CSC STRATEGY LETTER NUMBER 65

I Don't Always Make Monetary Decisions, but When I Do They Are Usually Wrong

You are welcome. I just saved you from having to read Meltzer's 3-volume set: The History of the Federal Reserve, which I am sure is still for sale at $1 per volume at the Hermosa Beach Friends of the Library Investment section curated by yours truly.

I am going to veer from the stated policy of "we don't do Macro here" as I think for the second time this year something extraordinarily interesting is transpiring in that world.

The topic d'jure is that Kevin Warsh just gave his first Presser (Oh yes, we love that word) as new Chairman of the Federal Reserve, and it was fascinating, although in fairness, I have a Zen and the Art of Motorcycle Maintenance streak in me that delights in what others might consider head-rolling minutiae.

Warsh is attempting to re-establish some very old-school thinking which happens to be the party line here at Cove Street. Let's just say like any number of things that seem obvious to me, they are either a deeply minority opinion or truly it has been THAT long since what I am saying was considered orthodoxy that it is either treated as new news or you are on the receiving end of the WTF blank stare.

But the old college effort here in the face of global trillions on leverage has a probability set that is wide and success might not rank highest in that stack, despite how "right" it may be. If you have been served Daniel Boulud quality French Tarts all day, and every day for…a few decades?…and still managed to stay thin, starting your week off on Monday with a piping bowl of Post Grape Nuts and no guidance on what is being served for the foreseeable future thereafter is unlikely to sit well with the consumer of risk. Here is another metaphor if that one didn't sit well: we are still cavemen with reptilian brains poorly suited to judging an uncertain future despite any assurances from those with advanced degrees from Ivy League schools.

But, let's cut and paste from the Presser.

Warsh:

> Uncertainty, however, does not mean a lack of clarity. For some households, businesses, and market professionals, five years of high inflation have left a mistaken impression that is hard to shake: that the Fed's implicit inflation target was somehow above 2 percent. Let me reiterate: There is no soft inflation target, there is no soft implicit target—not on this Committee's watch. There is only a target, and it is 2 percent. Not one of my FOMC colleagues is under any illusion. We have begun a new chapter, and we understand that the five-plus years of inflation above target cannot be cured in nine weeks—or by a single month of modest price decreases.

And More Warsh:

> Market participants are learning to play the ball, not the referee—and market prices will continue to

respond in the direction and magnitude they see fit. This is, in my view, a change for the better—and we are just getting started. After all, the central bank need not always and everywhere be the center of attention. I understand the desire for rolling forecasts and commentary from this Committee. But for our part, we need to observe market reaction to developments, direct and unfiltered. I want to stress, of course, that decisions by this Committee matter a great deal. And where necessary and appropriate, we will not hesitate to act.

Warsh Throwing in a Little Passover Analogy:

...the four questions, which I will enumerate. First, we talked a lot about the implications of the past five years of high inflation on the current policy conjuncture. To echo an old phrase, has the past really passed? Second, my colleagues and I considered the economic shocks of recent years. Strained supply chains arising from the pandemic, military conflicts, energy-supply disruptions, substantial increases in tariff rates, and yes, the surge in A.I.-related investment. These differ in their sources—do they also differ in their effects on output and employment? Third, we took up the related question of price increases arising from shocks. The business capex boom, for example, is driving up prices of memory and logic chips and associated A.I. infrastructure. Do those changes indicate a broader inflationary dynamic, or do we just focus on them just because they are under the bright streetlight? Finally, we discussed monetary policy tools and strategies for achieving stable prices. If, as the Fed has long held, interest rate policy should be its primary monetary policy instrument, how much accommodation are we getting from the balance sheet? In all this, our job is advancing at the Fed. We are asking the right questions. And in this consequential time, we know how very much depends on getting the right answers.

The following instigates a memory from a meeting in our offices some time ago with a representative from a PROMINENT investment consulting firm who took me up on my suggestion that perhaps the best way to understand our investment process and thinking was to sit in on our Tuesday investment meeting. (Never Monday.) We had our normal-ish three hours of discipline and focus careening with bouts of belligerence, model heckling, and jestful personal insults. I thought it went well until the frantic call from the main office the next day. (You don't need more than 1 person to agree with you and even then it only matters if you are right in the first place.)

Back at the Presser:

Claire Jones, Financial Times:

Thank you. You seem to have got the family fight you were after at this meeting; we saw three dissents. Could you characterize the arguments that those dissenters put forward, please, and tell us a little bit why you weren't persuaded by them at this stage? Thank you.

CHAIRMAN WARSH:

So, I guess I shouldn't give you their best arguments. I'll give you some others. So, you're right, I asked for a good family fight, and I got one. That's the purpose, that's the design feature. I come into this meeting, even this press conference, heartened by what I've experienced the last two days. Most of our discussion were on the big questions that matter to the conduct of monetary policy. We—we didn't sort of hide from them, we weren't scared of them. There was a lot more interaction between and among my colleagues, it was a real family fight. My view, which you've long heard, is that's the better way to get policy right. That's our North Star. So, there was a lot of agreement that I heard, that we have the powers, the tools, also the authority to deliver stable prices. No walking back from our responsibilities. There was a large majority support for the decision that we made in the room, but I also want to leave you, Claire, with one other impression. There was nothing inertial about that discussion. It was an active, robust discussion, about what's in the full range of what we can do, and might want to do, in the period ahead. You characterized accurately, there was a disagreement about a decision today, I would say that doesn't sort of capture the full essence of the discussion. The path to central bank heaven requires delivering on our remit. These days that means delivering on price stability. I wouldn't measure that path in 42 days, or any one particular meeting. And I came out of that meeting even more confident that this is the right team to win the battle against high inflation.

