What The Fed Did Next

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So far this year, we have seen US inflation repeatedly beat expectations, US gasoline prices creep higher, gold break out to new all-time highs, feverish speculation in crypto and parts of the equity market, bonds sell off, and the US dollar roll over. Now copper has suddenly broken out of its recent trading range. And against this benign backdrop, US corporate bond spreads remain tight, despite fears of a US commercial real estate bust and its impact on US regional banks.

Outside the US, Japanese trade unions have secured their biggest pay rise in 33 years. Coming on top of a higher-than-expected PPI reading for February, this points to a more hawkish Bank of Japan and a stronger yen, which implies less deflation and less capital exports from Japan. Meanwhile India, Southeast Asia, Latin America and the Middle East are booming. And in spite of weak domestic economic data, European stock markets are chugging along nicely.

In short, over the past two months the case for Federal Reserve rate cuts has taken on some serious water. This leaves investors with an important question. What will the Fed do next? Will it try to get ahead of the curve and beat back the expectations of imminent rate cuts that it raised in December? Or will the Fed deliver on the promise of rate cuts, even though the macro backdrop is no longer so supportive of easier policy?

One added complication is the calendar. The Fed will be loath to start a new rate cut cycle in July, smack in between the Republican and Democratic conventions. It will also be loath to start a new cutting cycle in late October, days before the US presidential election. This means that the obvious times for the Fed to start a new rate cut cycle are either in June or in December (unless a Lehman-style or Covid-type crisis forces its hand).

Checking The Boxes

Our short take on the latest news

Fact	Consensus belief	Our reaction
US U.Mich. consumer conf. fell to 76.5 in Mar, from 76.9 in Feb; **1y exp. inflation 3%, again**	Sentiment worse than the expected hold at 76.9	3% expected inflation is "on target" because it tends to run ~1pp above PCE inflation
China unemployment rose to 5.2% in Jan and 5.3% in Feb (both new), from 5.1% in Dec	N/A	This confirms labor market weakness last year has persisted this year
China fixed asset investment rose 4.2% YoY in Jan+Feb; from 3% in Dec	Better than the expected 3.2%	Strong headline, but infra. investment decelerated despite gov't support promises
Swedish unemployment rate fell to 8% in Feb, from 8.2% in Jan	Below 8.2% expected	Swedish labor market deterio-ration easing; bulk of rate shock has been absorbed

Now, having said all that, one of the first things I was taught as a young cadet at officer school was that “doing nothing” is still “doing something.” In the heat of battle, the temptation is always to freeze and attempt to gather more information before making any decision that could

potentially have dire consequences. But the decision to freeze and wait is still a decision—and one that itself can have dramatic implications.

- If the Fed freezes and does nothing—does not cut rates and lets the reverse repo reservoir drain without adding fresh liquidity—we can probably expect a sell-off in long-dated bonds, especially considering the volume of rollovers and new issuance coming down the pipeline. Few equities, least of all the more richly valued, would respond well to higher bond yields. The US dollar would likely rally, and commodities would struggle.
- If the Fed, despite the changed environment, goes ahead with rate cuts, precious metals will continue to rally; in the past few sessions, silver has started to show signs of life and seems to be joining gold in a new bull market. Emerging market debt and equities will rally hard. The US dollar will continue to weaken. And commodities will continue to rally.

So let's weigh the odds, starting with the reasons for the Fed to go ahead and deliver on rate cuts, despite all the recent strong data.

1) Institutional bias. In meeting after meeting, the Fed has made clear its belief that fighting inflation is much easier than fighting deflation. This belief will tend to push the Fed to err on the side of reflation.
2) Credibility fears. After being caught out and changing course in 2019 and again in 2022, Jay Powell probably wants to avoid another flip-flop.
3) Politics. If Powell fails to deliver rate cuts, triggering a bond and equity market crash just before the presidential election, he will never be invited to a dinner party in Washington D.C. again.
4) Treasury capture. In the last couple of months, both Treasury Secretary Janet Yellen and President Joe Biden have gone on record to say that the Fed needs to cut rates. In fairness, it probably does need to cut rates if the US treasury is to roll over US$8trn in debt and add another US$2trn on top without difficulty.
5) China fears. The constant Western media drumbeat on China is that the Chinese economy is imploding, that the renminbi is about to devalue, and that China is set to release a deflationary wave around the world that will make the Asian crisis look like a mere ripple. With a backdrop of such fears, you can see why the Fed might want to get few "insurance" cuts under its belt.

Against all these possible reasons to cut, the main reason Fed policymakers might want to sit on their hands is that Powell has made it clear he does not want to be remembered as another Arthur Burns. That's basically it: the fear of being remembered as Arthur Burns versus the fear of no longer getting invited to D.C. dinner parties.

Looking at copper, gold, bitcoin, the US dollar and others, it increasingly looks as if the market has already decided. The fear of losing the dinner party invites is stronger than the fear of getting a bad rap in the history books. In any case, over the last few years the new motto of public life in Western democracies seems to have become "Après moi, le déluge." Why expect a change now? The market is likely right to expect an easy Fed—and to position itself for reflation.

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