US Macroeconomics

May 12, 2023

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Déjà Vu All Over Again

We have highlighted numerous times the historical fact that the Fed quickly pivots from tightening to easing. Over 18 tightening cycles since the 1950s, **the average time between the last hike and the first ease is three months**. And the median is even shorter at just two months. Surely monetary policymakers are aware of this. With inflation still way above target, the Fed has pushed back against both a pause in tightening and second half 2023 rate cuts.

When asked at his post-meeting press conference whether he was prepared to pause interest rate increases next month, Chair Powell said, **"A decision on a pause was not made today."** When Powell was later asked about rate cuts, he said that given current and projected economic conditions, **"it wouldn't be appropriate for us to cut rates."** Official Fed forecasts are consistent with this view. Rate cuts are not anticipated until sometime next year.

Clearly monetary policymakers do not want to declare an end to the tightening cycle let alone open the door to an easing pivot. In this regard, **the current backdrop is eerily similar to August 2007**, when then Fed Chair Ben Bernanke had acknowledged financial stresses but did not want to lower interest rates because of a tight labor market. Inflation concerns dominated financial stability concerns but not for long.

The August 7th 2007 FOMC statement said that "a sustained moderation in inflation pressures has yet to be convincingly demonstrated. Moreover, the high level of resource utilization has the potential to sustain those pressures." Remarkably, three days later **the Fed flip-flopped and cut the discount rate by 50 basis points to 5.75%** "because of dislocations in money and credit markets" but left the funds rate unchanged at 5.25%, hoping that would be enough to stem financial stress. Unfortunately, it was not.

Two weeks later at the annual Kansas City Fed's Jackson Hole symposium, Chairman Bernanke said the Fed "stands ready to take additional actions as needed." Indeed, the Fed cut the funds rate 50 bps to 4.75% the following month and then 25 bps in October and another 25 bps in December bringing overnight borrowing rates down to 4.25% by yearend. **Fed policy effectively did a complete about-face in the six weeks from early August 2007 to late September 2007**. But there is more.

In January 2008 when financial stresses worsened, the funds rate was lowered a massive 125 bps in the month and then another 100 bps between February and April, taking the funds rate down to 2% in April. It stayed there until Lehman Brothers went bankrupt that September. Fed funds finished 2008 at near zero. While we do not believe rates are going that low in the next easing cycle, history tells us that when the Fed cuts, it cuts a lot.

Like 2007, the economy is weak, and many investors fear a credit crunch. Yet, the Fed is more worried about inflation than recession or financial instability. Hence, policymakers do not want to pivot. Admittedly, inflation is a much bigger concern now versus then. But **if the economy rolls over, further exacerbating a credit crunch which could then engender further economic weakness and a deep downturn, inflation worries will take a backseat**. Thus, we are assuming a different reaction function than what the Fed is telling us.

Chair Powell is doing his best to disabuse investors of a policy pivot, but the bond market is not listening. If we have a gripe with current market expectations, it is that they are not bullish enough on short-rates because when the Fed cuts, it cuts a lot and generally in big increments. Stay tuned.

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