

Why Am I “Fighting the Fed” When I Agree with Powell?

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As markets gyrated wildly and appeared to gear up for a ramp into the close ([ODTE](#) or otherwise driven), I had the good sense to at least pay attention to my own writing on the latest gamma squeeze risks. That is all fine and dandy (as it helped me survive an afternoon), but it mostly gave me breathing room to think about the recent Fed speak.

- **The Fed, collectively**, wants to paint a picture showing that it remains afraid of inflation. In addition, the terminal rate should (and will be) higher than the market is pricing in and we will not see a rate cut in 2023. Finally, the risks, while more balanced than several meetings ago, are still skewed towards a resurgence in inflation.
- **The Fed (Powell)** keeps messaging that inflation pressures have eased and inflation is under control. Even though the Fed still needs to watch for a resurgence, the risk is balanced or even skewed towards the deflationary side. However, he does seem committed to keeping QT in place long after the need for hikes is over.
- **I completely agree with Powell!** If I were the Fed chair, that is the message I would have started sending in September or October of last year (after having hiked more aggressively earlier in the year). My only quibble with him is that he started delivering this message too late, **but it has taken me a week to finally believe that he sees things how I see them.**

The Market vs the Fed vs the T-Report

For the Fed, let’s use what we’ve learned from Powell since consensus will form around whatever direction he pushes.

- **Terminal Rate.** Markets are at 5.13% in July (according to WIRP). That is higher than my terminal rate (I don’t think we reach 5%) and right in line/maybe even a touch high relative to Powell’s “real” message. This is more or less in line across the board, and since it has room to come down, that would be positive for bonds and stocks.
- **Rate Cuts.** The market is pricing in rate cuts by the end of the year. Powell and the rest of the Fed seem to say no to that. I also doubt that we see rate cuts, but that is partly because I don’t see the terminal rate getting as high as the market believes it will. I like 4.8% or a bit under for the year-end rate, but have a different path to get there than the market does. The market could be disappointed about that, but that isn’t a Q1 issue (at least not in terms of stock or bond prices).
- **QT.** I think maintaining QT is important. QE should be the Fed’s “nuclear option” and should never be used as blithely as it was. Powell may be messaging that believes this as well. Not selling mortgages is also smart as introducing an ongoing/price indiscriminate seller to a thin market only causes yields to soar (and not for good reasons). Sticking to maturing bonds makes sense. **I do believe that QE/QT affects asset prices more directly than other policies do so this will be a headwind for asset prices this year and next.**
- **Inflation.** Even after Friday’s “[Stunning Jobs Report](#)” I believe that we will see ongoing reductions in monthly inflation and could see deflationary prints later this quarter or in Q2. Powell and other Fed members discussing “structural changes to the labor market” could be real or just Fed speak for they don’t understand the data either. However, since they don’t see a wage increase driven inflation spiral, should they stop expecting it? Yes, there is a risk that

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inflation flares up again and I’m least comfortable with my deflationary view after seeing the jobs data. But, at least on the Core side of things, we have lower OER (owners equivalent rent) in our pocket. It will still be higher than it should, but the lag effects will be helpful. The big drops we should have seen in Q3 will start hitting the data. Powell seems balanced and even slightly skewed towards lower inflation as the trend. The market, as a whole, seems worried about an inflation resurgence. I’m much more convinced that we get a benign CPI number and that the bigger problem in another month or so will be fears that we’ve started a cycle of deflation. This will be when buyers hold off on purchases because things will be cheaper in the future. If I’m right, we should see stocks and bonds do very well (before bonds do well at the expense of stocks).

My “pendulum” theory is that as the pendulum swung down, we will hit a point where the data looks like a soft landing. We are there and I’ve made at least one mistake in my theory. I thought that the transition from soft landing data to fears about a hard landing would happen within weeks. That clearly isn’t happening, especially after the jobs report. I also don’t anticipate a “bounce back” scenario. Many people think that the pendulum, when it reaches bottom, will bounce back and restart the inflation cycle. I still don’t see that, but it is a theory and weirdly, it is the current “bear” case for markets.

The current “bear” case is a resurgence of inflation that forces the Fed’s hand and causes rates to rise and stocks to drop.

I don’t see the bear case occurring. My bear case is still the hard landing scenario, but that narrative has been taken out of play (at least for a few weeks) until we get more data.

So, I disagree with the current bear case, which should make me bullish, but I’m not exactly bullish either. The rally has been strong, but the breadth seems to come and go. The resurgence of “meme” stocks (or stocks that rally almost 100% during the day while their distressed bonds barely budge) don’t give me confidence in the current prices. The zero day to expiration option phenomenon concerns me. I don’t want to run large positions and have to respect the potential for that type of trading to accelerate price action in either direction.

If the Fed had done this 3 or 4 months ago I would be bullish, but rates would be lower and fewer responses would have been set in motion. The confirmation that QT will remain in place, while a sound strategy, is not bullish. If I’d been bullish into the Fed, would I be pound the table bullish now? That is a question that bothers me on many levels (**which is why traders and angry analysts have stop losses set in place**).

I’m left in a “trade this around” mode, but skewed towards being bullish into CPI depending on the levels (revisions come out on the 10th and latest data on the 14th).

I will respect moves in either direction more than usual, but I will give them less credence in terms of providing useful positioning information (ODTE).

On the bright side, I am having some great meetings in Birmingham and excited to speak at the Alabama Government Finance Officer Convention today and then I get to head to “balmy” Minneapolis for more meetings!

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