Credibility

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Pretty interesting Fed meeting yesterday – not really in terms of the outcome since the overwhelming majority of analysts projected a hold (with Citadel being a notable exception forecasting a 25 bp hike). While I may be speculating that Citadel was trying to scare the market with a high-profile hike projection to go shopping for one so-called Situational Awareness fund, there are some more realistic notable things I was thinking about regarding the meeting.

The hold isn't very unique except for the fact that included in the votes was three dissents in favor of a hike. Warsh was quoted when rationalizing the move by describing the FOMC's desire to "understand the underlying and generalized change in prices that are happening in the economy" and "see whether [the Fed] can't separate noise from the signal." This says a few things about the Fed's "personality" with Warsh as the new bossman: This dialogue reflects that the bar for rate hikes is higher than we have realized, which doesn't give Warsh the "credibility hike" he may need.

Seems like there is a slim possibility for no Fed hikes this year, although I have my own counter beliefs due to pressure on r* coming from AI capex overheating ~25% of the economy. If inflation sticks around then the Fed will most likely hike, although the strength of the Fed's reaction function remains in question as the Warsh vs. rest of FOMC dynamic continues to play out.

Contrasted from our recent memory of the Fed's consideration of the market's signals, Warsh seems to consider the market's signals more deeply than MoM economic data, even if he can't seem to define what underlying price stability means. All of this is a longer way of saying that there may be more uncertainty surrounding the Fed's 2% PCE target since the reaction function is more uncertain. The Fed has switched from validating markets to learning from them, which may be a refreshing change of pace given the inflation problems that may have been hiding in plain sight in 21-22.

All of this can contribute to another idea, which is that the market may be doing the Fed's job of tightening for it, naturally calling into question the Fed's credibility (as seen by the selloff in long-end yields and USD). This need to establish credibility increases likelihoods of a Sept. rate hike.

An ideal world for Warsh in my eyes is one where the Fed is kept on hold while the curve is steep, which keeps both tightening pressure on the economy and a natural way of keeping inflation down toward the magic 2%. While Warsh can try and take some credit for the yield jump and subsequent price action like he did during yesterday's meeting, the reduction in forward guidance may in fact be a factor in curve premiums. All in all, Warsh may plan to keep us in the dark to learn from our chaos function rather than us learning from him, even if he has unfulfilled obligations to prove his credibility with a hike from the upward pressure on r*.

Fuzzy and diverse market knowledge/sentiment are certainly harder to translate into FOMC hikes/holds/cuts, even if the AI r* story remains. I wouldn't say Warsh' credibility has improved since he still needs to show us that learning from the markets is something he can effectively do, but it has certainly shed some light on what may be in store for the markets.

- Will Barrett