

FED SHADOW

Next Stop on the Jay Powell Apology Tour

Monday, January 28, 2019

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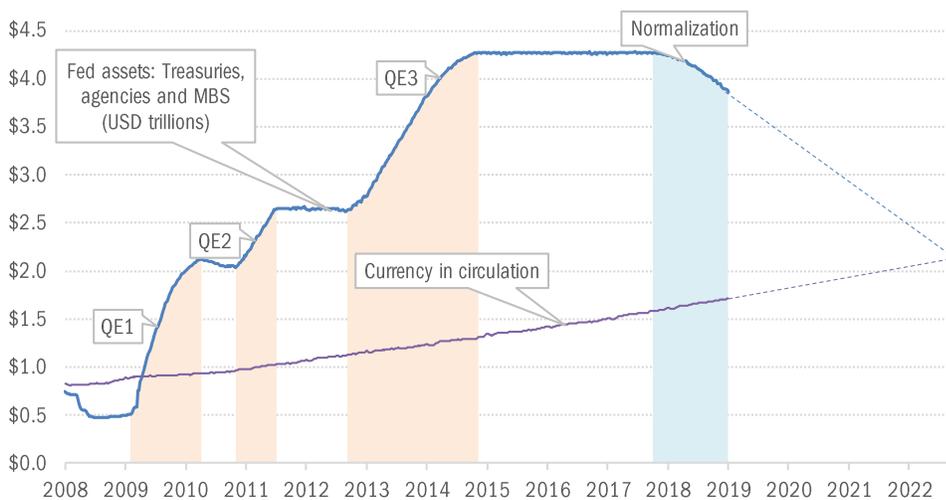
A planted story sets up Powell to sound both dovish and smart about the balance sheet.

[A report published mid-day Friday](#) by the *Wall Street Journal's* Fed-watcher [Nick Timiraos](#) announced pretty much as fact that this Wednesday's meeting will see the FOMC "deciding they will maintain a larger portfolio of Treasury securities than they'd expected when they began shrinking those holdings two years ago." *We think this story was a deliberate move in Chair Jerome Powell's efforts to rehabilitate himself and save his chairmanship after his humiliating performance at the December FOMC* (see ["It's Not 'Quantitative Tightening' – It's Powell"](#) December 20, 2018).

It was planted with the reporter most understood by the market to be an insider, to prepare the ground for Powell to announce a new balance sheet normalization policy outlook, erasing and over-writing his flippant "automatic pilot" remarks in December (see ["On the December FOMC"](#) December 19, 2018). *The planting of the story is itself intended to demonstrate Powell's late-blossoming grasp of the tools Fed chairs need to know how to use to talk to markets.*

- If you are wondering how we know the story is a plant, then you haven't read it!
- First, it's essentially unsourced. Timiraos claims no inside source.

History and projected path of Federal Reserve LSAPs (large-scale asset purchases)



Source: Federal Reserve Board, Bloomberg, TrendMacro calculations

Update to strategic view

US FED, US MACRO, US BONDS, US STOCKS:

Obviously no rate hike Wednesday. A *Wall Street Journal* story Friday saying the Fed will announce a policy of higher-than-expected levels for the balance sheet creates a demand-effect on Powell, both to deliver a result in that dovish direction and, perhaps more important, to appear to have mastered the subject matter. We think the story was planted by Powell deliberately to give him a chance to show well on Wednesday. Even at today's rate of run-off, the balance sheet won't fall below \$2.1 trillion, where it will converge with the amount of currency in circulation, in late 2022. But in the new regime of using interest on reserves as the main policy tool, the balance sheet should likely be larger, so that there is a sufficient pool of assets on which the policy rate can operate. Talk along these lines will be very market-positive – that is, risk-on, higher stock prices, higher bond yields. If Powell misses this easy pitch that he has thrown to himself with this planted story, markets will be very unhappy until he is gone.

