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US Watch

NOT THE FED'S FIGHT, NOT YET ANYWAY

Steven Blitz

- Pre-emptive has left the building, they will cut after payrolls fall.
- When they do cut, it will be a lot more than the benign path markets are pricing.
- Trump's shock is not creating the awe he may have hoped for – negative implications for growth from capital market disruptions. Unintended consequences loom large.

Simply put, what is driving current concerns about the economy is not an interest rate problem. The Fed cuts if the economy heads off a cliff, but not pre-emptively. The WH is bent on asserting its right to manage the economy, putting the Fed in second position, and believes they are revealing underlying weakness in the private sector as government spending is stripped away ("detoxing" is their word of the day). They are apparently willing to accept a downturn as part of rebuilding the nation's economic structure – but their shock therapy will amplify unintended consequences, illuminating the "fat tails". Against this backdrop, there is no reason for the Fed to step in and be pre-emptive. Cutting the funds rate to keep markets afloat only makes the inflation problem worse down the road, especially if a downturn fails to materialize, and a near-term downturn is not pre-ordained.

On Wednesday, what we expect to hear from the FOMC and Powell, aside from no change in policy rates:

- **The economy is in a "good place"** – if it was not, they would have to cut on Wednesday.
- **FOMC will downgrade 2025 growth in the SEPs**, after the Dec upgrade to 2.1% from 2.0%, the inflation shift is unclear, but in sum the SEP numbers will solidify market pricing rate cuts totalling 50BP this year and 100BP in the coming 12 months.
- **This will keep the short end inverted**, reverse growth in bank lending, and add risk to the outlook. It will **also cap the 10Y**, unless and until economic data swing more positive.
- **Suspend QT** – the excuse will be the debt ceiling's impact on TGA, RRPS and reserves, and the reverse when the debt ceiling is lifted. Reserves appear ample, but if current market volatility gets large enough, a bank problem somewhere will crop up – leaving banks wanting to increase their deposits at the Fed. As for the debt ceiling itself, Congress and the WH skipped the opportunity to address the debt limit in last week's CR, leaving the debt limit to be addressed closer to the X date (June/July), promising unnecessary unneeded market volatility.

If the economy fails to give the FOMC reason to cut the funds rate at the May 6-7 meeting, odds of cuts later in the year fall away. If, on the other hand, payroll declines move the Fed to cut by May, the funds rate will be cut by more than what markets have priced in. The projected

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steady pace of cuts through the coming 12 months, adds up to 100BP, which translates to 2% inflation and the same 4.1% unemployment rate a year from now. In the current environment, a steady economy with falling inflation is an unlikely combination. A modest recession dropping inflation to 2.2% and raising the unemployment rate to 5.1%, would put the funds rate at a Taylor Rule of 2.75% -- 150BP of cuts. Chances are, however, the FOMC would drop the funds below the Taylor-Rule level. Belief in a sour economy kicking off a round of rate cuts means taking advantage of further downside for the funds rate than the forward price Below is a simple table illustrating an array of possibilities for the funds rate.

