# A "Numble" Fed: What To Do When Random Flip-Flopping And Ambiguity Is The Strategy

By Vineer Bhansali, Ph.D. | January 28, 2022

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I would like to invent a new portmanteau word "Numble" to describe how central banks now operate these days: it is a combination of the Fed's new word-smithing twist, "humble and nimble", since "transitory" is so 2021.

The term perfectly describes the increasingly random (you can put lipstick on it and call it "nimble") policy decisions of the Fed which are anything but humble. The markets are being slowly conditioned to become numb to their stumbles, albeit in a volatile way. But like a rogue trader gone amuck, "data dependent" "nimble" central banks have become bulls in a china shop, armed with shaky economic theories and prognostications that at best are laughably silly and at worst seriously damaging to the long term financial health of the countries and economies they govern.

Let's recap before we dive into what actions investors can take. The Fed denied for almost a year that inflation was a problem and that it would go away; i.e. the famous "transitory" that we won't talk about anymore that I, and many others, wrote about being just out of touch with reality. This followed the "data-dependence" and "FAIT" (flexible average inflation targeting) paradigm that has pretty much been abandoned now. That of course followed policy pivots that

have now become standard expectations of Jerome Powell and the Fed's erratic behavior.

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In an interesting paper by a Cleveland Fed Economist titled "Average Inflation Targeting: Time Inconsistency and Intentional Ambiguity", which was presented at the recent American Economics Association annual conference, the authors discuss the "new policy framework of average inflation targeting and its ambiguous communication". They conclude that the central bank has the "incentive to deviate from its announced AIT and implement inflation targeting ex-post to maximize social welfare". And as the second motive for ambiguous communication they conclude that "ambiguous communication helps the central bank gain credibility". Yes, you read it right. By bumbling communication where the horizon is not communicated, the Fed, in the minds of these economists, gets more credibility, and thus can be justified in being "time-inconsistent" and pivot from being accommodative to being hawks, like they just did. I am a theoretical physicist by training, so the math did not scare me. But the logical jumps did. "Nimble" basically means not being clear, according to this interpretation so there is maximum flexibility. Please read the paper so you can see how simple logic can be contorted into a pretzel via the mechanisms of idealized theory and simulations that defy common sense. It is like bit like saying that the next time your kids are being bad you should promise them one thing, but when they start behaving like you asked them to, you should do a 180 and

change your mind completely since statistically that will build more credibility for your process. By repeatedly following “time-inconsistency”, if you believe this literature, your kids will think, after you test this strategy out 1000 times, that you are more credible if you are vague, random, and inconsistent. The whole argument relies on the fact that the central banks can convince the private sector to believe it over and over again, even though it fumbles and flip-flops repeatedly.

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But surely I must have something wrong. Inquiring minds want to know whether the current “humble and nimble” approach to policy making is actually part of a grand strategy to manipulate market expectations with “positive welfare”, and we poor and unwashed participants just don’t know the grand scheme that’s actually good medicine for us if we only knew. But we cannot dismiss the approach altogether. Those of us who have watched movies like “Rebel Without A Cause” will understand that a strategy of credible irresponsibility can actually be a way to win in the Game of Chicken; e.g. take off the steering wheel before you start driving headlong into your adversary’s oncoming vehicle. In other words show that you can be irresponsible but believable. If the markets credibly believe now that the Fed will tighten aggressively to squash inflation even at

the cost of crashing the stock market, animal spirits will begin to calm down by themselves, and the liquidity fueled demand shock will just dissipate. The Fed can declare victory. Problem solved. The bazooka in reverse.

Alas, I don't think the Fed is that strategic at the moment. I think the simple answer is they really don't know what is going on (and the ECB does not even want to distinguish facts from fiction), and will keep bumbling along. If inflation is such a big problem why else would they keep buying more bonds and pumping more money into the system until March of 2022? The strategy of pushing on the gas pedal and the brake at the same time is neither humble nor nimble – it burns more gas and also burns your brake pads. It does send confusing messages. But maybe sowing confusion is part of the strategy, huh?

Intelligent investors know that the Fed has three mandates, not two. They are, in a circular sequence: (A) minimize unemployment, (B) minimize inflation consistent with (A), and (C) minimize financial instability consistent with (A) and (B). The Fed thinks it can juggle all three at the same time, but they cannot. Right now the Fed has solved the unemployment problem (kudos for that), which has indirectly resulted in inflation, which they are now trying to solve. They can obviously bring inflation down the fastest by crashing the stock and bond markets (talk about throwing the baby out with the bath water), which they can rescue again in the future to go back to step (A).

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So what is an investor supposed to do when faced with a flip-flopping central bank that pivots each time it gets economic data and markets wrong? Uncertainty breeds illiquidity. Evaporating liquidity makes the correct portfolio posture to (1) build convexity, (2) have access to liquidity. Convexity means building asymmetries in portfolios; i.e. limited potential losses, but less limited upside potential. AKA "optionality" in the broadest sense of the word – the choice to dictate decisions. Liquidity means not being forced to sell at the wrong time.

Just as we have to drive defensively to avoid other drivers on a slippery road we are again at a point where liquidity in the deepest hedging markets is rapidly evaporating. This results in forced sellers who can't get out all at the same time.

Coming back to the Fed – if inflation control is problem 1 of the "whack-a-mole" game right now, don't be shocked by a shock-and-awe overdo by the Fed and maybe a stunning pivot by the ECB. When that fumble happens, markets will likely become even more volatile than they are already. And when markets stumble, the numble Fed will have to extend credit again. I have no idea when this will happen, but you can bet on a not-so-humble and a not-so-nimble Fed doing what it has always done – put out the fires that it often starts in the first place by not thinking through things carefully through the lens of common sense.

## Important Disclosures

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