Victory Cuts - 12/15/2023

When I first saw the Fed's SEP on Wednesday afternoon, I was quite surprised, even shocked, at the 50bps drop for the federal funds rate forecast at the end of 2024. After all, the core PCE projection had only dipped by 0.2 to 2.4%, and the unemployment rate projection remained unchanged at 4.1%. This was a significant interest rate drop with only a minor tweak to the economic forecast. But during the press conference Jay made it perfectly clear why this occurred. The Committee's longer-term risk assessment had changed markedly over the last three months. There was a new level of confidence regarding the efficacy of their relentless fight against inflation. And while he went out of his way to say that they were not declaring victory in the battle, he did say that the risk of overtightening had now returned to its more traditional pari-passu status with risk of being too accommodative. Here is the key excerpt from the press conference:

We're aware of the risk that we would hang on too long…. We know that that's a risk, and we're very focused on not making that mistake…. We've come back into a better balance between the risk of overdoing it and the risk of underdoing it…. You're getting now back to the point where both mandates are important, and they're more in balance, too.

Jay basically told us the Fed put strike has now returned to something more normal. It had dropped off the map in 2022 as inflation risks fully dominated those on the employment side (which is precisely why I left risk parity trades). But now, policy goal equality is essentially back. As such, the Committee can bring some additional cuts into the 2024 projections so as to curtail any potential longer-term risks on the employment side of the mandate.

Importantly, this change was not about the Fed expecting a higher risk of recession. And it was not even about a material change in the expected path for inflation. It was a pushback on the fat-tail risks of sticky inflation. And it was a recognition that they have successfully anchored longer-term inflation expectations after the great COVID supply shock. Bottom line —- their past focus on the inflation-fighting credibility front needn't continue to take precedence over employment goals any longer.

Although it's a bit tortured in the press conference, here is the excerpt on supply-side thinking that I believe best describes why the FOMC is now more comfortable scaling back its policy weighting on inflation in 2024:

I think that this inflation was not the classic demand-overload, pot-boiling-over kind of inflation that we think about. It was a combination of very strong demand, without question, and unusual supply-side restrictions both on the goods side but also on the labor side, because we had a — we had a participation shock…. We had the view that … you had essentially a vertical supply curve because you ran into the limits of capacity at very low levels because there weren't workers and because people couldn't — the supply chains were all broken. So we had the view that you could come straight down that vertical supply curve to the extent demand lowered/reduced; and you know, something like that has happened … so far. The question is…, once that part of it runs out — and we think it has a ways to run. We definitely think … that the sort of supply-chain-and-shortages side has some ways to run.

It has taken some time, but it looks like supply-side thinking on post-COVID inflation dynamics has now become scripture around the FOMC table. I do think that was always Jay's base case, but the Phillips Curvers had him worried for a while on the demand side. I will say, I thought it would take a little longer for Jay to bring supply-side victory cuts into the policy equation. I had even thought he might wait until after the election to avoid the perception of political bias. But he did earn the right to do this. He has done an incredible job!! So as long as he can keep politics out of the decision-making process, I see little harm in bringing the "W" onto center stage earlier. But let me state for the record, it was more than a little unpleasant to see Janet Yellen speaking about rate cuts just before a dovish FOMC meeting. The optics were awful. She still has many on the Committee with strong allegiances to her and the current administration. Jay needs to be very careful in 2024 with the speed at which he takes this W on the inflation fight. Rapid cuts will open him up to Burnsian critism quickly. And I for one will not shy away from pointing that out. Always remember the August 2019 Bloomberg piece by Bill Dudley in which he argued that the Fed should engineer a recession to oust Trump. To see an ex-Vice Chair of the FOMC go there in public tells you a lot about the dark political underbelly of the Fed. Jay needs to be very careful he doesn't get sucked into that Burnsian black hole. All that said, I think he can tweak policy slowly back toward neutral with a few rate cuts next year without getting “Burnsed” by Janet!! But it’s a very fine line!!

Anyway, all of this in the short run is extremely good news for our junk bond trades in 2023. The combination of spread contraction and lower yields have B/BB bonds and loans pushing total returns of ~12% for the year. I hope everyone followed our 2023 hat and “Got Junk”!!

