT (mis)adventures in the period pre and post Covid have in some ways had a similar outcome. In fact we haven't seen such a combination of loose fiscal and monetary policy working in unison since the 1970s. For the best part of three decades, the Fed have prioritised excessively loose financial conditions in the belief that such actions carried little consequences. This was in part due to fiscal austerity policies as well as the deflationary impulse from China. Today the situation is different, as the cost of playing loose and easy with monetary policy is rising exponentially and being felt both domestically and internationally. The Fed has a difficult decision to make around its true priorities – simply paying lip service to price stability while continuing to scratch the back of Wall St could now have very real economic consequences.

Central Bank Trade-Off – Short Term Pain vs Long Term Gain or Vice Versa

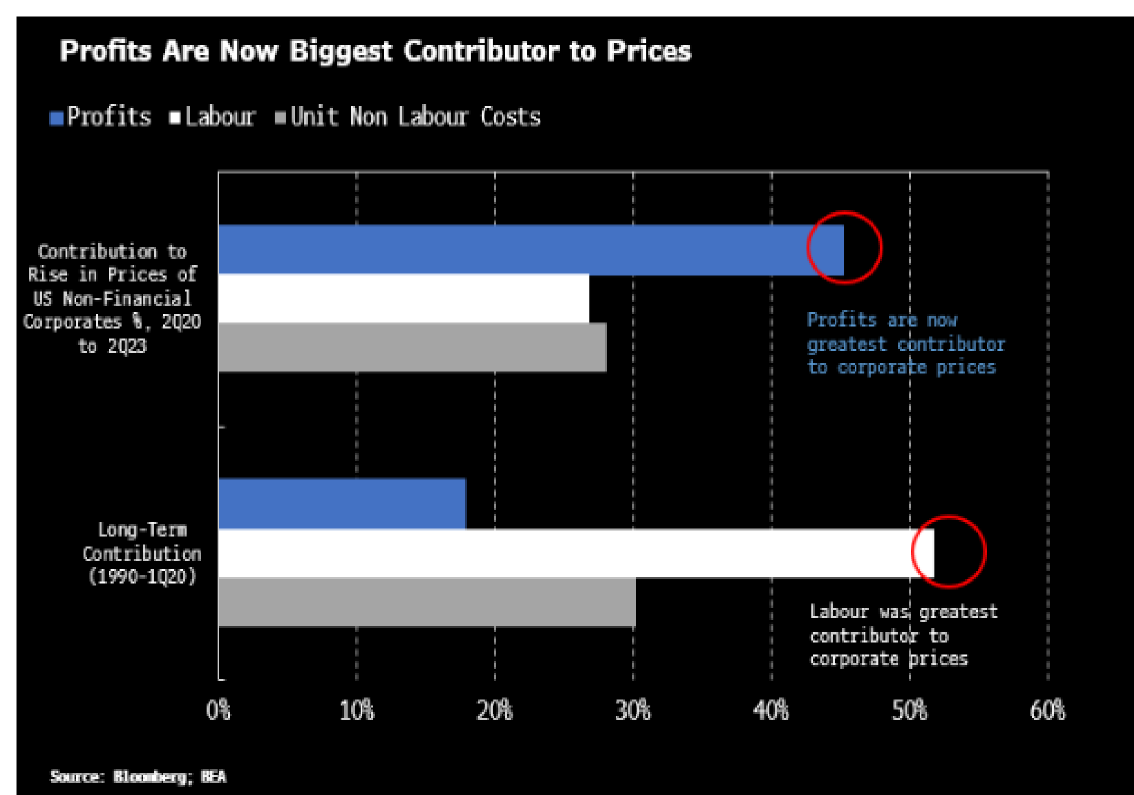
Central Bank Priority	Pros	Cons
Price Stability	Central Bank Credibility Retained	Possible Credit Crunch
	Reduced Price Pressure	Economic Contraction
	Lower Inequality	Risk Asset Revaluation
	Solid Growth Foundation	
Financial Stability	High Risk Asset Valuations (Wealth Effect)	Resurgent Inflation
	Easier Access to Funding	Perpetual Asset Bubbles
		Loss of Central Bank/USD Credibility
		Increased Social Unrest

