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Market Insights

What Powell Didn't Say

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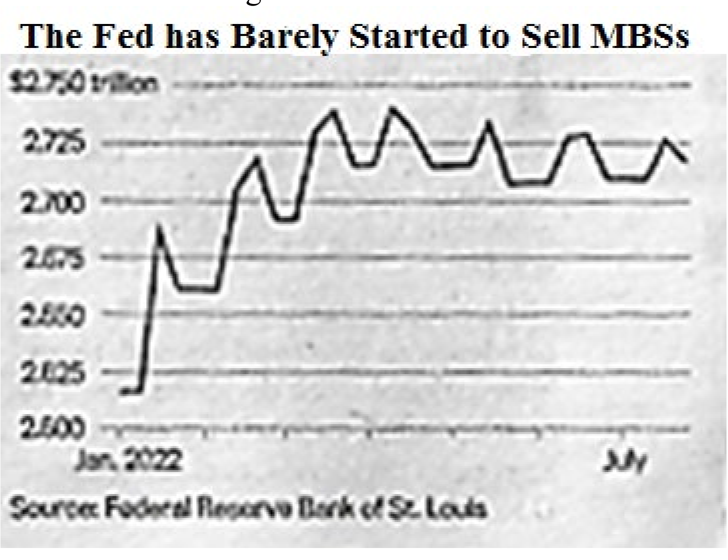
There was nothing surprising in what Federal Reserve chairman Jerome Powell said in his long-anticipated Jackson Hole speech on Friday. In just eight minutes, without questions—barely more than a press release—he repeated that the Fed might have another large rate increase in September, and that they would not stop tightening until they had achieved their inflation goal. Powell was attempting to burnish the Fed's inflation-fighting credentials which had got a little rusty after his comments following the Fed's last rate increase. After he spoke, the markets collapsed on Friday, with the Dow off over 1,000 points, while gold fell $20.

Wither the balance sheet?

What was important was what was *not* discussed. Though Powell mentioned interest rates a few times, he did not discuss reducing the Fed's bloated balance sheet. This is all the more surprising, since under their stated plan, the Fed will commence selling off Treasuries and mortgage-backed securities (MBSs) next week, at the rate of $95 billion per month. Given that the Fed is well behind with its planned balance sheet reduction, he might have mentioned their intentions. As of last week, two-and-a-half months into QT, which was supposed to see the Fed reduce its balance sheet by $47.5 billion per month, it has in fact declined by only $36 billion (rather than the $119 billion that should have been sold under the Fed's own schedule). All of that was run off from maturing Treasuries. Now, we are supposed to believe, they are going to start at $95 billion per month? All the more reason to mention it, given that withdrawing that much liquidity from an already weaking economy will have a serious impact. So its absence is perhaps meaningful; he can't have forgotten!



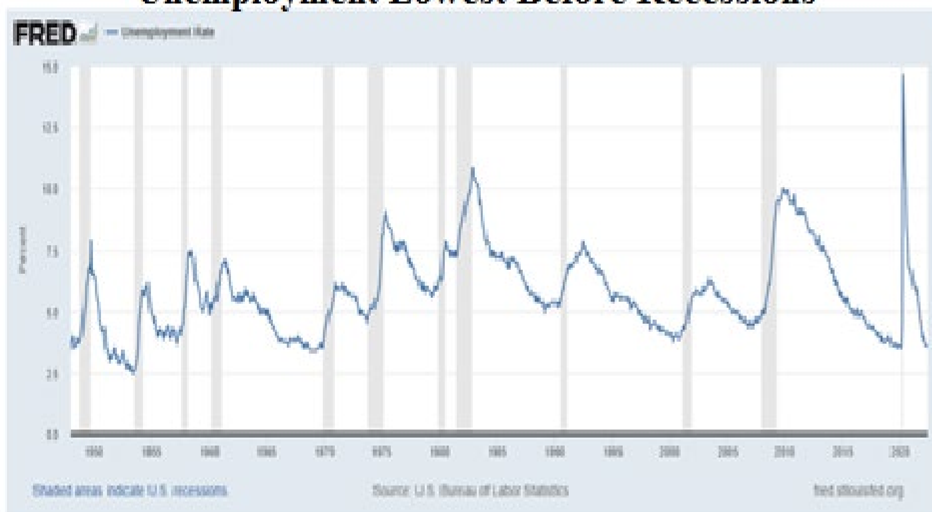
Arguably more important than Powell's little oration, given that he said nothing that was not already widely anticipated, were reports that the European Central Bank might raise rates 75 basis points at its next meeting (from its current zero level), and initiate QT, balance sheet reduction. Maybe the market was reacting to the ECB rather than the Fed. Given the energy crisis in Europe as well as the condition of some European banks, however, I doubt the ECB will tighten very much for very long.

The other thing missing from Powell talk was any nod to the Fed's role in creating inflation in the first place. The Fed, the administration and apologists, and many academics, seem to think that though higher interest rates and a reduction in the Fed's balance sheet can solve inflation, mysteriously, lowering rates and increasing the balance sheet in the first place had nothing to do with causing it.

Serious recession ahead?

The risk of a serious recession continues to increase. Both Powell and President Biden emphasize that the jobs market is strong, based on the low unemployment rate. This is symptomatic of the Fed's penchant for looking at incoming data, which sounds sensible until you realize it means that they are backwards looking. Yes, the unemployment rate is low, but that is always at its low point immediately before a recession starts. Listening to corporate earnings calls, from AT&T to Starbucks, shows that many corporations are either instituting a hiring freeze of planning layoffs.

Unemployment Lowest Before Recessions



Stock rally over and gold turn near

What does this mean for the markets? First, the stock market rally that started in mid-June and took the S&P 500 up over 17% from the lows, is over. The initial rally in a bear market is typically the strongest, and 15% is usually the most markets can manage. The dollar may be strong in the immediate term, based on Powell's hawkish speech, but if the ECB turns aggressive, then the euro may turn upwards, putting the brakes on the dollar's rally. The ECB may not keep tightening for long, but long enough to halt the dollar's rise. Gold will be soft so long as the market continues to believe the Fed's rhetoric, but serious economic hardship may see it turn.

Gold, as I write Sunday evening, is down 5% for the year to date, which in itself is far less than most markets and assets, while the dollar is up over 14%. It is worth noting that gold is up when priced in terms of most currencies. If the ECB starts to raise rates at a faster pace than the Fed—and remember, 75 basis points off zero is a faster pace than 75 basis points starting at 2.25%—then sentiment could shift from the dollar. That would be bullish for gold.

Gold might also see a fundamental turn when the market fully appreciates that the Fed will be unable to bring inflation down to its 2% target level without causing a serious recession, and raising the spectre of systemic risk, and therefore, the Fed will not stick with the job; it will pause if not pivot. This may not come now, or by year end, but, I suspect, by early next year it will be clear that a serious recession is in the offing.

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