Epsilon Theory

Post-Fed Follow-Up

June 16, 2017

I sat on the porch
Listened to the rain
Smoked a cigarette
And counted to ten

Oh no, here it comes again
That funny feeling

— **Camper Van Beethoven, *Oh No!* (1985)**

A quick post-Fed follow-up to "**Tell My Horse**", the best-received *Epsilon Theory* note to date (thank you!). I'll jump right into what I've got to say, without the usual 20 pages of movie quotes and the like. Well, I've got one quote above, because I can't help myself. They're the lyrics to the best break-up song ever, and they're what Janet Yellen was singing to the market on Wednesday.

Let's review, shall we? Last fall, the Fed floated the trial balloon that they were thinking about ways to shrink their balance sheet. All very preliminary, of course, maybe years in the future. Then they started talking about doing this in 2018. Then they started talking about doing this maybe at the end of 2017. Two days ago, Yellen announced exactly how they intended to roll off trillions of dollars from the portfolio, and said that they would be starting "relatively soon", which the market is taking to be September but could be as early as July.

Now what has happened in the real world to accelerate the Fed's tightening agenda, and more to the point, a specific form of tightening that impacts markets more directly than any sort of interest rate hike? Did some sort of inflationary or stimulative fiscal policy emerge from the Trump-cleared DC swamp <sarc>? Umm … no. Was the real economy off to the races with sharp increases in CPI, consumer spending, and other measures of inflationary pressures? Umm … no. On the contrary, in fact.

Two things and two things only have changed in the real world since last fall. First, Donald Trump — a man every Fed Governor dislikes and mistrusts — is in the White House. Second, the job market has heated up to the point where it is — Yellen's words — close to being unstable, and is — Yellen's words — inevitably going to heat up still further.

What has happened (and apologies for the ten dollar words) is that the Fed's *reaction function* has flipped 180 degrees since the Trump election. Today the Fed is looking for excuses to tighten monetary policy, not excuses to weaken. So long as the unemployment rate is on the cusp of "instability", that's the only thing that really matters to the Fed (for reasons discussed below). Every

other data point, including a market sell-off or a flat yield curve or a bad CPI number — data points that used to be front and center in Fed thinking — is now in the backseat.

I'm not the only one saying this about the Fed's reaction function. Far more influential Missionaries than me, people like Jeff Gundlach and Mohamed El-Erian, are saying the same thing. If you think that this Fed still has your back, Mr. Investor, the way they had your back in 2009 and 2010 and 2011 and 2012 and 2013 and 2014 and 2015 and 2016 … well, I think you are mistaken. **I think Janet Yellen broke up with you this week.**

The Fed is tightening, and they're not going to stop tightening just because the stock market goes down 5% or 10% or (maybe) even 20%. Bigger game than propping up market prices is afoot, namely consolidating a reputation as a prudent central banker before the inevitable Trump purge occurs, and consolidating that reputation means keeping the evilest of all evil genies — wage inflation — firmly stoppered inside its bottle.

Let's be clear, not all inflation is created equal. Financial asset price inflation? Woo-hoo! Well done, Mr. or Mrs. Central Banker. That's what we're talkin' about! Price inflation in goods and services? Hmm … a mixed bag, really, particularly when input price inflation can't be passed through and crimps corporate earnings. But we can change the way we measure all this stuff and create a narrative around the remaining inflation being a sign of robust growth and all that. So no real harm done, Mr. or Mrs. Central Banker.

Wage inflation, though … ahem … surely you must be joking, Mr. or Mrs. Central Banker. How does that possibly advance economic efficiency and social utility? I mean, even a first year grad student can *prove* with mathematical certainty that wage inflation only sparks a wage-price spiral where *everyone* is worse off. What's wrong with you, don't you believe in math? Don't you believe in science? Hmm, maybe you're just not as smart as we thought you were. But I'm sure you'll be very happy as an emeritus professor at a large Midwestern state university. No, Ken Griffin is not interested in taking a meeting.

I know I sound like a raving Marxist to be saying this, that the Federal Reserve system and all its brethren systems were established specifically to serve the interests of Capital in its age-old battle with Labor. But yeah, that's exactly what I'm saying. Propping up financial markets? That's a nice-to-have. Preserving Capital as the apex predator in our social ecosystem? There's your must-have.

Whatever you think full employment might be in the modern age, 4.3% is at the finish line. And 4.1% or 3.9% or wherever the unemployment rate is going over the next few months is well past the finish line. You're already seeing clear signs of labor shortages, particularly skilled labor shortages, in lots of geographies. Wage inflation is baked in, and modern populist politics make it impossible for corporations to play the usual well-we're-off-to-Mexico-then card. Not that wages in Mexico or China are really that much better anymore, depending on what you're doing, and there are inflationary wage pressures there, too.

Bottom line: I think that the Fed is going to do whatever it takes to prevent wage inflation from getting away from them, and shrinking the balance sheet is going to be a vital part of that tightening, maybe the most important part. Why? Because the Fed thinks it will push the yield curve higher as it lets its bonds and mortgage securities roll off, which will help the banks and provide an

aura of "growth" and a cover story for the interest rate hikes. Otherwise you've got an inverted yield curve and a recession and who knows what other sources of reputational pain.

But here's the problem, Mr. Investor. Ordinarily if the Fed was determined to take the punchbowl away by tightening monetary policy and raising interest rates, your reaction function was pretty clear. Get out of stocks and get into bonds. Wait out the inevitable bear market and garden-variety business cycle recession, and then get back into stocks. Or just ride your 60/40 vanilla stock/bond allocation through the cycle, which is the whole point of the 60/40 thing (even, though, of course, you're really running a 95/5 portfolio from a risk perspective). But now you're going to have both stocks *and* bonds going down together as the Fed hikes rates and sells bonds, in a reversal of both stocks *and* bonds going up together over the past eight years as the Fed cut rates and bought bonds.

Hmmm. 'Tis a dilemma. What to do when indiscriminate long-the-world doesn't work? What to do when nothing works? **Maybe, with apologies to the old Monty Python line, active management isn't quite dead yet.** And just at the point of maximum capitulation to the idea that it is. Wouldn't be the first time. In fact, that's kinda how maximum capitulation works.

Is everything as neat and clean in reality as I'm making it out to be? Of course not. Other central banks are still buying bonds. Maybe global growth pulls everything through. Maybe President Pence/Ryan/whoever-is-fourth-in-line pushes through all the tax cuts and regulatory rollback and infrastructure build programs that your little old capitalist heart desires. Plus, this isn't some cataclysmic event like "China floats the yuan" or "Italy has a bad election". It's a slow burn.

But I think that if your investment mantra is "don't fight the Fed", you now must have a short bias to both the U.S. equity and bond markets, not the long bias that you've been so well trained and so well rewarded to maintain over the past eight years. This is a sea change in how to navigate a policy-driven market, and it's a sea change I expect to last for years.

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