Is the Fed Put Gone Forever?

By No Author *Thu, Dec 9, 2021*

'The Fed has turned hawkish belatedly due to a policy error on inflation. But it will have to back off as asset prices decline, yield curve approaches inversion—a telltale sign of a recession—and as inflation eases in early 2022,' say the analysts at the Clocktower Group.

Two extraordinary leads graced major news outlets over the past week. First, Reuters carried an article titled, “WHO chief scientist urges people not to panic over Omicron.” Second, Bloomberg led with “Jerome Powell Ditches ‘Transitory’ Tag, Paves Way for Rate Hike.”

What do both news items assert in common? An egregious example of institutional failure. [For the original version of this article, including charts, click **here**.]

For the Fed, the failure is in its belated reaction to inflation. If there is anything the Fed ought to get right, it is movement in prices. That is, after all, its mandate! We are not even asking the Fed to predict inflation, just to explain it. But apparently it took until late November for Jay Powell to realize that COVID-19 is not deflationary.

The lesson from how policymakers have reacted to the pandemic and inflation is that they overreact belatedly to yesterday’s news. As they do, material constraints to the overreaction build, forcing an about turn.

In the context of the Fed’s über hawkish pivot, our conclusion suggests that a dovish pivot is coming in 2022. We are taking the other side of the view that the “Fed put is gone.” Why? Because no matter how much inflation hurts the median voter—and we maintain that the actual level of pain is overstated—a recession will hurt more.

The current Fed trajectory, given the peak in growth this cycle, will cause a recession. And a recession is unacceptable in the current US political and macro context.

Where do we go from here? While we think that the Fed is crying wolf on inflation, it is going to take a significant equity market correction to shift its thinking. As such, investors should prepare for a deep correction over the course of December.

The mid-December FOMC meeting—December 14-15—may be an opportunity for the FOMC to change course. But if the underway correction eases by then, we doubt that they will change course so quickly. As such, investors should approach the current selloff with the "no pain, no gain" mentality. More pain is needed to set up the rest of the cycle.

Investors should prepare for more USD strength in the near term, particularly if the market starts pricing in further rate hikes in 2022 (Chart 18). The US 10-year yield could decline further, taking risk assets—especially commodities and especially BTC (Chart 19)—further with it.

However, we expect a big macro context reversal sometime in early 2022, potentially in Q1.

First, as we discussed above, inflation will ease. Don't get us wrong, we remain in the *inflationista* camp. To be clear, the membership in the sane *inflationista* camp carries a low threshold. One simply has to assume that the long-term inflation expectations rise above ~2.3%. Given our structural view that geopolitics is not transitory, we are in that camp.

But with the most severe supply shortages easing and with the Fed clobbering commodities with its hawkishness, prices will ease further, both in the US (Chart 20) and abroad. This will allow it to pivot to the "5% is the new 2%" view elucidated in this missive. In other words, inflation will prove to be "transitory" just as the Fed capitulates that it is not.

Second, Chinese policymakers will wake up to the risks of a severe deleveraging campaign. As we posited in the latest *China Macro Watch*, the policy inflection is already upon us. We have played this thesis by going long iron ore relative to oil, a trade that has already netted 19% since publishing our missive on November 23.

More importantly, a China that puts a floor to its own growth will put a floor on global growth as well. Given Europe's high beta to Chinese imports and growth, a shift in Beijing calculus should have a meaningful implication for the USD and commodity prices.

A moderation—if not outright reversal—of Fed hawkishness combined with Beijing policy inflection should allow the US 10-year yield to resume its higher trajectory. In 2021, a number of big trades were essentially correlated to the "one big trade"; the path of US yields. And to our chagrin, the path of the US 10-year bond yield has been influenced by the relative COVID-19 response between the US and the rest of the world (specifically Europe).

Next year, we expect our COVID-19 desensitization thesis to continue as antiviral medication becomes widely available and as investors and the public realize that viruses have a Darwinian logic in mutating into a highly infectious but less virulent forms. This will allow the combination of a Fed dovish pivot and Beijing policy inflection to take over as the major macro catalyst and lead bond yields, globally, higher.

In this environment, investors should expect more commodity strength. If commodities managed to outperform in a year defined by a USD bull market, they will be absolutely set alight in 2022. And no, the correlation between the two has not changed. In fact, the correlation of their daily returns has been as negative as ever. What that means is that commodities would have gone even higher had USD been weak in 2021.

A macro context defined by Chinese policy inflection and high commodity prices should also see the star performer of 2022, India, lose some of its shine. Already this year, India's outperformance relative to EM was historically illogical given commodity strength. While the overall setting would obviously be positive for EM, India would be the biggest loser. In anticipation of this shift, investors may want to tactically go long China relative to India.

Another reversal in 2022 should be the outperformance of tech, particularly US FAANGs, which have been the "only game in town" for a decade, a decade extended by the pandemic. This year, global tech/global energy has tracked COVID-19 data. Next year, combination of a higher inflation regime, Chinese policy capitulation, and easing of the pandemic should allow energy—and value sectors in general—to finally catch alight. This should also ease capital inflows into the US, a tech heavy economy and market, inflows that in 2021 reached the highest level since pre-GFC 2007. Given the current net longs in the USD, a macro context reversal should see the greenback peak and ease in 2022. Then again, why anyone would take our USD call seriously after our call in 2021 is unclear to us!

Bottom Line: Tactically, the pain and carnage must continue. Investors should avoid risk assets, commodities, and crypto assets in particular. Cyclically, nothing has changed. The Fed has turned hawkish belatedly due to a policy error on inflation. But it will have to back off as asset prices decline, yield curve approaches inversion—a telltale sign of a recession—and as inflation eases in early 2022.

The narrative that the median voter hates inflation only works up to the point of a recession. We may not know everything about geopolitics and politics, but one thing we know is that the public hates a recession. And a recession catalyzed by unelected, millionaire, technocrats is a recipe for *la Terreur*. Meanwhile, the greatest macro development of November is neither the new COVID-19 variant nor Powell retiring the term "transitory." Rather, it is the policy inflection in Beijing, which should put a floor on Chinese and global growth in Q1.

Cyclically, we remain commodity bulls. In 2022, the biggest call for investors may be emerging markets. They remain deeply unloved by institutional investors. And yet, they would be the prime beneficiaries of a set of circumstances that sees the Fed ease its hawkish rhetoric, Chinese growth bottom, and dollar peak.