Getting Ready For The Dovish Pivot From The Fed

By Vineer Bhansali, Ph.D. | April 25, 2022

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In the last few days, the chorus of Fed Officials talking about "getting to neutral" has reminded me of the famous Yogi Berra saying: "if you don't know where you are going you might end up somewhere else". The current state of affairs is probably more apropos of "Alice's Adventures in Wonderland" author, Lewis Carroll: "If you don't know where you are going, any road will get you there". The flip-flopping and apparently random decision making, under the guise of "data-dependence", is going to inevitably lead us to high volatility and fat-tail moves, especially as the Fed is no longer buying massive amount of assets. That place, a world of financial instability, is where this new-found love of "neutral" is leading us. And in due course, because that neutral point is so far away, this new mantra will likely be met with a dovish pivot to squash the volatility and unhinge markets. Investors should be getting ready for this pivot to happen sooner rather than later, in my view.

Theoretically, the "neutral" rate is the rate at which the stance of Fed policy is neither accommodative nor restrictive (the "real" rate version of this is called "r star" and is part of the famous Taylor Rule that prescribes monetary policy given economic potential, inflation, and growth rates). It is the short-term, real interest rate consistent with the economy maintaining full employment with associated price stability (see Kaplan, Dallas Fed here). However, the Fed really does not know, and for that matter, no one knows, where this mysterious "neutral" interest rate is that they are increasingly talking about.

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What the officials who point to the neutral rate are referring to is an imaginary, make-believe number that reflects their own median forecast on the "dot-plots". According to this consensus "model" the current neutral rate is 2.4% (see here). This way of getting to a credible (though very possibly inaccurate) result is a great example of what Charles Seife calls "proofiness". His book of the same name opens with this statement: "If you want to get people to believe something really, really stupid, stick a number on it." Seife further calls these types of numbers "Potemkin" numbers, or fabricated statistics, numerical facades that posture as real data, but just something that motivates the arguments that one is trying to make. And this is not the first time that the Fed has made up a number or a concept that justifies what it is trying to do. I am sure that the good, non-elected folks have the best interests of the economy at heart, but since they have no real skin in the game like investors do, they can basically make up terms and rationales as they go. And in the process create volatility, and do I dare say, opportunity, for investors who can see the naked emperor.

The real problem with pinning a numerical value on a number, such as the neutral funds rate, is that we are in an environment that the economy has not seen in 50 years and we are dealing with the consequences of actions that are incredibly path-dependent. The "equilibrium" concepts that result in the concept of neutral simply do not exist for an economy beset with massive externalities like COVID, war, inflation, helicopter money, negative yields…the list goes on.

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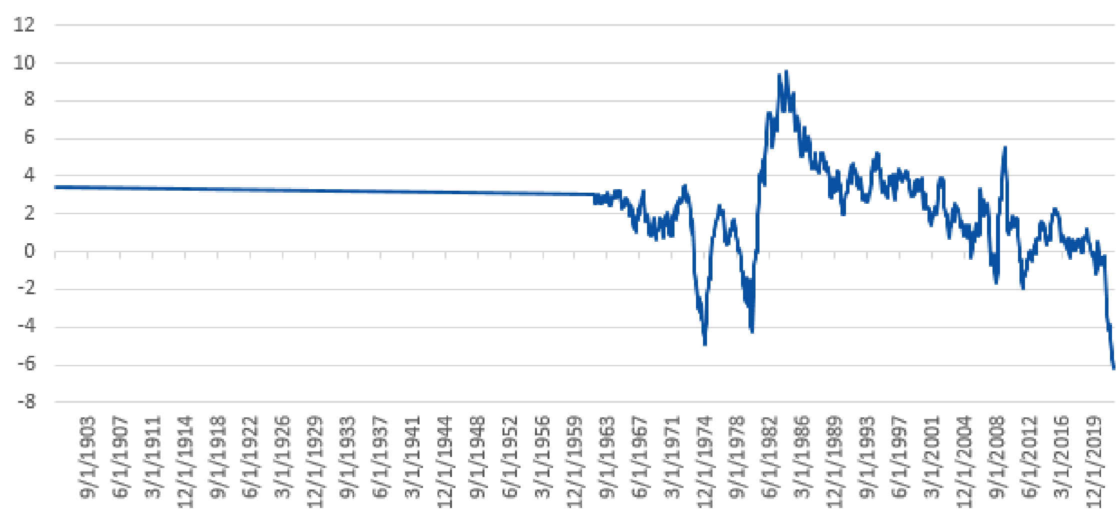
Think about brake pressure used to stop a car (again the car analogy has been used by Kaplan, above, while Powell used the analogy of sailors navigating by the stars in his metaphor for the elusive r star almost four years ago at the Jackson Hole symposium). When moving on a flat surface, the average amount of brake pressure needed is quite predictable by solving the simple equations of physics. But when going uphill and downhill on mountains that one has never before driven on, the average amount of brake pressure means very little, since the acceleration and deceleration required is highly dependent on the local slope at the time. A flat-land driver in the mountains inevitably ends up riding the brakes too hard down hills.

Which is where the Fed is today. Their use of the term “getting to neutral” means that they will likely become too aggressive even as the economy is slowing. The real long-term interest rates, as measured by 10-year TIPS (Treasury Inflation Protected Securities, is still negative (-0.10%) but the Fed owns a large proportion of these TIPS.

The real yield as measured by the difference between nominal yields and headline inflation is still the most negative it has been in decades (10-year nominal Treasury is at 2.8%, and inflation is running at about an 8.5% year-over-year rate, making the real ten-year yield shown in the chart below minus 6%! (Source: Bloomberg), the neutral real yield is far, far away even if inflation moderates in the coming months. To recycle the quotes used above: “you can’t get there from here without breaking something”!

REAL TEN-YEAR YIELDS: NOMINAL TEN-YEAR YIELDS MINUS HEADLINE CPI INFLATION 1952-2022



Source: Bloomberg

A large part of this predicament is due to the Fed falling very far behind the inflation problem (they literally just stopped buying assets a month ago, long after everyone got sticker shock at the grocery store and gas pump!). For a levered economy not quite set up to take a sudden, sharp increase in interest rates, the most likely outcome is a sharper than expected slowdown if the Fed tries to stick to its goal of getting to the “neutral” that it cannot forecast. With inflation running as high as it is already and consumers beginning to slow down consumption, can rates get so high that it becomes even harder for consumers to consume? What if inflation does not go down much in the aftermath of rising rates, but the economy, stock markets, and confidence all tank in a self-fulfilling prophecy?

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As I mentioned in previous posts on this forum, today we are at a point where the short-term yield curve has already priced in multiple interest rate increases. The two-year nominal Treasury is at a yield of about 2.5% (Source: Bloomberg). With roll-down and carry this could translate to a total return of 3% plus for a year and with little principal risk if held to maturity. Not bad given the liquidity it provides on top of all this. And if the Fed is forced to pivot to policy earlier than what is priced in? Well, these short-term Treasuries could see positive price gains as well.

As readers of my prior posts in this forum know, I have been concerned about negatively yielding bond markets now for a few years (see here). As rates rise and normalcy returns, we will start to find that good old bonds become attractive again as investments and hedges. We are definitely not at that point yet, but since all good things start with the first step, investors would be well served to consider dipping their toes in the short end of the US Treasury curve as we start to prepare for financial instability.

Important Disclosures

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