Market Insights

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Is the Federal Reserve Losing its Independence?

When U.S. presidential nominee Donald Trump accused the Federal Reserve of political bias in 2016, then-Chair Janet Yellen was given some advice: “Grin and bear it.” Indeed, there is a demarcation line that separates the government from the Central Bank — since 1951, the U.S. Federal Reserve has largely operated independently. Today, however, driven by lingering inflationary pressures, there have been increasing cries for the White House to push the Fed to make policy moves to fix the perceived inflation problem.

Will the Fed surrender to these pressures? We suggest that an impatient implementation of monetary policy tightening, without any data to support inflation being out of control, will significantly increase the possibility of a hard landing. And, right now, the data doesn’t support a lingering threat of inflation.

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When U.S. presidential nominee Donald Trump accused the Federal Reserve of political bias in 2016, then-Chair Janet Yellen was given some advice: "Grin and bear it."[1] Indeed, there is a demarcation line that separates the government from the Central Bank — since 1951, the U.S. Federal Reserve has largely operated independently. Today, however, driven by lingering inflationary pressures, there have been increasing cries for the White House to push the Fed to make policy moves to fix the perceived inflation problem.[2] We suggest that Powell will uphold this sacrosanct of independence and not bow to political pressure, reiterating his stance that the "data" should drive any decision making on inflation. While price instability and hyperinflation are risks that central bankers need to control, the extreme tightening of monetary conditions that many are calling for would generate a recession and push the economy close to another deflationary episode.

A History of Central Bank Independence

Central bankers have been tasked with the challenging role of making monetary decisions that can sometimes be contentious and difficult for many — both governments and the public — to accept. They are not immune to the criticisms of their policymaker counterparts. Recall in the late 1980s when then-President Bush fired a warning shot at Allan Greenspan, suggesting that the Fed was overreacting to inflation fears by increasing interest rates. Greenspan's moves would later be blamed for Bush's defeat in the ensuing presidential election.

History reminds us of the extreme consequences that can be tied to the difficult decisions faced by central bankers when trying to normalize economic policy. Takahashi Korekiyo served as Japan's finance minister in six cabinets between 1913 and 1936 and is referred to as the Japanese Keynes.[3] He is prominently remembered for his success in navigating Japan's positive economic growth through the 1930s, while the rest of the world suffered from the Great Depression. Korekiyo instituted policies to remove Japan from the gold standard, devaluing the yen, cutting interest rates and coordinating monetary and fiscal strategies — all touted by Keynes — but long before Keynes released his seminal book, The General Theory of Employment, Interest and Money. Korekiyo largely transformed Japan's economy into a beacon of hope, the envy of the rest of the world. Yet, as he tried to normalize economic policy, he made the difficult decision to cut the military budget. In 1936, he would pay the ultimate price: the 3rd Imperial Guard's two most senior officers would kill Korekiyo in his bed as he slept. The events highlight how easily monetary and fiscal policies can become political and the extreme consequences that central bankers can face.

While today's central bankers have largely maintained independence, it hasn't always been this way. Prior to 1951, the Federal Reserve and the Treasury worked in tandem. However, this would all change under President Harry Truman's watch and as a result of WWII. Going into the war, there was an agreement that interest rates would be kept unusually low to allow the government to borrow money and finance the war. After the war ended, inflation skyrocketed. The Fed tried to limit this inflation, but Truman wanted to keep interest rates low. By 1951, he was engaged in an epic struggle with Federal Reserve Chair Thomas McCabe, who sought to establish the Fed's right to set an independent monetary policy. Truman, now at war in Korea, failed to force the Federal Reserve – who were fearful of another depression — to maintain a 2.5% limit on treasury yields. The result? The Treasury and Fed reached their famous "Accord."[4] This victory over fiscal dominance is often seen as the moment in which the modern, independent Fed came into existence and a new era began.

The Fed: Continuing to Assert Independence?

Will the Fed maintain this independence? Our thesis is that today's central banks — like their modern-day predecessors — will not bow to the abounding political pressures of the status quo, prophets and certain elected officials who suggest the need to take commanding and rapid action to fight inflation.

The minutes of the Federal Reserve's December 2021 meeting reveal a specific section on their discussion about policy normalization,[5] which may provide insight on the Fed's thought process. In the text, they explicitly state that no decisions regarding the Fed's future approach were made at the meeting and key to the discussion was the assumption that growth and price pressure would remain strong in 2022. As such, future analyses and any decision making would be data dependent.

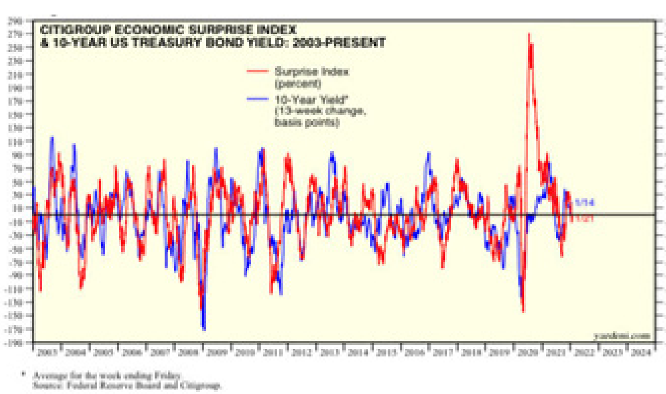
So, What Does the Data Show?

