Uber-credibility - 07/12/2022

One month ago, just before the last FOMC meeting, I penned the following lines in a note entitled “Jay’s Volcker Moment”:

> Jay is going to act, and act aggressively!!! That surely brings 75bps into play on Wednesday. And one could make a very cogent argument for guidance towards multiple 75s…. And while the market may wobble on his initial flex, in the end this is the best thing for the economy, for the financial markets, and for Fed credibility. A proven commitment to inflation fighting should ultimately be welcomed…. A lot of negativity has already been priced into risk assets. And we should always remember that stocks, like commodities and real estate, are hedges for inflation. Further, having short-term inflation spikes, with anchored long-term inflation expectations, can actually be quite positive for the entire real asset complex — especially when one views these assets through a levered-balance-sheet lens. Inflation devalues nominal debts and drives nominal asset valuations higher. That’s about as good as it gets for those with levered balance sheets…. So, while the stimulus withdrawal is surely painful, or some might even say heartbreaking, the markets are always forward looking. There will be some relief in having a responsible Fed. To that end, I think a major risk-asset catastrophe is not the obvious outcome from a more aggressive Fed this week. In fact, it may very well be exactly what settles us down.

Looking back at the last four weeks since that aggressive 75 bps hike, there has been a continuous stream of additional hawkish messaging from virtually every FOMC member. And in response, a very distinctive financial market pattern began to emerge. The 2s10s curve flattened sharply, with the 10yr yield DOWN over 25bps and the 2yr yield little changed. The DXY rallied over 3%. The 5y5y breakevens dropped around 30bps to their lowest level since the spring of 2021. And most importantly, spoos found some footing and are currently up around 1-2%

Now, a stronger dollar, lower long-run inflation expectations, and a flatter curve are all quite consistent with elevated Fed hawkishness. But lower yields and higher spoos? That’s a bit more unusual. So, what is really going on here? Is this price action consistent with the ever-so-banal inflationista market narrative which argues the Fed is losing credibility, and we are heading back to the ’70s? Is this price action that suggests that the market is losing faith in the Fed? HARDLY!!! Rather, this is price action that suggests the market is losing faith in all the Fed-hating inflationistas!!

What we really have embedded in these market moves is a Fed that has achieved one of the most desirable positions a central banker can hope for: a central banking holy grail, a deeper consciousness of policymaking bliss, or alternatively, a state of “uber-credibility.” This Fed has pounded the table regarding their need to deliver an unpleasant withdrawal of stimulus. But at the same time, they have told us it is for our greater long-run good. Their messaging has been crystal clear: Anchored inflation expectations are crucial for achieving consistent, high-quality, long-run real economic growth. And the market seems to be getting it – after some initial grumpiness in the first half of the year. Of course, it’s not an easy message to deliver to a group of typically myopic traders, but as of late it appears to be resonating quite well.

So, looking ahead to the second half of 2022, I suspect folks in the return-to-the-’70s camp will find some tough days. Back in the ’70s, inflation expectations became unanchored, and eventually so did nominal yields. Right now, there is no way Jay is heading down that path. He is having his Volcker moment!!! But acting like Volcker, with inflation expectations already so well anchored, will produce a completely different outcome: an uber-credible flattening/inversion at a much lower level of nominal yields. This is nothing like the ’70s. Rather, it’s a monetary policy backdrop which ultimately provides strong long-term economic support through a heavy handed anchoring of long-term inflation expectations. Good luck trading.

Upcoming Travel Schedule:

After spending the last month in Europe, I will be in the NY area until the end of July. A detailed schedule for August and the autumn will be coming out shortly. Stay tuned.