Daily Note

FED KEEPS BETTING ON TRANSITORY

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- **Fed rhetoric far tighter than policy – markets catch on**
- **QT is far from tightening financial conditions, we run through the numbers**
- **Labour still before inflation in their list of concerns**
- **Fed never expects the unexpected, we do – a credit cycle in the wings?**

The Fed admittedly has no idea what economy emerges out of the run of one-offs that have spiked prices, so "neutral" is the best objective they can offer – a 2% funds rate by the end of July. In other words, do not overdo it and send the economy off a cliff, at least not yet. In turn, because equities are the main conduit for policy, the Fed cannot allow markets to get too far ahead on policy– lest the resulting downswing crashes spending. And so, on Wednesday, Powell pulled back extreme hawkish sentiment and markets went along willingly – fully aware the Fed is still capping market upside but deciding instead to focus on the put being back in play. Market participants also understand the Fed is a lot easier than their rhetoric, as indicated by the re-steepening of the yield curve. All want to believe the FOMC's hope that "neutral" plus transitory equals an economy heading back to 2% inflation with employment still strong. **This is akin to going all-in on drawing an inside straight – it's a possible outcome but I wouldn't bet on it.**

To be clear, the Fed is not tight at all, and this includes their proposed drawdown of the balance sheet. The funds rate has been upped to 0.75%-1.00% with core PCE m/m running at 3.5%, leaving the real rate in deep negative territory – and the Fed does not propose getting to even 2% until the end of July. They keep to this dovish pace of tightening because they still believe elevated inflation reflects "supply and demand imbalances related to the pandemic, higher energy prices, and broader price pressures" The ordering of this list is no accident, it is meant to convey that the transitory narrative still dominates.

As for the pace of balance sheet reduction, it promises to have little impact as designed. Consider that they were buying $80bn/month of UST, but in the face of high inflation and attendant hawkish rhetoric, they aim to hit a $60bn/month run-off and not until September. They begin in June with $30bn/month, followed by the same in July and August. This is hardly stressing financial markets especially given the downshift in Treasury financing needs (Table 1), Further, the Fed is raising IORB in line with the increase in the funds rate, meaning they are holding onto to reserves and looking instead to run down reverses ($1.8trn out of a $9.9trn b/s). This is the very definition of paint drying because the money funds will simply swap their repos for Treasury bills, creating no lost liquidity to the markets.

Table 1: Balance sheet runoff creates no strain for markets ($bns, NSA)

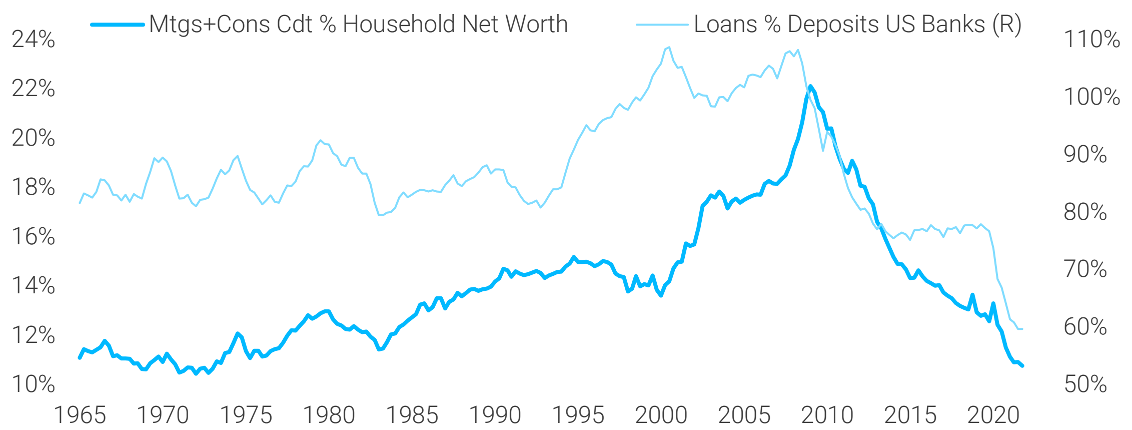
	(1) Financing Need	(2) Chg in Tsy Cash Balance	(3=1+2) Total to be Raised	(4) SOMA Net Change	(5=3-4) Net Financing from Public (ex Fed)
2021Q3	$751	$(637)	$114	$240	$(126)
2021Q4	$480	$191	$671	$221	$450
2022Q1	$423	$245	$668	$108	$560
2022Q2E	$(203)	$98	$(105)	$(30)	$(75)
2022Q3E	$311	$(150)	$161	$(120)	$281

Source: Federal Reserve, US Treasury, TS Lombard

Powell kept referring to the hot labour market as signal the economy is too strong, and that this is a supply/demand imbalance they can correct – without creating unemployment We will leave others to sort out this math, but his "too hot" labour story runs counter to FOMC statement construction and their dovish tightening. Their stated goal is "inflation to return to its 2 percent objective and the labour market to remain strong" and that they are willing to "adjust the stance of monetary policy as appropriate if risks emerge that could impede the attainment of the Committee's goal" Yet, the order (order is always important in any Fed list) of what policy will respond to is "public health, labour market conditions, inflation pressures and inflation expectations, and financial and international developments." Inflation is third on the list but has come before employment in years past. The FOMC does not now have to balance rising unemployment with their inflation goals, they are not goals in tension according to Powell, but when they do, the Fed is going to have make a choice – and current actions, not rhetoric, suggest they back off in favour of jobs.

Because the Fed is so model driven in its forecasts, they never expect the unexpected to alter the path to their equilibrium, or even change what defines a balanced economy – even though something unexpected always happens. I have written a lot about the potential for a credit cycle to emerge. I leave you with Chart 1 and ask whether such low debt/wealth levels and loan/deposit levels are likely to be sustained – or whether some mean reversion gets started. If it does, especially with inflation settling in above 3%, Powell's promise to raise rates above neutral will be tested. My bet is that this is what happens, with the Fed failing to recognize it is still following inflation until sometime in the fall.

Chart 1: Is a low leverage economy here to stay? Doubtful



Source: Federal Reserve, TS Lombard

In sum, Powell is playing high stakes game that delivers tough rhetoric but weaker action in the hope no one notices while waiting for falling goods prices to bail him out. Fact is, high commodity prices are not softening consumer demand -- only equities appear able to do that and, today, Powell pulled the market back from crashing demand -- and the re-steepened yield curves confirms this. Powell's tough rhetoric belies the fact that real interest rates remain far too low to restrain financial conditions, and the proposed pace of QT will not drain market liquidity. The Fed is more sensitive to a weakening job market than they let on and extraordinary low leverage ratios in the economy are unlikely to last, setting up for the return of credit driven growth. The Fed's current resolve determines whether they end up chasing down inflation and end up creating a hard landing, or not. Today, their actions fell short,