Exponential Rise in Stimulus



Source: Bloomberg as at 30/04/24

Corporate Profits Driving Inflation (Unlike 70s)

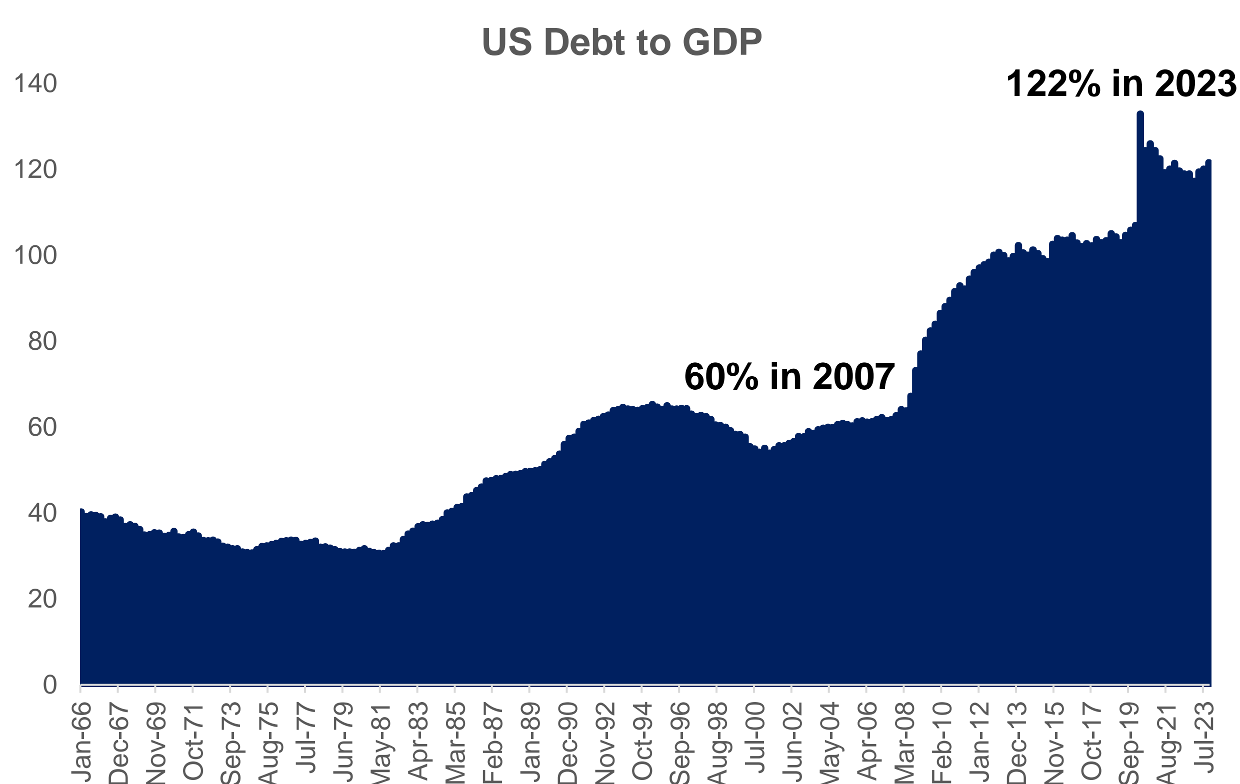


Source: Bloomberg as at 30/04/24

How Did We Get Here?