Table 1 Where the funds rate can go, if easing begins

Lombard-adjusted Taylor Rule, yellow marks current levels

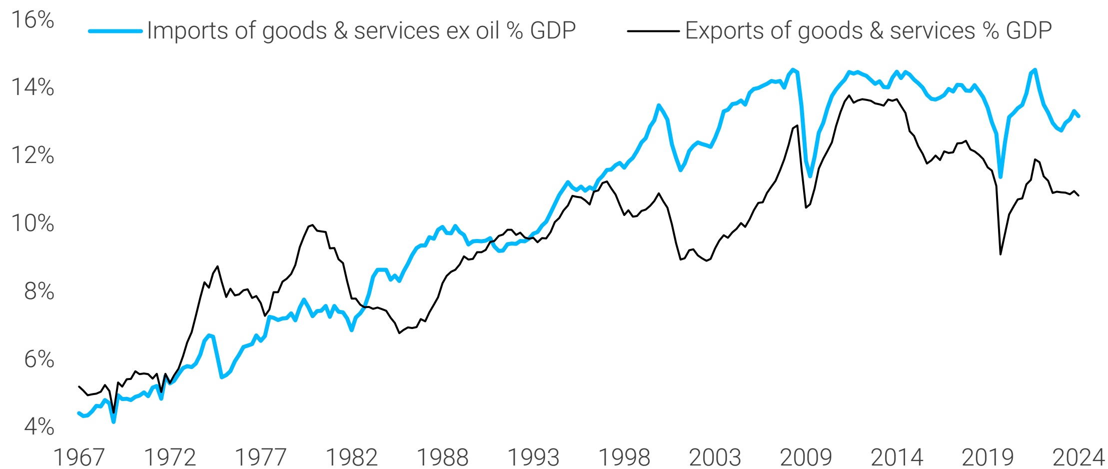
		Core PCE Y/Y %ch				
		1.15	**1.65**	**2.15**	**2.65**	**3.15**
Unemployment Rate	**6.1**	*0.29*	*1.04*	*1.79*	*2.54*	*3.29*
	5.6	*0.79*	*1.54*	*2.29*	*3.04*	*3.79*
	5.1	*1.29*	*2.04*	*2.79*	*3.54*	*4.29*
	4.6	*1.79*	*2.54*	*3.29*	*4.04*	*4.79*
	4.1	*2.29*	*3.04*	*3.79*	***4.54***	*5.29*
	3.6	*2.79*	*3.54*	*4.29*	*5.04*	*5.79*

Source: BEA, Bloomberg, BLS, Federal Reserve, GlobalData TS Lombard

What are the odds of recession?

In my "2025 Outlook – Strong growth, if policy can unlock it", I wrote "all is set for a strong year of growth, and it will be stronger if Trump's policies can unlock household and business leverage to support capital spending – what we expect. If, however, policy chaos instead causes people to be more cautious than daring, recession risk is very much present" **To date, it looks like my assessment that Trump would take cues from the equity market and be more deliberate in layering in tariffs ahead of planned tax cuts, so that the totality of his efforts could work on the economy in sync with each other, was wrong**. **Instead, Trump is engineering a "trade shock" that will drop the economy to a lower growth path** – before even calculating in the negative impact from disrupting capital flows. Exports and imports (ex oil) are large enough sectors of the economy, especially imports (Chart 1). There is little monetary policy can do to offset a trade shock through tariffs, and it is not clear that they even should, since this is WH policy– except to counter rising unemployment and/or inflation, and the economy could end up with both. After all, this is the opposite of supply side economics as practiced from Reagan through Obama, that is having the world supply US demand and, in turn, pull down US inflation. The domestic costs of policy have been high, yet as the Trump plan is now being executed, visions of the Trump trade shock igniting a domestic boom in capital spending, at least in the intermediate term, is a bit heroic – especially if global capital flows reverse and the Federal budget deficit remains large.

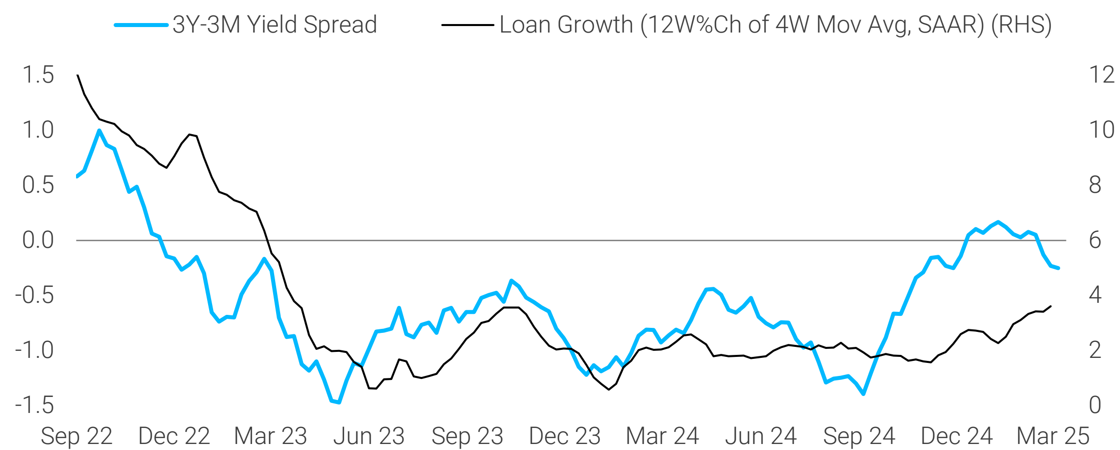
Chart 1: A trade shock sharply deflating imports and exports will hurt growth