Not yet Weary of Warsh:

There's a lot there, Neil. So, rates are higher today than they were 42 days ago. Markets have made decisions because we stepped back in part from trying to influence those. Market judgments have moved up on what nominal rates are, across the Treasury curve. That doesn't mean we take them as—by dictation, but we're observing them. So I think it's a mischaracterization to say that markets haven't reacted because we didn't move today. Markets are reacting in real time. In the period ahead, we've got important decisions to make about the policy rate. Markets in the intervening period, I think, have quite a bit of decisions to make. I'll see if I can put it this way, monetary policy matters not just by what we say, or even what we do, monetary policy matters by how it affects the real economy. And these prices that we see in financial markets is one of the many ways in which it affects the real economy. We'll be continuing to watch that market information, see how it responds to incoming events, and that can help inform our decision making when we meet in seven or eight weeks

Warsh and Lego Theory:

CHAIRMAN WARSH. Yeah, so, let me go back to first principles, Nick. I don't believe that either part of our mandate is generally at war with the other part. I do not believe that price stability and full employment is an either/or proposition. There have been policy makers over the last several generations who have thought that there is a strict tradeoff there. That isn't my judgment. In fact, my judgment is if and when we deliver on our remit, we're going to be satisfying both prongs. We're going to have price stability and full employment, and in fact, if you want to do the most harm to the labor markets, you would run a period of high inflation that's variable such that employers, businesses, wouldn't really know what's going on. So I think the two parts of our mandate are equally important. We have no legislative orphans here. I've been talking mostly about price stability, because we're doing pretty well, collectively, as a country, as policy makers on the full employment side. But we're doing considerably less well on prices, that's why we describe them as elevated, and that's what's taken most of our discussion.

Warsh Incredulously Realizing That We STILL Have to Explain Why Communism is Dumb and Anti-Semetism is Wrong. (Author license here.)

Jonnelle Marte with Bloomberg:

So, some of your peers have continued to discuss how they think about policy decisions, and if you don't offer your reaction function, or your way of thinking about it, how concerned are you that you're ceding control of the narrative?

CHAIRMAN WARSH:

So, not very concerned. That's a short answer to the question. When some people that follow the Fed say, well we don't want your forecast. We don't want your—we just want your reaction function. Part of me hears the—what we really want is your forecast. What we really want is your dot. In terms of reaction function, let me sort of disabuse people of a question that may or may not be real and be out there. Any central bank, especially a central banker where the labor markets are more or less at equilibrium. Any central banker, when he or she sees underlying inflation moving higher, he or she is more inclined to tighten policy. Again, when you've achieved the other side of your mandate, and you see underlying inflation falling, he's more inclined to loosen policy. That's my reaction function, and I don't suspect it will cause people to not continue to pry for more, because the truth is, for a very long time, in a lot of countries, coming out of the 2008 crisis, where in crisis mode we were purposely providing a lot of information. Trying to provide a lot of assurance, trying to tell people exactly what we're going to do, offering forward guidance with clarity, as if we're tying our own hands behind our back. Well, in crisis mode, that strikes me as a very prudent policy. But in more benign conditions, it strikes me as worth revisiting. But markets and market participants, and reporters, have learned to devour all that information so I take seriously that the pullback of forward guidance requires some transition. Reform isn't easy, but our general judgment is going to help us make better decisions and in so doing, satisfy our remit.

More Jonnelle Marte with Bloomberg.

Following up on that, there was more uncertainty in the markets about what the Fed would do at this meeting. To some extent you might think that's what you want to see, but my question is about, is there a point at which you would not want to surprise the markets if they were pricing in something with higher certainty that was opposite of what you were

> intending to do? What are the risks that you see associated with that?

CHAIRMAN WARSH:

> Yeah, so it's a good question. Surprise is not the objective function. Surprise is not what we're solving for. We have a clear North Star. What we're solving for is how to make the best decisions. Almost everything else should be in service to that goal. By not spoon-feeding markets, by not previewing our decisions, by not sort of giving nudges and leans, my colleagues and I have found in the intermeeting period what we're getting is the views from a very accomplished economist. That's the internals of financial markets. Instead of just repeating or echoing what we're saying back to us, they're giving us somewhat, not perfect, their own judgment. So, surprises are not the objective. But at the same time, I would say, we didn't come into this meeting feeling constrained by the full range of alternatives we had in front of us.

And If you were ever wondering if the Bloomberg media empire could be posing as a NY Times caricature, I present to you their man MICHAEL MCKEE:

> I'd like to follow up on the task forces as well, and ask, what vetting did you do of the people that you appointed to the task forces. In particular, given Marc Andreessen's substantial political spending, $25 million in just the past year to back candidates who oppose stricter AI regulation, how can the public be confident that a committee he co-chairs will provide an independent assessment of AI's economic effects, rather than one aligned with the interests of the AI industry?

And that is about it in my eyes. There is risk in any regime change, and risk must be considered against reward, and valuation and the relative stage of present hype in which one thinks they reside. And that is the uneasy feeling.

Lastly, we don't have to have a set of regularly disclosed public "dots" as to where we think this group of people think the world is headed, as that is one license somehow overlooked by the Feds as necessary for conducting investment business. And as anyone who has taken a very public position on a stock or investment in any form, and then have it go terribly and publicly wrong against you, the emotional fortitude is difficult to muster to enable one to shout equally as loud, "I WAS WRONG and I SOLD IT," versus go down a committee rathole—and that can easily be a committee of one—and come up with more and more highly articulate reasons of why you aren't wrong, just early and misunderstood.

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