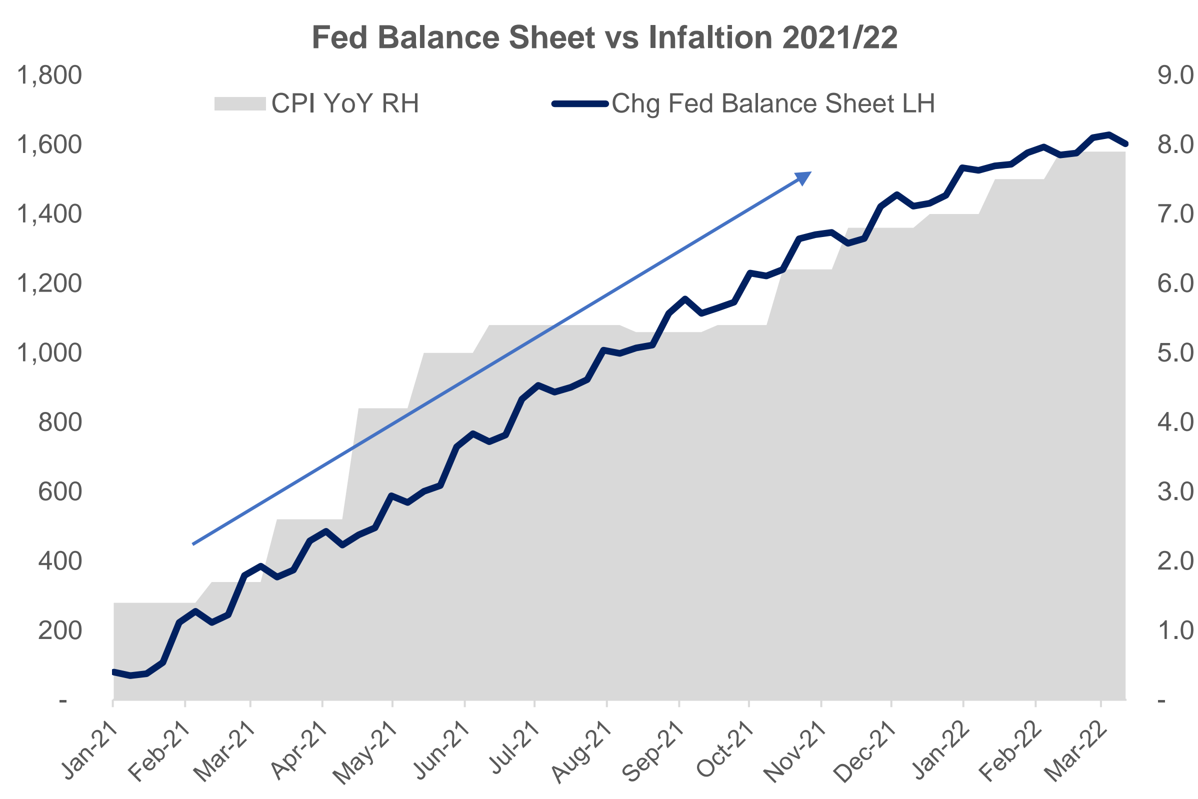
While we saw improvements in the inflationary outlook in 2022 thanks to a reduction in stimulus and higher interest rates, all of this was undone by the naive actions of both the Biden administration and the Federal reserve. By adopting the 'T Bill and chill' approach in H2 '23, Janet Yellen was able to tap into the $trlns of RRP liquidity to fund US treasury deficit spending without taking a dime out of the system. This was followed in short order by Jerome Powell, who's verbal pivot in December unleashed a colossal loosening in financial conditions in the face of an already hot US economy. The result was a shift from a disinflationary trajectory in 2022/23 to a reflationary one in 2024. Great for risk assets, not so much for the goal of achieving a soft landing.

