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The forward guidance trap: revising our Fed call following Jackson Hole

From Global Fixed Income

Kevin Warsh took the stage at Jackson Hole facing a credibility problem. Most importantly, he had previously refused to describe his own or the Committee's reaction function, that is, how monetary policy might adjust under different economic scenarios. As a result, he talked tough on restoring price stability at his June and July press briefings but without offering any insights on how the FOMC intended to achieve that goal. He compounded the issue at the July briefing when he suggested that he is not beholden to measuring price stability against a PCE inflation benchmark, potentially opening the door to a more subjective and forgiving definition of price stability. And all the while, he has preferred to talk about the process of policy setting ("good family fights" at FOMC meetings, task forces to reform the Fed) rather than decisions or actions.

Given these concerns, we were uncertain what to expect from the Chair at Jackson Hole, and were especially skeptical that he would provide further clarity on his reaction function. As anticipated, he provided a vigorous defense of his preference for a quieter Fed, one that is less reliant on forward guidance:

> "Oversharing policy deliberations and overcommitting to future decisions can lead markets, businesses, and households astray. And I believe when policymakers make quasi-commitments on interest rates through the cycle, we inhibit our own freedom to make the right calls when it's time to decide."

Still, Warsh went on to highlight the principles that guide his thinking on the conduct of monetary policy, and then essentially applied these principles to his current assessment of the economy. In doing so, he laid out a roadmap of his own reaction function, overdelivering relative to our expectations.

Of Warsh's principles with the most direct bearing on the policy outlook, we highlight two:

- "The Fed's price-stability objective of 2 percent, as measured by the personal consumption expenditures (PCE) price index, is a firm, fixed target. Let's be equally clear about another aspect of the objective: Price stability is not self-executing, nor is inflation necessarily mean-reverting. It is the Fed's job to deliver stable prices."
- "short-term interest rates are the predominant tool to achieve the dual mandate."

In the first of the above two principles, Warsh resolved the ambiguity he created in July when he cast doubt on measuring the price-stability objective against PCE inflation. He also made clear that the Fed can't just expect inflation to return to target on its own – it has the ability and the responsibility to bring about that outcome. The second of the above principles tacitly walks back his earlier musings about tightening through balance sheet policy (QT). If the Fed is going to bring down inflation, the overnight interest rate is the tool to use.

As for his assessment of the economy, he implicitly lined up with the hawks on the Committee who call for rate hikes by noting that he does not see financial conditions as restrictive: "Certain sectors—like housing and agriculture—are showing strains. But, on balance, I would be hard pressed to describe broad financial conditions as restrictive." Nor did he offer any argument for why inflation might moderate going forward, including via stronger productivity growth. Instead, Warsh simply offered a fact-based assessment of where inflation stands today:

> "Inflation is running above our 2 percent target. So the Fed's predominant focus right now should be on prices . . . And while this summer's PCE and CPI readings were better than expected, they do not tell me that underlying trends have meaningfully improved."

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And as he wrapped up the outlook section, he tied the inflation environment of the last several years back to his principle on the Fed's responsibility to achieve price stability: "The responsibility for 65 months of sustained, elevated inflation sits squarely with the central bank. And that is where it belongs."

We believe these communications, especially the principles that underpin his thinking, clear up a lot of the mystery about his reaction function. Linking these principles to his views on the economy, if it were not for his disdain of forward guidance, we would say Warsh is signaling a September hike. So we will put it this way instead: absent a collapse in the September payrolls print or an extremely weak September CPI print, we believe Warsh now has to support a September hike to maintain the credibility he is trying to win back with this speech.

For a few months now we have been projecting a hike at the December meeting, followed by two more in the first half of next year to restore a somewhat restrictive policy stance. Based on Warsh's speech, we have moved up our hike call to September, with additional hikes to follow in December and March. The destination for the policy rate remains the same, we just see the Fed getting there a bit more quickly.

Interest rate futures have also moved closer to discounting a September hike, pricing 65% odds at time of writing, up from 36% before Warsh's speech. One could argue that given sticky inflation and a stable labor market, the voting members who are already in favor of a hike, and the tone of this speech, the odds of a September hike should be much closer to 100%. Our interpretation is that investors have some lingering uncertainty around the Chair's willingness to follow through with action. We share this uncertainty, but in the end believe that not following through on this speech with a hike would deal too significant a blow to Warsh's credibility. Ironically, as with the more traditional forward guidance that he disdains, Warsh has to some extent tied his hands, at least when it comes to the September meeting.

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