

The Past is a Great Darkness, and Filled with Eccles

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In this report, I will try to find a way to highlight the sense that the Fed is not only battling difficult to interpret economic data, but they are also battling “demons and echoes” of the past.

- The majority of the people in leadership positions at the Fed (including the Chair) were in those leadership roles when they seemed to miss the fact that inflation wasn’t “transitory”. Not only did they miss it, but they seemed to add fuel to the fire by continuing QE (albeit at a reduced scale) into early 2022. Disciplined traders use stop losses for a reason and the knowledge that getting something wrong tends to lead to poor decisions going forward is an integral part of even the simplest day trader’s strategy. However, it is odd that it would happen at the national central bank policy level.
- The Fed also seems to be worrying about historical precedent. The mistakes their predecessors made in their battles against inflation are haunting their thought process. Long gone are the days of the “Greenspan Put”. The Fed is fixated on Volcker and Burns and what they did right or wrong in their respective fights against inflation (however, those were very different times compared to today).

I wasn’t hopeful that I’d find a relevant quote that captured what I was looking to portray, but then I found this gem from Margaret Atwood’s “The Handmaid’s Tale”:

“As all historians know, the past is a great darkness, and filled with echoes”.

That statement captures the essence of what the Fed is dealing with and encapsulates the “darkness and echoes” of past mistakes.

Today’s report is a natural progression of last weekend’s [For the Record](#).

Where Would we be Without the “Demons” or “Echoes”?

At this point, that seems obvious - we’d be ending the hiking talk.

Much of this week’s data was skewed to the negative. The “positive” news included rising inventories. However, this is not actually a positive because inventories are already too large and consumer spending seems to be waning!

Without these demons or echoes, the Fed would be focused on whether or not they had done too much. They would also be highlighting the dramatic improvements in the fight against inflation and talking about how ridiculous the rent component is relative to reality. The bond market wouldn’t be fighting the Fed’s rhetoric or anticipating rate cuts later this year because the Fed would be much less hawkish.

There would be a “wait and see” element to every single Fed statement. They would be admonishing those screaming that inflation hasn’t been fully beaten down because they know that monetary policy takes time.

Governor Brainard recently said something that the T-Report wholeheartedly agrees with! She said that there was little evidence of a 1970s style wage-price spiral. We agree because the [“Rise and Fall of Inflation Factors”](#) piece explains inflation’s rise, fall, and the coming deflation much better than “traditional” models do.

If it wasn’t for those past demons, the people meeting in the Eccles building “might” be able to steer us towards a “softish” or “squishy” landing.

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But the “Demons” are Real

The Fed can look to the distant past as a guide and can maybe even glean some useful information about the mistakes that were made. However, the recent “mistakes” (I can’t really think of anything else to call it) are more difficult to ignore. Speech after speech, the overall message was that inflation was transitory/under control/easy to deal with and that we still needed accommodation because liquidity concerns remained. How do you ignore all of that when trying to move forward?

On the bright side, in the grand scheme of things, missing inflation was a minor mistake compared to asserting that the sub-prime crisis was contained (though Bernanke did go on to win a Nobel prize for fixing a mistake that he was part of creating/missing, so maybe it wasn’t really a mistake).

Traders use stop losses for a reason. It is human nature to compound mistakes. Once a mistake has been made (such as buying a stock at \$100 and watching it drop to \$90) it tends to cloud your judgement. Hence, even the most rudimentary risk management systems use some form of stop loss. Effectively, this means that “you got it wrong so we are going to close the position and give you time to think about it”. Maybe that is important for the average day trader (let alone hedge fund), but not for those setting monetary policy (arguably) for the free world. Any corporation that missed one of their two targets by miles would have shaken up their decision making process, but again, maybe this isn’t applicable on the monetary policy side. The recent “big changes” seemed more related to personal trading than anything having to do with prior monetary policy decisions, but I guess that it makes sense because there is virtually never any dissent on policy making decisions.

In any case, given all the demons that this Fed is dealing with, they will likely be fighting the inflation demons long after they’ve been exorcised. While the bond market can (and should) fight it, it will be more difficult on the risk asset side because policy errors will hurt the economy and ultimately corporate earnings and stock prices.

Have they Already Done Too Much?

Even if the Fed behaves as they should without the demons, have they already set too much future pain in motion? Did their demons get the better of them in meetings late last year? Should they have dialed back their tough talk and started the “wait and see” process?

I suspect that the answer to that will be yes, but only time will tell. Hopefully the data in the coming weeks will provide some clarity so we can determine if my pessimism has been justified because I believe that the path to a deeper and longer recession has already been paved.

A Special Shout-out to Waller

Governor Waller said something that makes some sense, but may also prove to be bearish for risk assets. He is onboard with a 25 bps rate increase in February and seemed to indicate that he was leaning towards the “wait and see” camp. He also said that not only would he keep QT, **he would encourage QT even if we needed to do rate cuts.**

I think that makes sense. **What made less sense (to me) is that he tried to equate some amount of QT to some amount of rate hikes.**

I don’t think shifting Fed funds up and down behaves anything like growing or shrinking the balance sheet ([Rates vs Balance Sheet](#)). I like salt and pepper, but they don’t serve the same purpose and so far, I haven’t had a doctor tell me to monitor my pepper intake! Both salt and pepper shift the taste of food, but they are not the same at all.

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I think QE and QT act more directly (and in a much timelier manner) on asset prices than rate changes do.

One Caveat is that Political Winds are Changing

One thing to keep in mind is the report that we did a week or so ago on [The Shifting “Politics” of Inflation](#). In that report we identified a shift in political and media talking points and predicted that it could pave the way for a series of Fed speakers to come out and downplay the inflation risk.

Bottom Line

The Fed might capitulate to the “wait and see” argument, but they are likely to still err on the side of being too hawkish.

The Fed should have gone to “wait and see” mode months ago, but they are likely being haunted and already went too far.

Even after they realize that they’ve gone too far, rate cuts are a long way off and they will continue to run with QT (which will weigh on asset prices).

Equities. I am mildly bearish because the need to respect the “soft landing” is a narrative that is gaining momentum. Fortunately, as a mild bear, I don’t think that positioning is heavily bearish and I’m in the camp that believes the market is more or less balanced.

Credit.

- **If you are an issuer, issue bonds now.** Treasury yields, especially out on the curve, are reasonably low as are spreads. The all-in combination seems attractive as I see scenarios where all in credit yields struggle regardless of the direction that the economy heads. I believe that spreads will blow out fast as Treasury yields go lower in a “recession” trade and Treasury yields will go higher faster than spreads can tighten in a “soft landing” scenario. Also, investors had “dry powder” for what was expected to be a huge new issue calendar at the start of 2023. That hasn’t materialized, so take advantage of the overall yield environment AND the dry powder.
- **For asset managers,** resist the urge to put the dry powder to work!

Maybe it’s because I’m on a flight, or I’ve been focused on the Fed, or I just hate the subject so much, but I have avoided discussing the **Debt Ceiling** today (or I did until now).

Debt Ceiling 2023 is starting to look, feel, and even smell different than prior debt ceiling deadlines.

I think that because it is far enough off (as a market moving issue) I don’t need to address it today, but I will have to remedy that soon, as it is pinging all over my radar since the vote for Speaker turned out so “interesting”.

Good luck preparing for the data, the Fed, and the narratives and my sympathies go out to all of us as the debt ceiling seems destined to become a household conversation!

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