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He says he is going on “recent public comments and interviews” by “Fed officials.” But the only actual citations are more-than-a-week old offhand remarks by Kansas City Fed President Esther George and Minneapolis Fed President Neel Kashkari. So either he’s making it up (certainly a possibility), or there’s a source so deep that he can’t even say he has a source. *That would be Powell, pre-FOMC “quite period” or not.*

- Second, though you’d think Timiraos would have cited it as a source, there was no mention of the 1,223 words devoted to the subject in great depth in the [minutes of the December FOMC](#) (see [“Data Insights: FOMC Minutes”](#) January 9, 2019).
- That glaring omission demonstrates Powell’s hand in the story. Surely the price of access to Powell for Timiraos was an agreement not to humiliate the Chair by citing that discussion, which makes the “automatic pilot” remark – made just minutes after the very meeting at which there was apparently an hours-long discussion of how normalization is likely *not* going to stay on “automatic pilot” – seem all the more foolish. And for those aware of the *Journal* story but not the minutes, the omission let’s Powell take the credit, or at least get to announce the seeming surprise, on Wednesday.
- By the way, for connoisseurs of Fake News and students of how to detect it, we’ve already introduced the Ninth Paragraph Rule (see [“On the Margin: True Fake News on China Trade”](#) January 18, 2019). Now with this story we can now introduce the Self-Reference Rule. You know it’s Fake News when the story refers to itself – as Timiraos’ does, bragging right up-top in his third paragraph how “Stocks climbed on the news...” – in this case, “the news” being his own story.
- *Whether or not you agree with us that this story is a plant – it is still highly significant for Wednesday’s FOMC. Plant or not, and even if it is completely off-base, it nevertheless creates a demand-effect upon Powell to show leadership with thoughtful and clear communications on the issue of balance sheet normalization. So far, since his chastening by markets in December – and since our outside-the-box and in-the-moment call that he cut a deal then with the Trump administration (see “Did Powell Just Cut a Deal?” December 23, 2018) – his apology tour has consisted only of easy-pitch interviews with friendly interlocutors, and no official speeches at all (see “On Powell in Rehab” January 4, 2019). There have been no in-depth policy statements.*
- By the way, we note that the Trump administration has been chastened, too. In the wake of the December Powell fiasco, [Federal Reserve Board nominee Nellie Liang](#) has [withdrawn from consideration](#) by the Senate, having been criticized by Republicans for not being aggressive enough on bank deregulation. At the same time, the nomination to the Board of Marvin Goodfriend, [an unreconstructed perma-hawk](#) whom we warned clients about a year-and-a-half ago (see [“On the July FOMC, and Cohn for Fed Chair?”](#) July 26, 2017), has expired with the seating of the new Congress, and it seems it [will not be renewed by the White House](#). Our friend Larry Kudlow, National Economics Council director, [said Thursday](#), “The White House wants highly capable, competent

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people who understand that you can have strong economic growth without higher inflation.”

- Powell may never live up to the first part of Kudlow’s wish list. *But as to Wednesday’s FOMC, we’re going to guess here that, whether the Timiraos story is a plant or not, Powell will get it more right than wrong. Obviously, no rate hike. And at this point, how could he not continue with the new post-December mantras of “patient” and “data-dependent”? We think he will signal at least that he is sensitive to, well-informed about, and focused on the markets’ concerns about the balance sheet as policy evolves. There will be strong hints, if not an actual program announcement, that point in the direction of less-than-expected balance sheet reductions. But we don’t have full confidence, because at his January 10 interview, he had every opportunity to talk comprehensively and dovishly about balance sheet normalization – especially considering that the minutes of the December FOMC at which it was discussed had been published just the day before – yet he merely glided over the subject (see “The Most Annoying Fed Chair Ever” January 10, 2019).*
- *For that matter, we think the market’s December organ-rejection of Powell was triggered by just such a communications error – the failure to deliver comfortingly dovish language in the December FOMC statement, turning the rate hike into the “dovish hike” expected by the market – having just three weeks before promised to do that in the minutes of the November FOMC meeting (see “Data Insights: FOMC Minutes” November 29, 2018). His track-record as a promise-keeper – that is to say, as a reliable narrator of policy, a leader who seems in control of himself and his jurisdiction – is simply awful. He has a lot to prove, and until he does, it remains unproven.*
- *That means if he gets it right Wednesday, it will be a very market-positive event – that is, risk-on: higher stock prices, and higher bond yields.*
- *If he gets it wrong, well... he may yet have to accept President Donald J. Trump’s offer to be the next ambassador to France, and while he’s thinking it over, markets won’t be happy at all.*