Exponential Rise in Debt



Source: Bloomberg as at 30/04/24

Policy Error - Continued QE as Inflation Rose



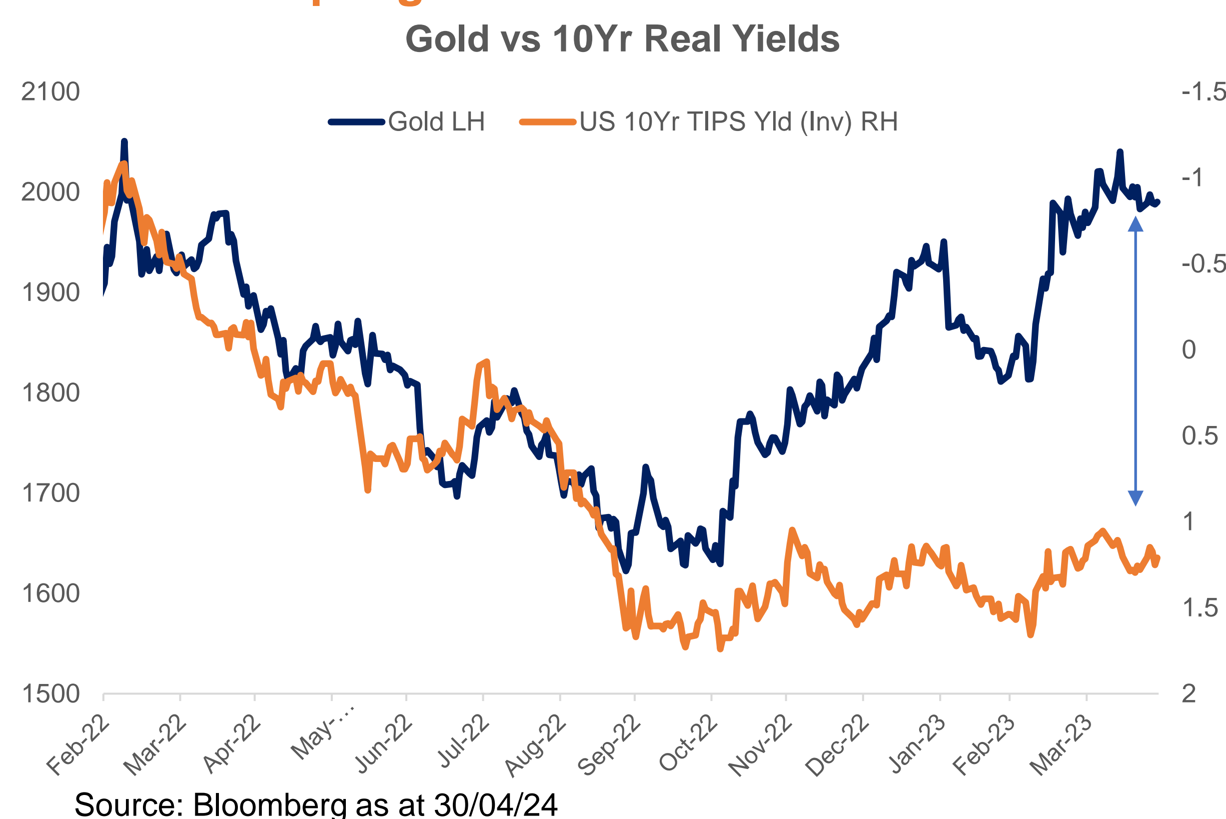
Source: Bloomberg as at 30/04/24

The Fed is left with an ugly dilemma on their hands: face up to the current reality that their policies were ill timed and counter-productive or continue to follow their model-based rule book which has invariably faltered. Remember it was their own economic models in 2008 that failed to appreciate the impact of the over-leveraged financial sector on the economy leaving them completely blindsided. In a similar vein, the failure in 2021 and 2023 to understand the impact of fiscal policy on inflation is another major error. The Fed now needs to decide between the short-termism of financial market support or the long-term goal of price stability. Historically the answer was simple – follow the path of least resistance (financial markets). ***However, for once, this approach might well represent the bigger risk. Allowing the mere perception to take hold that price stability is a secondary concern could be potentially disastrous for the Fed.***

The political and economic backdrop has undergone some big changes in the years post the pandemic. For one thing we have moved from a period of largely structural deflation to one of structural inflation. There are many reasons for this, but the bottom line is the flexibility of the economy has been diminished such that the impact of monetary support on inflation will be higher than previous cycles. Decades of low rates, QE and more recently outsized pro-cyclical deficits have left government debt to GDP ratios in an unrecognisable state.

