Remember, Jay Has No Choice In The Matter

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by: The Heisenberg

Summary

- Market participants had a good laugh at Jerome Powell's expense following a very hot June CPI print on Thursday.

- While it's tempting to lampoon the Fed for what is now an inevitable July rate cut given the economic backdrop, remember that there's a lot of nuance to be had.

- "Data dependent" sounds straightforward enough, but in the current environment, it's anything but.

Everyone had a bit of laugh at Jay Powell's expense on Thursday morning, when, exactly 24 hours after his prepared remarks to the House Financial Services committee crossed the tape, core inflation for June came in much hotter than expected, printing 0.3% MoM, the briskest pace since January of 2018.

Financial Twitter ("FinTwit" for short) had a field day with the number. Powell spent quite a bit of time on Wednesday explaining to lawmakers how subdued inflation might not be a "transitory" phenomenon after all, as he famously suggested at the press conference following the May FOMC. The June CPI data (which also beat on the headline) was thus something of an "egg on your face" moment for the Fed chair.
If you have any doubt about what's driving the price action these days, look no further than the following simple chart, which shows the dollar and the short-end reacting to June payrolls, Powell's testimony and Thursday's CPI report:

To be sure, the CPI print on top of the June jobs number (and the best jobless claims number in 12 weeks, also out Thursday morning) does make a mockery of the imminent July Fed cut in the eyes of many.

But most of those folks already viewed the forthcoming cut with extreme skepticism, so their derision is nothing new. Importantly, it's not misplaced either. That is, nobody is under the impression that the US economy is screaming for rate cuts. Rather, it's all about...
"uncertainty", which came through both in Powell's congressional testimony and in the June Fed minutes, released Wednesday afternoon. The word "uncertainty" appeared 22 times.

Frankly (and I'm not sure how else to put this), that's probably a "mission accomplished" moment for President Trump, assuming there's something to the idea that the White House is deliberately stoking trade tensions and engineering uncertainty in an effort to push the Fed into cutting rates ahead of an election year.

Remember, that is not some far-fetched notion, nor is it necessarily a derisive comment about the administration. The "crazy like a fox" theory has been discussed openly by multiple desks on Wall Street.

It's often referred to by other names, such as "3-D chess", etc. If there is indeed a "method to the madness," so to speak, it doesn't, in and of itself, make Trump some kind of anomaly. No politician wants the economy to crater in an election year and to the extent monetary policy can help avert the downturn clearly presaged by the yield curve, any president would welcome the assist. Of course, Trump's methods are unorthodox, to say the least, but that's another story.

There are obviously a multitude of visuals you can trot out to suggest the Fed "has" to cut and/or that a recession is now virtually assured. I use them when they're useful and instructive as opposed to just tossing them about purely for page views. In light of the
debate about the relative wisdom of a July cut, I'll use a couple of them here. The spread between the 2-year and the funds rate is at negative levels that have historically preceded recessions and/or triggered cuts:

(Heisenberg)

You're also reminded that one metric favored by the godfather of yield curve/recession analysis (Duke's Cam Harvey) triggered in June, when the 3-month-5-year curve wrapped up a full quarter of inversion:

(Heisenberg)

Call it the tail wagging the dog, or call it Trump "engineering" chaos in order to force the central bank into preemptive easing, but whatever you call it, just make sure you understand that in many respects, Powell has no choice.
You should also note that it is by no means lost on the Fed that expectations for rate cuts are the primary driver of the recent loosening in financial conditions despite worsening trade frictions and geopolitical turmoil. Although this didn't get a lot of attention on Wednesday, the following passage from the June Fed minutes is interesting to my mind:

While overall financial conditions remained supportive of growth, those conditions appeared to be premised importantly on expectations that the Federal Reserve would ease policy in the near term to help offset the drag on economic growth stemming from uncertainties about the global outlook and other downside risks.

That amounts to an explicit acknowledgement of something I've been pounding the table on for two months - namely that the rally in stocks, credit and bonds in June was predicated almost entirely on expectations for rate cuts. Because higher stocks, falling long-end yields and tighter credit spreads serve to loosen financial conditions, a reversal of those trends tied to a hawkish surprise at the July meeting would likely lead to an acute FCI tightening impulse, which would make a cut necessary anyway. So, why wait if you already know that?

When you think about the forthcoming July rate cut in the context of the blockbuster June jobs data and, now, the hottest MoM core CPI read since January of 2018, it's ok to chuckle, but don't forget the nuance. "Data dependence" sounds straightforward enough, but in the current environment, it is anything but.

What happens after the July cut is anyone's guess. Easing bets were trimmed following the CPI report (to ~68.5bp of easing by January) but the Fed will continue to face the same addiction liability as long as market expectations remain disconnected from the Fed's own projections.

For now, enjoy the rally.

Disclosure: I/we have no positions in any stocks mentioned, and no plans to initiate any positions within the next 72 hours. I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it (other than from Seeking Alpha). I have no business relationship with any company whose stock is mentioned in this article.
Comments (143)

Mike Nadel, Contributor
It's obvious there's no need for a rate cut. If anybody else were president, Citizen Trump would be twittering up a storm ripping the president and the Fed for even thinking about cutting the rate now.

Gotta give him credit, though. In addition to conning millions of Americans, he beautifully bullied Powell into an unnecessary cut to goose "the strongest economy ever" into hyperdrive.

He's betting that the inevitable bubble-bursting and huge recession won't start until after the election. Until then, he's desperate to make the only person he loves look good, no matter what it takes and no matter how bad it might be for our country.

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Scootrd
“He (who) knows nothing; and he thinks he knows everything clearly points to a political career.”
— George Bernard Shaw

The less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own.
- Warren Buffett

don’t pay too much heed to the daily ebb and flow of the markets. In the short run, people get excited and stocks get way overpriced. Then a sell-off happens, the stock price goes down, and that sends [price-earnings ratios] lower. The long-term investor should pay no attention to that. The stock market is a distraction to the business of investing.
- John Bogle

"There are two kinds of forecasters; those who don't know, and those who don't know they don't know”.
- John Kenneth Galbraith

"The herd instinct among forecasters makes sheep look like independent thinkers."
- George Fielder

Just Thoughts,
Scootrd

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