Source: BEA, GlobalData. TS Lombard

Sentiment never leads the economy into a downturn. Lost jobs do, and given the winter weather, we should wait to see how March spending turns out before declaring that consumers are on a spending strike– scared off by the 10% decline in equities. There are, admittedly, a number of troubling data points, including railcar loadings of cyclical cargo. My biggest concern is that the return of inversion at the short end of the yield will curtail lending (Chart 2). Part of my base case for growth in 2025 was a positive yield curve supporting bank extensions of credit. Still, in the absence of large layoffs, current ebbs and flows of economic activity do not yet add up to a cycle peak.

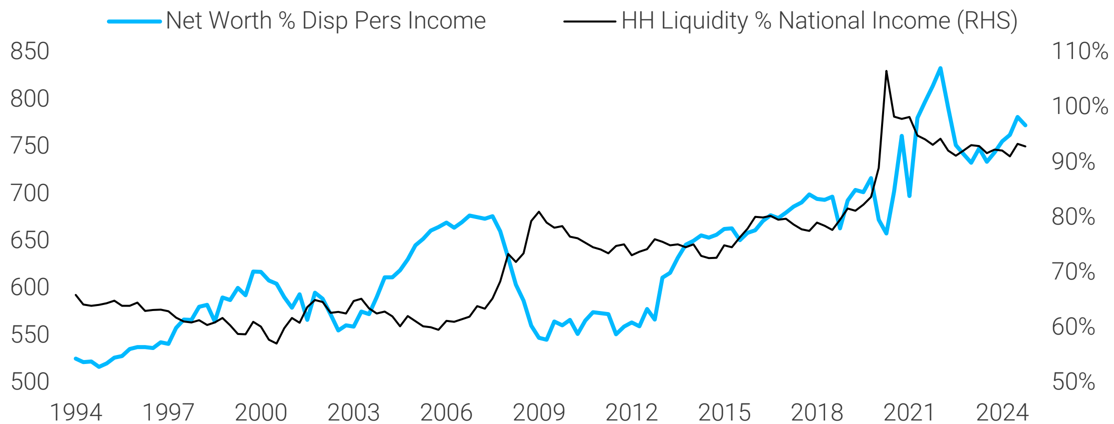
Chart 2: Re-inversion of short end yields portends reduced loan growth



Source: Bloomberg, Federal Reserve, GlobalData. TS Lombard

What has not changed is the fundamental position of the US economy – the overhang of liquidity remains massive. Recession still runs through the asset side of private sector balance sheets; weakening with the drop in equities, and growth runs through private sector's willingness to leverage their balance sheets to add physical capital –a willingness stymied by Trump's actions (for the moment, at least). **Household net worth is still around record levels relative to disposable income, as is liquidity as a percent of national income** (Chart 3).

