MONETARY SCENARIOS

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Global Monetary Alert

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EXECUTIVE SUMMARY:
The Powell Fed has entered a period of "rate-setting paralysis". This is most likely to be broken by real economic and financial events ahead.

The Fed's ostensible aims are stable prices, maximum employment, and turning the present mid-cycle slowdown into a new growth cycle upturn.

From a short and medium and long-term perspective the Powell Fed is set to fail in all these aims.

Read on!

S&P 500 dependent Fed pins real rate at 0: Its data/shock monitoring is deeply flawed

A non-event meeting and a deadly boring press conference are a good opportunity to take stock of Fed policy.

The Fed in its statement repeats its paraphrased mandate – the pursuance of stable prices and maximum employment.

This Fed is doing neither.

Inflation is running at just around 2 per cent per annum (a tiny bit less according to some data points). Maximum employment does not refer to a data point in the present but a plausible central scenario over many years into the future. The pursuance of a powerful asset inflation policy – with its almost inevitable corollary of asset deflation, recession, and huge revealed mal-investment, at some distance down the road – is not obviously consistent with a maximum employment objective in any meaningful sense.

Such matters are not the discussant points of Fed chair conferences. Even the more prosaic question did not pop up – have you, Mr. Chair, been influenced in your decision today to indicate caution about further rate cuts by the fact that the S&P 500 is touching all-time record highs?

Maybe the answer is so obvious to all, that the question did not merit the airtime. Only those seconds-obsessed traders or their algorithms who crazily thought that this Fed might deliver a promise (implicit) of another rate cut seemed seriously to have considered the possibility – to be rudely disappointed.)

So why all the fuss? The Fed funds rate – in a band now of 1.75-2% - is zero in real terms. Is that not where Professor Fama said the riskless rate in real terms was in his epic studies of stock market efficiency in the 1970s, based on masses of empirical evidence?

What Fama failed to impress on his readers was that this was a real riskless rate during a long period (from the early 1960s to the late 1970s) of the greatest peacetime monetary inflation in the US. That was surely not the norm of a sound money regime!

Chief Powell had much to say about potential shocks ahead which could upset the Fed's forecasts and prompt a change in rate path under the present "data-dependent policy". He mentioned implicitly or explicitly "trade war" and "geo-politics".

Readers of Global Monetary Viewpoint (and Alert) already know that the view here is that the China-US tariff war is not in fact a key source of downward momentum in the global economy. Chief Powell may also admit that possibility but he maintained (in his press conference) that the Fed has to be guided by how businesses interpret these matters – and their surveys show trade a matter of deep concern.

When it comes to geo-politics, most likely the Chief's speech and the FOMC statement were finalized ahead of the latest news, not providing enough time to adjust to the latest take. According to this, Iran is most likely the big loser from Saturday's attack on Saudi oil facilities.

The cost to the Saudi regime is the apparently modest re-construction costs related to the destruction of its plant; the main gainers (modest) will be shale oil producers (and their lenders in particular), if indeed the oil price remains a few dollars higher than otherwise. Military suppliers principally in the US could see some extra orders.

Iran loses potentially from greater isolation – as he US gain greater adherence through multilateral channels (based perhaps on UN condemnation, albeit vetoed by Russia, of Iranian aggression) for its strengthened sanctions against Teheran.

The amount for which Aramco can be sold in its looming IPO could be in jeopardy according to some analysts; but we should not underestimate the skill of the financial engineers to devise alternative strategies or for markets to be impressed by a new reality of Saudi anti-missile defences.

Back to the data-dependent Fed.

It is not too late to ask yet again what this actually means. The suspicion here is that the Fed means responding to any increased in danger of sustained economic downturn by a timely easing of monetary policy.

Chief Powell said as much when in a previous press-briefing he maintained that the present juncture is similar to mid-cycle slowdowns in the super-long cycle of the 1990s, to which the Greenspan Fed always responded by substantial easing. Its luck (and record) ran out, when the NASDAQ crash and telecommunication downturn took their toll in 2000/02.

Even so with hindsight the Greenspan Fed had "remarkable success" in keeping that downturn shallow, though the eventual payback of all these extensions was the Crash and Great Recession of 2007-9.

Sometimes, indeed, such mid-cycle extensions by the Fed are "successful" in the short and medium-term. The long-run costs only become apparent long after Election Day – and even then they are denied not just by the monetary policy makers but the policy-dominant school of neo-Keynesian economics.

That is Chief Powell's gamble, irrespective of the sniping from the White House, whose concern may well be in any case setting up a fall-guy for if and when recession comes rather than seriously influencing monetary policy now.

The lesson of history and principle is that fine-tuning monetary policy to iron out (and reduce) short-run pull-backs in the economy encounters failure more often than success even when defined in these short-run horizon terms. Tweaks to short-term rates cannot turn around suddenly amassed and strong cyclical forces – which indeed the Fed will be no quicker to recognize than market-participants (most likely considerably slower).

If Fed Chief Powell fails this time it will be most likely because the global slowdown spreads to the US, not just via the trade route, but also via financial contagion (which would include a second round of capital spending cuts by a whole range of businesses).

Nor have the risks of an unexpected break-out of goods and services inflation to the upside been eliminated – though this remains a lower-order probability scenario than the recession scenario.

Bottom line

Yesterday's FOMC meeting is an utter non-event for anyone except traders whose horizon extends to seconds or perhaps minutes.

The Fed continues to aim primarily at extending this cyclical expansion – using the tools at its command (including vast propaganda) to help moderate any build-up of recessionary forces. It is aware though of the risk of failure, whether via recessionary forces being so strong, or asset inflation assuming even more vigor to the point of even bursting within say a year, or goods inflation emerging from camouflage. Hence the present new paralysis in rate-setting action.

The next act in the Fed drama will come from economic and financial events beyond its corridors of power.