Everything we’ve said so far deals just with the dynamics and implications of the potential restoration of trust in Powell. That’s probably the most important thing – we’ve been saying all through the December volatility that the problem is more Powell himself than any actual policy decision he had made or failed to make (again, see [“It’s Not ‘Quantitative Tightening’ – It’s Powell”](#)). *But now let us turn to the matter of policy itself – what would it mean for Powell to announce, as Timiraos put it, the FOMC’s “deciding they will maintain a larger portfolio of Treasury securities than they’d expected”?*

- Well, right off the bat, no one actually knows what “they’d expected.” Going all the way back to [the original FOMC statements on normalization in 2014](#), all they’ve ever officially said on the subject is “The Committee intends that the Federal Reserve will, in the longer run, hold no more securities than necessary to

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implement monetary policy efficiently and effectively.”

- So let's start from first principles, and ask ourselves why a central bank needs an asset portfolio at all, to implement policy?
- The most basic concept to start with is [seignorage](#) – the right of the sovereign to mint coins and print currency for circulation in the economy – essentially, to issue non-interest-bearing debt. In the case of the Fed, the amount of currency in circulation is determined by market demand for it. To obtain it, the market gives the Fed in exchange interest-bearing assets such as Treasury securities. The currency is booked by the Fed as a liability, and the Treasury bonds as assets. Therefore, the Fed's balance sheet should never be smaller than the amount of currency in circulation – and indeed, it rarely is – because that would be to turn away from the arbitrage opportunity for the central bank to facilitate interest-free borrowing for the government.
- Today, currency in circulation is about \$1.7 trillion, so we think that sets a hard boundary on the downside for the Fed's balance sheet. There is a widespread misconception that full “normalization” would entail the return to a Fed balance sheet of about \$900 billion, because that's where it was before the Global Financial Crisis. That's wrong, because then that was about the level of currency in circulation – in the decade-plus since then, currency in circulation has grown (it always does), and so the normative size of the Fed's balance sheet should grow along with it (it always does, too – please see the chart on the first page). Today, by the most basic rules, the balance sheet must be no smaller than \$1.7 trillion.
- If today's “automatic pilot” maturity run-off continues with no alteration, then the balance sheet should finally stop shrinking at about \$2.1 trillion in late 2022 (again, please see the chart on the first page).
- By those basic rules, it seems at first glance that the minimum is also the maximum – because a balance sheet that exceeds currency in circulation means the Fed is “[monetizing debt](#)” or indulging in “[monetary financing](#).” But even when the Fed's balance sheet peaked at over \$4 trillion, nothing like that was actually happening. That's because for every dollar of interest-bearing debt the Fed acquired as an asset, it issued a dollar of interest-bearing debt in exchange – in the form of interest-bearing deposits on its balance sheet casually known as “excess reserves.” So all that really happened under the three quantitative easing programs from 2008 to 2014 is a vast maturity-swap and credit-swap between the Fed and the private sector. That is, in the case of long-term Treasuries and MBS acquired by the Fed, the Fed took on fixed-rate long-term assets in exchange for floating rate overnight obligations; and in the case of MBS, the Fed took securities only ambiguously guaranteed by the full faith and credit of the US government in exchange for deposits with a bullet-proof issuer: the Fed itself.
- It is simply a myth – a vast and very widespread misunderstanding – that QE was ever about “pumping banks with money,” to use the lingo employed by Timiraos in his story. It was nothing but a de-risking exercise, classic central banking doctrine going back to the

19th century basics that [monetary historian Ben Bernanke taught us](#) when all this started in 2008.

