Hey… well done, Jay!!! - 07/19/2023

I was thinking of titling today's missive "It just ain't that bad – part 3," but then I thought that a little too banal. The bottom line, though, is that this past week's inflation data certainly adds to a theme of overall positivity. A 3.6% unemployment rate combined with a 3% CPI inflation rate has that old chestnut, the misery index, on its knees. Of course, that in turn has brought the angry mob of Fed haters out there to their knees. But as any good Fed hater knows, there is always a reason to castigate monetary policy actions — even with low inflation and low unemployment. So, that cacophonous group of inflationista critics, who have been so vocal for the past two years, have now pivoted from their prior flawed forecasts of a return to the '70s, to the always exciting new risk of overtightening. Remember, they must always have a reason to hate — doom just makes for much more provocative and sellable headlines. How many people want to open an email entitled "Fed policy has been perfectly calibrated"? Not so many!! But if you write a piece entitled "Misguided Fed policies will lead to the next Great Depression," you get people's attention. Doom always sells best!!

Anyway, at the risk of losing readers, I'm going to continue with my more optimistic messaging. As such, I went today with the simple title: "Hey… well done, Jay!!!" He has nailed it — and there really isn't much more to say.

As for the Fed's next move, even after the soft inflation data, I continue to believe they will be slow to declare victory. With such strength on the employment side of the policy equation, they have every incentive to stay restrictive and make sure inflation is fully quashed into 2024. More specifically, if we get three more 0.2s, on average, for the core CPI/PCE before the September FOMC meeting, then they should hawkishly pause after a July hike. But if that average gets closer to .25%, then they have another 25bps to go in September. Honestly, I think it's that simple, and that boring

With all that said, I now want to pivot away from patting the Fed on the back and revisit a more controversial topic that regular readers know is near and dear to my heart. That is the idea of bringing asset sales into the policy-tightening mix. Now to be sure, I have written countless times during both this cycle and the last one about the Fed's potential for using asset sales in conjunction with rate hikes to tighten monetary policy. And not once did I get that call right. Nevertheless, as we go into the last phases of this tightening cycle, I want to give it one last try, especially given that a few folks around the FRB table are regular readers of these notes. I still believe that it makes a ton of sense for the FOMC to consider bringing more rapid balance sheet reduction into play rather than to continue to push the curve towards even more awkward inversion levels.

To see this argument more clearly, imagine if short rates had only peaked thus far at 3.5%, but there had been asset sales of $1.5 trillion in longer-dated USTs and MBS. While there is no precise metric for trading off asset sales for rate hikes, I think the ratio of 10bps of rate tightening for every $100b in asset sales seems as reasonable as any. In that case a 5% rate with zero in asset sales would be equivalent to a 3.5% rate with $1.5 trillion in sales. To be honest, we could go with 5bps or 15bps per $100b if folks feel strongly about it. I just use 10bps per $100b because I think it's the least controversial ratio. Anyway, the question then becomes: With all else equal, what is the preferable outcome for the yield curve as a result of a monetary tightening — a 2yr at 4.00% and 10yr at 4.75% with the asset sales, or a 2yr at 5% and a 10yr at 3.75% with no asset sales? The higher long-term rates with the asset sales would have probably slowed housing much more. And the lower short-term rates would have created less financial instability in the regional banks. Both outcomes would have been net policy positives relative to what has occurred this year.

Now, some may complain about asset sales generating losses, but keeping IOER closer to 3.5% would stop the bulk of the negative NIM that is currently crystalizing significant losses on the portfolio everyday. And let's just take a quick look at where some of the portfolio would price in order to gauge loss potential from sales. In 30yr Agency MBS, the SOMA has $187b in 3.5s, $120b in 4s, $50b in 4.5s, and $14b in 5s. That's a total across Fannie, Freddie, and Ginnie IIs of ~$370b in higher-coupon securities. My MBS buddies tell me that seasoned pools like these would move out the door at around these dollar prices:

3.5s	92-16

4s	95-16
4.5s	97-16
5s	99-08

Now, these securities were all purchased at around par in the TBA markets at least two to three years ago, and some were purchased well over a decade ago after the GFC. The SOMA will make sizable total return profits on this portfolio if it is sold anywhere near to these prices. And I suspect the market would love to get their hands on these lower-loan-balance, well-underwritten, seasoned pools. They wouldn't be tough to sell. So, instead of one to two more rate hikes, how about selling $250b to $500b in high coupon Agency MBS. It slows a red-hot housing market faster. And it slows funding-related financial instabilities from higher short rates, which are still occurring at the regional banks. Further, with the curve steepening out in the process, the "inversion = recession" crowd starts to go quiet. The odds of a soft-/no-landing scenario surely rises, at least when viewed through the curve lens.

For me, a 3.75% 10yr, with the funds rate north of 5%, is just screaming a simple message to Jay — don't hike, just sell some stuff!! The market clearly wants duration. And the committee clearly wants to rid itself of this massive balance sheet, particularly the MBS. My summer dream is that Jay comes into Jackson Hole saying that any further tightening, if needed, will be accomplished by accelerating sales in MBS assets. That would make for such a exciting trading environment. Now, I have been dead wrong on this type of call for a long time, but you can't fault a man for trying one last time. I would still, after all these years, happily go to the mat with anyone in a debate about the merits of bringing asset sales into the tightening equation, especially during periods of deep curve inversion. It just makes too much sense!! Good luck trading.