The Fed Put: Is Powell Repealing It?

A week before the January 26th Fed policy meeting we asked [Instability or Inflation, Which Will The Fed Choose?]()

Liquidity is the lifeline of markets, and the Fed, directly and indirectly, manages its flow via QE and zero rates. With inflation raging, the pandemic subsiding, and economic activity normalizing, the Fed is keen to start reducing liquidity via higher interest rates and reductions in its balance sheet. The purpose of normalizing monetary policy is to bring inflation down. However, the removal of said liquidity could prove problematic for stock prices, especially if done more aggressively than expected.

Per the article:

"The Fed is making it clear they want to reduce inflation. They are also telling us they will ensure financial stability. ***Sounds like a good plan, but walking the narrow tightrope successfully by achieving lower inflation without destabilizing markets is an incredibly tough task.****"*

"We think the odds of success are poor. As such, we must carefully consider which goal they will prioritize when push comes to shove."

Deciphering Fed speak is tedious but given the Fed's new fight on inflation and the considerable impact they can have on markets, it is worth getting a little wonky. Please stick with us as we dissect Powell's insightful press conference and what it may mean for monetary policy and inflation. **Equally important is Powell willing to sacrifice the Fed put and leave investors without the support they are accustomed to.**

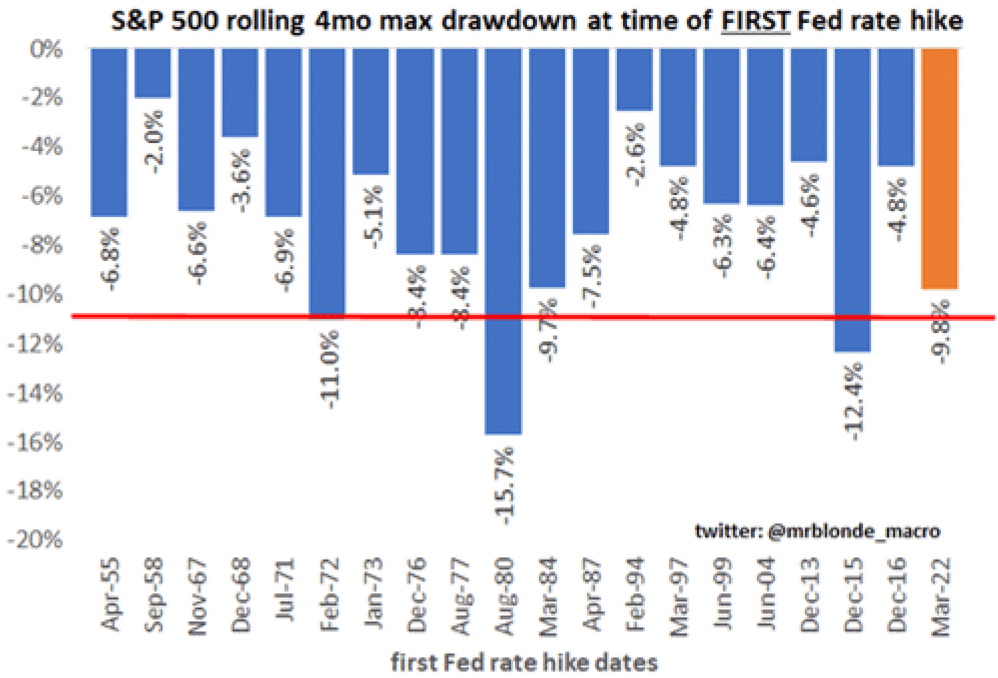
The following LINK provides access to the press conference we will discuss throughout this article.

Will Powell Sacrifice The Fed Put to Quell Inflation?

Until the last Fed meeting, we thought the answer was yes, but only until the stock market fell by 10% or a little more.

Following Jerome Powell's recent FOMC press conference, we may have underestimated his concern for inflation. As such, we now think he is willing to let stock prices fall more than we initially imagined. Might a 20% decline or even more be an acceptable price for Powell?

As a point of reference, the recent 10% drawdown is in line with other periods leading to the first rate hike of a tightening cycle.