- We have been saying all along that the gradual normalization of the Fed's balance sheet therefore has no effect except to gradually drip a little maturity-risk and credit-risk into the market (for example, again, see ["It's Not 'Quantitative Tightening' – It's Powell"](#)). Nowadays the market ought to be able to handle a little of that kind of risk far better than it was able to in the Global Financial Crisis and its immediate aftermath.
- *It was obvious that the private sector was pathologically risk-averse in 2008 and 2009 when QE began. In some sense the argument today can be understood as concerning the degree to which risk-tolerance has actually returned – which would potentially limit the amount of risk the Fed can ask the private sector to re-absorb.*
- At the same time, there is another key element that the December FOMC discussion was really centered around: *how to design a new operating regime for the Fed now that the Fed pays interest on required reserves and other assets deposited on its balance sheet – a practice that started only in 2008 with the passage of the [Troubled Asset Relief Program bill](#), after 95 years of the Fed paying no interest at all.*
- *In the new regime, the interest rate on reserves (IOER) becomes the Fed's primary policy instrument.* Though a target range for the interbank fed funds rate is announced at every FOMC meeting, that is in fact only a target. The gun – that is, the tool for hitting the target – is the rate on reserves paid by the Fed itself. By the way, as a matter of law, that rate is not set by the FOMC, but rather by the Board of Governors. In terms of Fed decision dynamics, that means the FOMC picks the target, but the Board wields the gun.
- *What no one knows – because we've never tried it – is how large the pool of reserves has to be so that controlling the interest rate on it functions sufficiently to hit the target fed funds rate.*
- The discussion at the December FOMC tended to focus on the risk of losing precision-control over the target if the quantity of reserves got too small. *So why not just maintain an extremely large balance sheet, to be sure the Fed doesn't fall below the unknown amount required for control? Because, at least as structured today, a too-large balance sheet de-risks the market more than necessary, interfering with market-driven signals of the price of risk, potentially inviting dangerous imbalances in risk-allocation.*
- One possibility, covered in the FOMC's discussion, would be to change the maturity structure of the Fed's assets to better match its overnight liabilities – that is, to reverse [2011's "operation twist"](#) and convert the Fed's long-term securities into shorter-term ones. *If Powell announces this approach on Wednesday, we'll have to look carefully at the details, but markets may not like it, at least not at first. While such an approach appears to preserve a large balance sheet, it in fact reduces it in terms of its de-risking footprint. Just like today's policy of letting long-term securities mature, it would have the property of putting maturity risk back into the private sector. We don't find that objectionable, but Mr. Market may well do so.*

Bottom line

Obviously no rate hike Wednesday. A *Wall Street Journal* story Friday saying the Fed will announce a policy of higher-than-expected levels for the balance sheet creates a demand-effect on Powell, both to deliver a result in that dovish direction and, perhaps more important, to appear to have mastered the subject matter. We think the story was planted by Powell deliberately to give him a chance to show well on Wednesday. Even at today's rate of run-off, the balance sheet won't fall below \$2.1 trillion, where it will converge with the amount of currency in circulation, in late 2022. But in the new regime of using interest on reserves as the main policy tool, the balance sheet should likely be larger, so that there is a sufficient pool of assets on which the policy rate can operate. Talk along these lines will be very market-positive – that is, risk-on, higher stock prices, higher bond yields. If Powell misses this easy pitch that he has thrown to himself with this planted story, markets will be very unhappy until he is gone. ▶