Now, on the subject of hats and trades, it is the time of year to make some changes. On the trading front I am seriously toying with some version of risk parity again. Those blue SFR contracts are still at ~3.5% yields. There has to be a little risk-off insurance value coming back into play after what we learned from Jay on Wednesday. That said, I’m still a little nervous that balance-sheet funding facilities like the BTFP could whittle away at the traditional rate put value. That risk was something I highlighted in a note back on Nov 3 entitled “How much of the Fed put has shifted to the balance sheet?” So I need to noodle a little longer before making a final decision on my 2024 trade recommendation. Needless to say, though, it will involve some sort of credit or equity risk-on structure.

As for the hats, I have already made my final decision for 2024. I will be placing the logo below on the front of baseball caps, bucket hats, and beanies:

It’s time to fully recognize the exceptional job that Jay has done in managing the worst inflation shock in 40 years. It has certainly been my longstanding view that Jay was not going to make the mistakes of the ’70s. And that has played out about as well as I could have expected. Jay was criticized heavily by so many of our competitors over the last couple years. Those folks forecast either runaway non-transitory inflation or recession or both. In the end, though, our more benign view that successful and credible Fed actions would keep inflation expectations anchored while these temporary supply-driven inflation shocks worked their way through the system appears to have won the day. The “crowned J” hat is a celebration of these policy-making successes and the likely set of modest “Victory Cuts” that will begin at some point in 2024.

Now I know that the beaten-down Jay Haters out there will be annoyed with and agitated by this hat. And you know what, that makes me so very happy. There is really nothing I enjoy more than crushing haters. To that end, I am going to reprint an excerpt from one of my favorite notes from 2023 — “Dear Jay”. If you know some haters who haven’t yet written their apology letter to Jay, please forward this template. It has aged oh so well. Enjoy the reread below and good luck trading.

Excerpt from “Dear Jay” 5.22.23

Below please find below my version of an apology letter template for all the Jay-haters out there to use as they own up to their past sins:

Dear Jay,

I am truly sorry for doubting you since the summer of 2021. I incorrectly applied faulty Keynesian demand-side theories to rebuke your monetary policy decisions. Clearly, the post-COVID shocks that have hit the global economy came predominately from the supply side. If I had just looked more closely at the inflation experience in Europe, where labor market slack was much greater than in the US, the supply-side storyline would have been much clearer.

I am also deeply sorry for having compared you to the late Arthur Burns. You correctly saw that this adverse supply shock, which persisted much longer than initially anticipated, generated a serious risk of de-anchoring long-run inflation expectations. You then engaged in an aggressive tightening campaign to ensure that the hard work of credibility rebuilding over the last 40-plus years by the Federal Reserve was not undermined. The tough love of slowing aggregate demand was the only choice in response to this supply shock. And unlike Arthur Burns (or his predecessor Bill Martin), you did not acquiesce to partisan calls to pull back on the tightening efforts late last year. In the end, your policies made sure that the ghost of Burns never returned to those hallowed halls at 20th and Constitution Ave. And there is no doubt in my mind that Paul Volcker is currently looking down from his perch at the pinnacle of central bank heaven with an approving smile.

You should also be extremely proud that your policy efforts have kept long-run inflation expectations in check, the dollar strong, and term premiums low throughout this entire unpleasant inflationary experience. It now even appears that short-run inflation expectations, after initially spiking, have come back to target levels. Every measure of Fed credibility has remained fully intact over the last 18 months as you fought back against this supply-side storm that brought us to a peak of 9% inflation. All I can say is, bravo, Jay!!

After realizing my misguided economic ways, I wanted to share with you that I will be spending the next few years retooling. It certainly appears that I have underestimated the important neoclassical/supply-side work of economists such as Lucas, Sargent, Wallace, and so many other freshwater macro theorists. Sadly, I got hung up on old-school Keynesian demand-side IS/LM-based theories that coveted things like Hall’s consumption function and the Phillips curve. These concepts are clearly failures. My economics training requires a complete pivot now. Thank you for helping me see the light.

I sincerely hope you can forgive me. I was completely wrong. Your efforts were truly Herculean during this difficult period. Thank you for your tireless efforts to keep long-run inflation expectations anchored. There is nothing more important for creating maximum sustainable long-run growth potential than low, stable, and anchored long-run inflation expectations. The American people are deeply indebted to you for “keeping at it” during this epic inflation battle.

With the deepest of both regret and sincerity,

[Insert a Jay-hater name here]