3/17/2021: We're Bullish But Have Some FAIT

Today is arguably one of the more important FOMC meetings in a while.

The reason?

Powell's messaging has fallen behind that of our rapidly changing economic situation. As a result, the market is doing what it thinks the Fed will eventually have to do. It's raising short-term rates, implying that rate hikes will begin sooner than what the Fed has stated — 3-year Treasury yields have risen 0.15 % points over the last month, implying multiple rate hikes in 2023 and rising odds of one next year.

This risks tightening financial conditions and killing the Fed's grand reflationary experiment.

You see, the Fed's growth forecast at the beginning of the year had real GDP coming in at 4.2%. This is laughably low… We've been writing over the last few months how we expect real GDP to come in above 6.5%. Goldman Sach's recently revised their GDP forecast to 8%, which is quite feasible.

The market is seeing these increasingly bullish dynamics and it's saying "hey, things are a lot rosier than what the Fed and everybody had originally predicted. That means their original schedule for hiking rates is *way* too dovish…"

But, here's the thing… The market is operating as if the Fed hasn't gone through a paradigm shift. It doesn't yet believe that Powell and company have a completely new reaction function. It's still operating as if the Fed is running countercyclical monetary policy as it has since its inception.

We know this isn't the case though. The Fed is no longer paying attention to just basic U3 unemployment data. It wants to see full employment amongst those hardest hit by the crisis, it wants to see things like the racial unemployment gap close.

It's also not concerned about above-trend inflation this year, which it expects and views as transitory.

But its messaging is stale. It's fallen behind the curve. And what it needs to do today, in order to achieve its objectives, is meet or exceed the bullishness of the market while firmly reiterating its commitment to its dovish rate path (ie, zero hikes by the end of 2023).

If it fails… if we see Fed dots shift from a consensus 2023 rates of 0 to 1, then the market will see that as an endorsement of the recent rise in yields… This will signal that the Fed's reaction function has not changed and that it has the green light to continue pricing in earlier hikes (tightening financial conditions) as stronger economic and inflation data come in.

This, of course, would become self-defeating. As higher rates would eventually destabilize the market, which would tighten financial conditions, which would hurt the real economy.

So we need to see a few things from the Fed today. They need to (1) raise their growth forecasts to something in-line or more bullish than the market's consensus (above 6%) (2) communicate that they're not just looking at headline measures of unemployment but want to see broad-based and inclusive full employment before they even think of tapering, let alone begin to tighten and (3) keep the dot plot on its current dovish path.

It's a tall order but failure to nail the above three will be a big communication error and likely lead to a selloff in bonds and volatility in markets. Powell needs to come out as very bullish while convincing the market to keep its FAIT…

If he's successful, we should see bonds in the belly of the curve (5-years) catch a strong bid, as they're grossly mispriced if the Fed is *actually* committed to sticking to its guns, which we believe they are.

We'll be out with a follow-up note after the meeting.

Your Macro Operator,

Alex