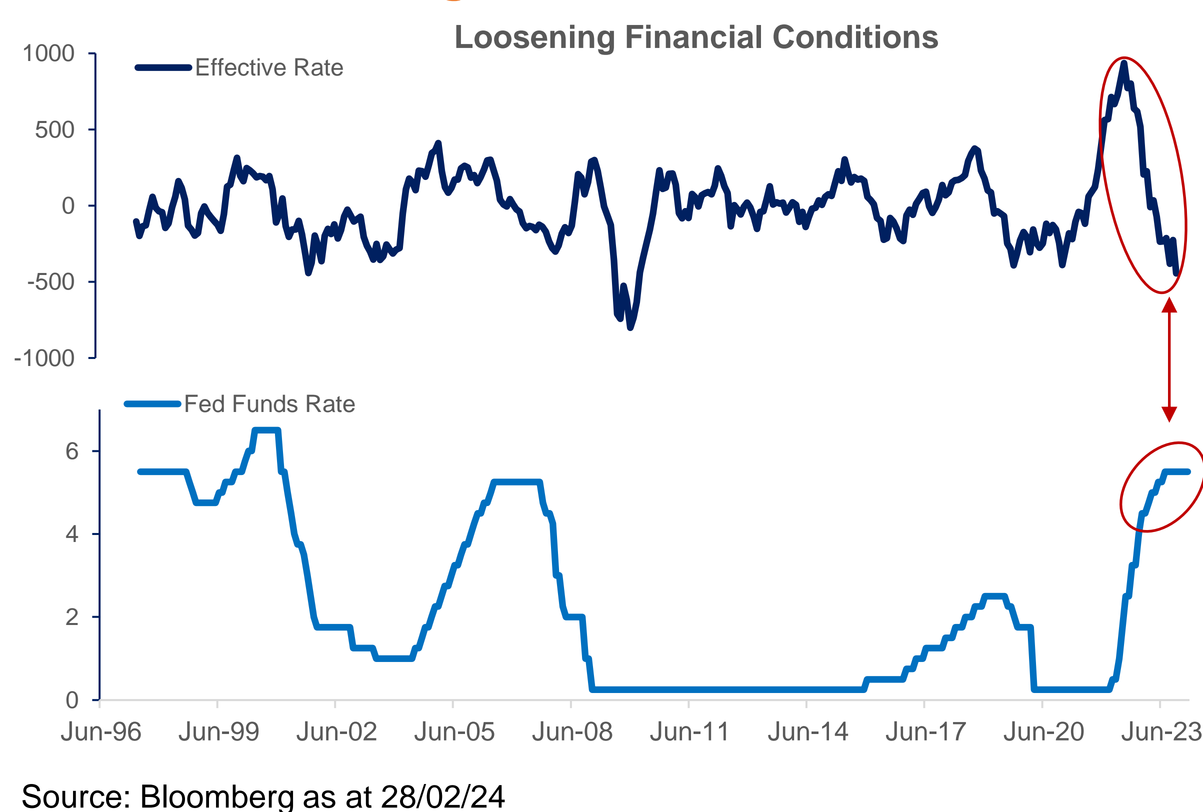
They have also facilitated the growth of a two-tiered economy for both households and corporates. Additionally, through its constant intervention, the Fed has created an environment in which liquidity/debt is the main driver of activity not productivity (Rubrics' flow over fundamentals thesis). The detrimental impact of this on market liquidity means that any hit to financial markets can result in outsized volatility. With each crisis, the costs of bailing out the markets grows exponentially. While supporting capital markets in their time of need has benefits, continually driving asset prices to record highs for the wealth effect of trickledown economics is proving counterproductive. One hopes the Fed is starting to learn that feeding this monster has consequences and that a change in approach is required. Globally many economies are straining under the impact of higher US rates. Notice the Yen recently, or the Chinese domestic demand for Gold? All the while the economies of Europe are crying out for lower rates but are afraid to move ahead of the US for fear of FX induced inflation. The point is that any decisions the Fed makes will have far reaching consequences. The threat to the US from further de-globalisation and moves away from the Dollar are real. Further policy mistakes risk putting increased pressure on these critical relationships – ***the Fed must tread carefully.***

Gold De-Coupling from Real Yields



Source: Bloomberg as at 30/04/24

Record Loosening Without Rate Cuts



Source: Bloomberg as at 28/02/24

This flexibility the Fed once had has evaporated with their constant reliance on easier monetary conditions to solve all problems. We have plenty of evidence that the costs have been significantly higher than the benefits over the longer term. William Dudley, former head of the New York Fed and vice chair of the FOMC, was the latest to outline the litany of Fed mistakes made during Covid in a recent Bloomberg column (funnily enough he didn't mention any of the mistakes made during his time). The chorus of hitherto Fed cheerleaders now turned critics continues to grow, with many acknowledging the damage inflicted by the infamous Powell Pivot on the Fed's inflation fighting credentials. Today, as the Fed attempts to row back their recent mistakes, the markets no longer believe them. The Fed Put has been enshrined in stone, Powell has made sure of that. Financial markets are convinced their needs trump all other policy goals, no exceptions, which itself has created a perilous dynamic. The Fed's independence and reputation has never been more at risk, any misstep from here will have meaningful consequences.

