Jay’s Volcker moment - 06/13/2022

“For now, we have a very easy policy reaction function to predict. This is a hawkish Fed that is unlikely to be backstopping financial markets anytime soon. Simple as that” (from my note on May 26th entitled “Central Bank Vigilantes”).

While many have focused on the upside surprise in the CPI from last week as a reason for the Fed to move even more hawkishly this week, there was another piece of data on Friday that was far more problematic for the FOMC. The University of Michigan consumer sentiment survey showed that long-term inflation expectations, those for 5–10 years ahead, jumped from 3% to 3.3%.

Now, on the face of it, that increase hardly sounds like a big deal. After all, we are dealing with 8.6% headline CPIs, so why should anyone care that expectations broke to 3.3%? Well, these readings represent the highest level since 2008 — and thus, for the FOMC, a narrative on the unanchoring of long-term expectations is now becoming MUCH easier to spin. If these expectations were to continue to grind just another 0.2% higher, which at this point seems highly probable, then we are talking about expectation levels not seen since the early ’90s.

Remember, Volcker and Greenspan spent 25-plus years getting these expectations down from 10% to 3%. And Bernanke and Yellen spent the next 12 years making sure they remained anchored. Does Jay want to go down in the central bank history books as the Fed chair who destroyed 40-plus years of inflation-fighting credibility? Does he want to play fast and loose with those long-term inflation expectations, as Bill Martin and Arthur Burns did in the late 60s and early 70s? NO and NO!! 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. Jay could also elevate the discussion of future asset sales and give a strong nod toward moving “well beyond neutral.” All the hawkish guns are on the table and ready for action. Which weapons they decide to use, and in what capacity they decide to use them, is really not relevant. Their message will be hawkishly clear. And they will surely be getting AHEAD of current market expectations as they have done in the last two meetings.

This really is Jay’s moment to prove he is not Arthur Burns. 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. Whether that happens after a bigger skid in risk assets or not, I’m not sure. 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 debts and drives nominal asset valuations higher. That’s about as good as it gets for those with levered balance sheets. The worst thing for a levered balance sheet is deflation (just ask the Japanese or those with a lot of leverage in 2008–09).

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 tge obvious outcome from a more aggressive Fed this week. In fact, it may very well be exactly what settles us down. Good luck trading.