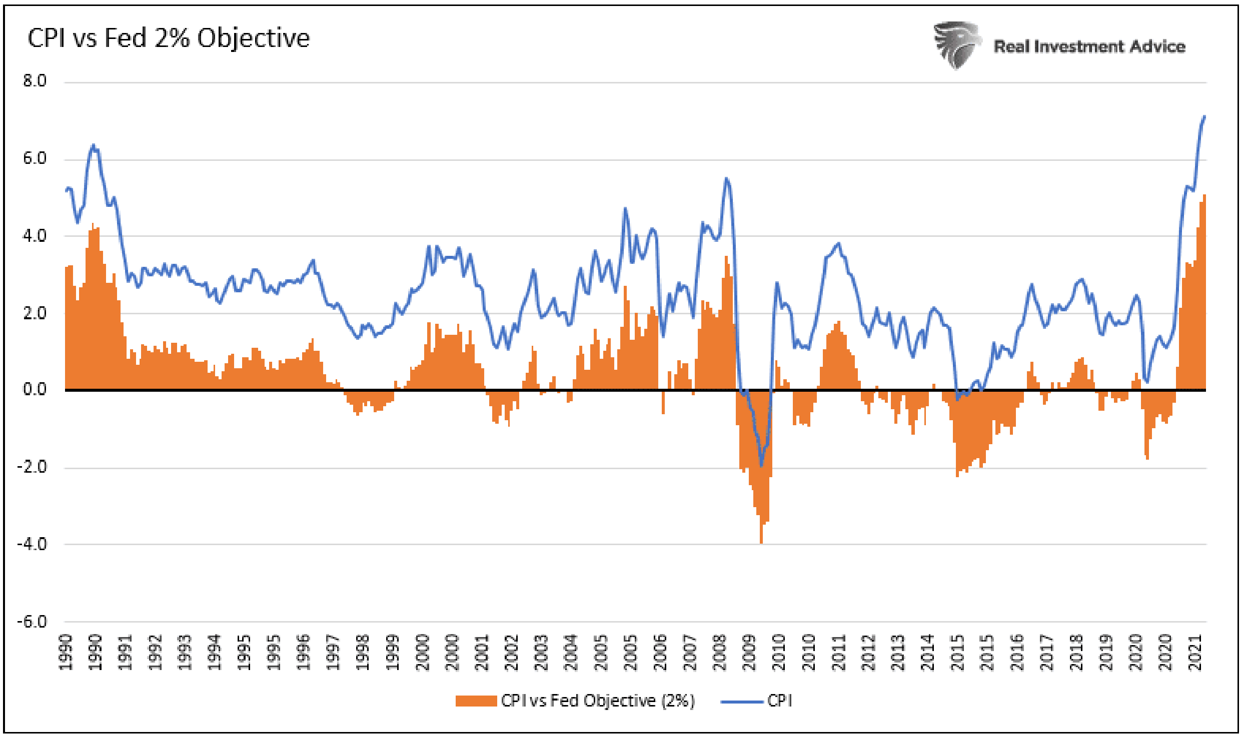
Powell on Inflation

Powell's tone throughout the question-and-answer session felt different than prior sessions. Broadly speaking, his confidence level in managing inflation has fallen sharply. At times he appeared shaken by the high and persistent level of inflation. In prior meetings, he brushed off inflation as transitory and purely a function of Covid and related supply line problems. The arrogance in the Fed's ability to manage inflation has vanished.

Powell's inflation forecast since the mid-December meeting, just six weeks ago, is now higher "by a few tenths." More telling, he seems disturbed by the trend higher in prices. **It appears he fears the trend is more potent than expected thus will not be as easy to reverse.**

That said, he thinks supply line-related price pressures will abate in the latter half of 2022. However, he stresses on numerous occasions that the red-hot labor market will keep upward pressure on inflation. Further, his attention to labor shortages appears more acute than before.

He used the word "inflation" 71 times in the one-hour session. While inflation is the most important economic data to watch, those factors that feed inflation, such as the tight labor market, bear close attention.