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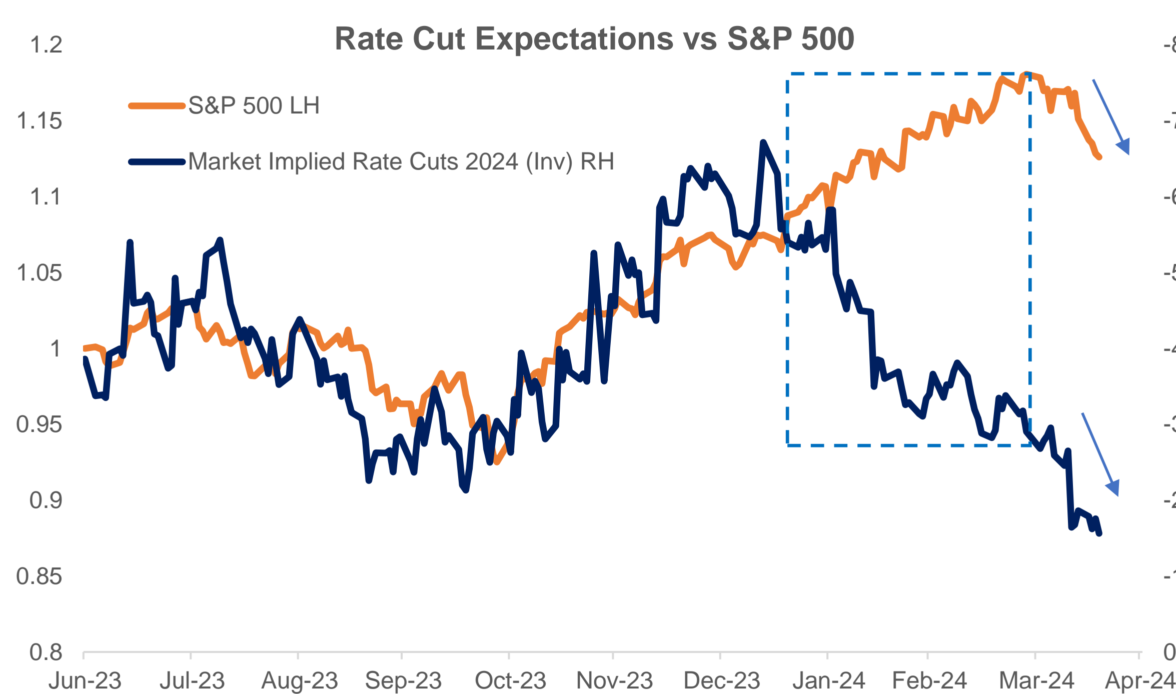
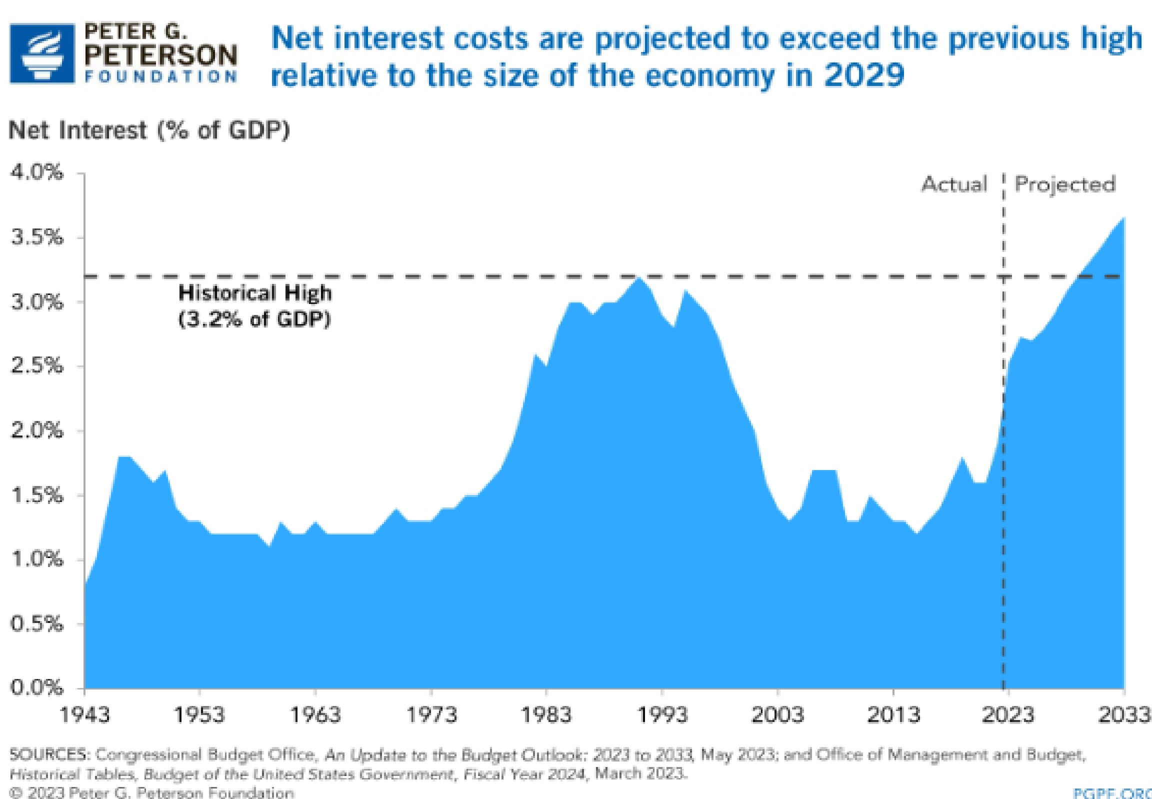
While muscle memory tells us the Fed will not sacrifice the financial markets on the altar of "price stability", the path of least resistance may now be price stability. Although the benefits of the wealth effect from stratospheric stock prices can help in the short run, longer term the risks of stagflation outweigh this. The knock-on impact of any misstep may require more direct action in terms of full Japanese style yield curve control. Any attempt to force real rates back into negative territory would clearly undermine the reserve currency status - the rush for foreign assets could even undermine the financial system itself. Regardless of the Fed's utterances, they fully understand the errors they have made with domestic and international pressure at its most acute. Though many strategists point to the exceptionally high growth rate and low unemployment in the US, they fail to recognise the ramifications of how we got here - trillions of dollars in monetary and fiscal stimulus and the political and economic fallout that came with it.