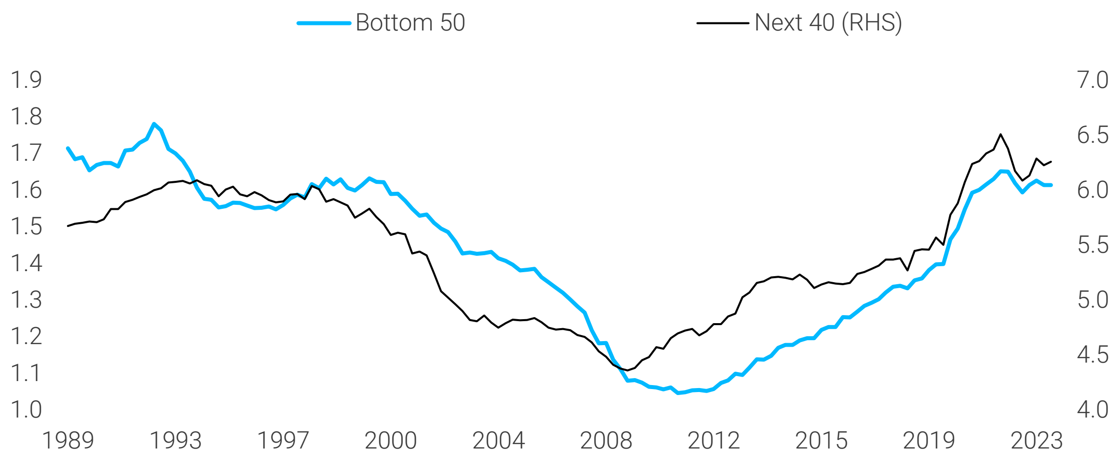
Chart 3: Households balance sheets remain extraordinarily liquid



Source: Federal Reserve, GlobalData. TS Lombard

Improved balance sheet positions are also evident in the lower net worth percentiles (Chart 4) –using asset/liability ratios that include nonfinancial assets.

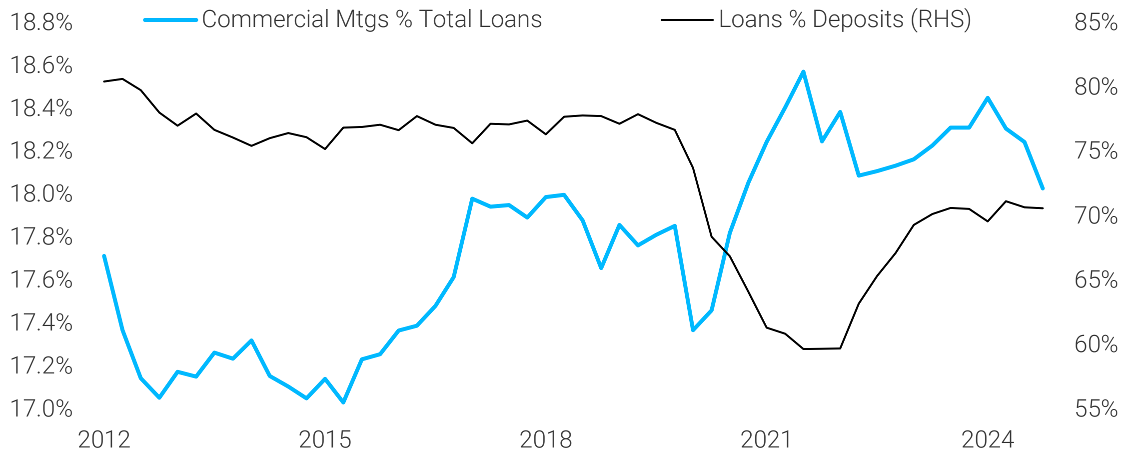
Chart 4: Asset/Liability ratios remain strong even for lower net worth percentiles



Source: Federal Reserve, GlobalData. TS Lombard

Banks are also well capitalized, some might argue over capitalized with loans at 70% of deposits, (Chart 5). CRE remains an issue, but it is one that most banks have begun to grow out of in the past five years. The Fed keeping a cap on the 10Y until domestic growth demands otherwise will also help in the refinancing to come.

Chart 5: Banks are liquid and CRE is a declining share of outstanding loans



Source: Federal Reserve, GlobalData. TS Lombard

In sum, there is a lot to be nervous about, as Trump has gone for shock therapy instead of going for a more gradual rebalancing of trade and domestic production. It may yet work out as planned, but shocks bring forward acute disruptions that impact capital markets and, in turn, real economic activity. Against this backdrop, this is not yet the Fed's fight, nor are they necessarily welcome to the fray. Look instead for them to talk softly enough on Wednesday, but pre-emptive has left the building. They will cut when payrolls drop, and while the economy is softening there is no strong indication of recession, only a lot of potential. If conditions do end up warranting a cut in the funds rate, the cuts will run a lot deeper than what markets are pricing. A trading opportunity for the more pessimistic among us.

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