Political Pressure on the Fed

Rachel Siegel asked Chair Powell "*how inflation affects different groups of Americans, especially lower-income earners.*"

For the first time, Powell seems to reflect on how damaging inflation is and its detrimental impact on lower-income classes. It appears that political pressure from the President and members of Congress are influencing his view on inflation and its harmful effects.

- *"I think the problem that we're talking about here is really that people are on fixed incomes who are living paycheck to paycheck, they're spending most or all of their -- of what they're earning on food, gasoline, rent, heating their heating, things like that, basic necessities. And so inflation right away, right away forces people like that to* ***make very difficult decisions****."*
- *"The point is some people are just really in --* ***prone to suffer more****. I mean, for people who are economically well off, inflation isn't good. It's bad. High inflation is bad, but they're going to be able to continue to eat and keep their homes and drive their cars and things like that."*
- *"But part of the -- part of it is just that it's* ***particularly hard on people with fixed incomes and low incomes*** *who spent most of their income on necessities, which are experiencing high inflation now."*

The Fed's shift toward fighting inflation occurred right after Powell met President Biden and secured his renomination bid. We don't know what happened in that meeting, but based on the abrupt change in tone around fighting inflation, the President is likely pressuring the Fed to stop high inflation. With a mid-term election around the corner, such is in Biden's best interest. It appears Powell took the bait or, at a minimum, is talking the talk.

Inflation or Financial Stability

So having established the Fed seems much more serious about fighting inflation, we move onto financial stability. Investors believe the Fed will do everything in its power to keep higher stock prices and lower bond yields. Many market participants believe the term financial stability is Fed code for strong asset markets.

In the conference's last question, a reporter asks about prior hiking cycles and how they were problematic for asset bubbles that resulted from easy monetary policy. Powell's response:

"So asset prices are somewhat elevated, and they reflect a high-risk appetite and that sort of thing. I don't really think asset prices themselves represent a significant threat to financial stability, and that's because households are in good shape financially than they have been. Businesses are in good shape financially. Defaults on business loans are low and that kind of thing. The banks are highly capitalized with high liquidity and quite resilient and strong."

He is saying current asset prices are not a threat to financial stability. Powell also distinguishes asset prices from more valid measures of financial stability. His response is a clear signal that the recent downdraft in prices is not a concern.

Background QT

Curiously Powell uses the term "background QT." The phrasing makes it appear QT is not an important issue and should not be followed by the public. Specifically, he claims QT is in the background to interest rate hikes. His quote reminded us of when Janet Yellen in 2017 declared the QT process would be "like watching paint dry." It turns out the market did not think it was so dull.

"So, again, we think of the balance sheet as moving in a predictable manner, sort of in the background, and that the active tool meeting to meeting is not -- both of them, it's the federal funds rate."

Minimizing QT will not get investors to forget about QT. The problem is higher rates and less liquidity are not supportive of record valuations. Investors will link QT with liquidity, just as they link QE with liquidity. As they say, you can't have your cake and eat it too.

Fisher Votes Inflation Over The Fed Put

Former Dallas Fed President Richard Fisher provides insight on whether Powell will follow through on his fight against inflation at the expense of the stock market.

*"Let's face it Joe, I want to come back to the alcohol metaphor we started with, **the market has been wearing beer goggles for the longest possible time...**and **they just assume the Fed's going to bail them out. I think the strike price on the Fed put has moved significantly**...and **unless we have a dramatic turn in the markets that indicates it can infect the real economy,** I don't believe - under this chair in particular who has a credit market background - **that they will be weak in following through on what they pronounced."***

Summary

It appears the Fed's sensitivity to stock prices is not as acute as some investors believe. In the words of Richard Fisher, the strike price on the Fed put has moved significantly. If this take is correct, the Fed may sit idly by if markets voice displeasure with abrupt changes in monetary policy.

We caveat that statement by reminding you the Fed will relent if stocks fall enough. For the last 30 years, they have been increasingly aggressive in defending markets. While protecting asset prices is not in their Congressional mandate, we have little doubt this time will be different. The only thing that might be different is the losses the Fed will tolerate before it exercises its put.