Higher Rate Expectations Impacting Risk Assets



Source: Bloomberg as at 30/04/24

Interest Burden Set to Grow Further



Where do we go From Here?

There is a growing feeling that the Fed needs to get rates higher to fight the recent uptick in inflation. We disagree with this. The problem is not that rates are too low, but rather the liquidity overhang is too high. The contraction in bank lending is indicative of the impact higher rates are having, ditto the growing list of other contractionary indicators (rising delinquencies etc). However while money supply growth remains at recessionary levels, the market is awash with liquidity. Shadow banking continues to flaunt new billion-dollar deals while selling existing ones at discount levels. House prices are hitting all-time highs while affordability has never been worse. ***Rates are not the problem, financial conditions are. Confidence that the Fed will always bail out risk takers is absolute*** – this needs to be addressed. The Fed must allow a tightening in financial conditions to happen otherwise the battle against inflation will become a war with even worse consequences. The good news is bond yields are now hurting once again, this will allow a reduction in interest rates to levels that are sustainable. Economist Barry Eichengreen was asked after his speech at Jackson Hole last August how he thinks the Fed should they proceed. His answer was simple - "carefully". Like many others, he knows that all of the easy solutions are behind us. There is only one option left, to do the right thing because the balance of outcomes says that taming inflation is now the lower-risk option.

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