Slowing Economic Growth: A More Fragile Economy

While the narrative in the latter part of 2021 suggested that robust economic growth was to continue, recent indicators are pointing to a more fragile and slowing economy in the near term. With moderating economic growth, inflation will decline, not rise. In fact, we see today that long-term inflationary expectations continue to be well-anchored, despite what is happening on the frontlines.[6]

The Citi Economic Surprise Index (CESI), a gauge to measure whether economic data is beating or missing estimates, recently had a swift decline into negative territory, suggesting that the economic numbers are coming in weaker than expected. This index is sometimes seen as a leading indicator for bond yields.

Citigroup Economic Surprise Index (CESI): Falling into Negative Territory



The rapid peaking and flattening of the yield curve[7] also echoes the warning calls being shouted by the credit markets that the economic cycle is turning. Fixed income markets do not appear to believe that inflation is as big of a long-term problem as the status quo may believe.

Beware: Flattening Spreads Between 10-Year and 2-Year Treasury Yields

Too many of us may have forgotten (or chosen to ignore!) the deflationary forces and secular stagnation that lingered prior to the virus' proliferation — and these forces will be patiently awaiting us on the other side of the pandemic. To be clear, inflation was caused by two main factors: profound changes to both demand and supply as a result of the anomalies of the pandemic. On the demand side, the composition of demand was altered by Covid-19's shutdowns, with growing dependence on e-commerce, as well as the significant impact of economic stimulus packages, which are now running low. On the supply side, the pandemic slowed operations at all levels of the supply chain and exposed a global infrastructure in dire need of an upgrade. It's folly to assume that these issues will be alleviated in the short term by rapidly rising interest rates and contractions in the balance sheets of the central banks.

We must also remember that inflation is a *lagging* economic indicator, still measured against a period in which economies were adjusting to the anomalies of the pandemic. Moreover, we have yet to return to normal. Yet, we find ourselves in the company of the "Tik-Tok" generation, a growing population that possesses the need for instant gratification — and perhaps our propensity to be patient is quickly becoming extinct. Let's not forget that we haven't overcome the pandemic — by this fact alone, disagreements about whether inflation is "transitory" are specious. Why can't inflation still be transitory, if we are yet to transition back to normal?

The Need for Patience: Lessons from the Post-WWII Recovery

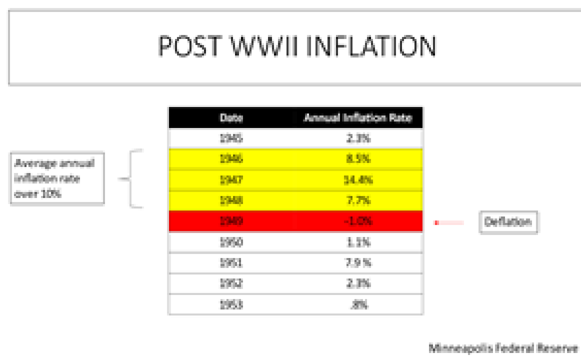
Indeed, patience may continue to be the central bank's virtue. History reminds us of the importance of patience in rebuilding after traumatic and consequential events. The post-WWII reconstruction phase provides guidance on what we may expect during periods in which economic growth and inflation are highly volatile. Ironically, too soon we forget how many were calling for aggressive central bank action back in March of 2020, comparing the pandemic to WWII. These are the same pundits now ignoring the long-term scarring effects that the pandemic has had on economic growth and consumer preferences.

In the post-WWII reconstruction era, concerns about the re-emergence of populism, technology transfers, a 40% increase in population, strong fiscal policy programs and the development of a new rule-based global order all led to a decade of high and volatile inflation. Between 1946 and 1948, the U.S. economy experienced three years of strong inflationary pressures averaging over 10%. The Fed could not raise rates, but, finally, after three years of inflation they rapidly contracted their balance sheet by close to 12% to attack inflation, sending the economy into a recession and reintroducing deflation.[8]

The lesson learned is applicable today. The use of balance sheet reduction should be considered as the primary tool to control inflation — and not interest rates. Doing so could help support growth, as well as eliminate the unintended consequences of a strong USD with respect to the developing world, specifically Hong Kong and China, both with currencies that are fixed to the USD.

To wit, our thesis is that if the Fed succumbs to pressure and aggressively tightens its policies in a similar fashion, the economy will go into a recession and deflation will once again rear its ugly head. This is what history suggests. Consider also that in the post-WWII period, the Fed was patient and balanced, but waited for three years! We certainly don't anticipate that inflationary pressures will linger for a similar period — in fact, by the back half of 2022 we expect them to have rapidly declined. As the shock from the Covid-19 pandemic begins to dissipate, so, too, will the inflationary pressures. Rate hikes can't solve the pandemic-related shocks and losing patience will have dire, unintended consequences, just as we saw in the post-WWII period. To be clear, the amount of tightening that central bankers can do before they damage economic recovery is much less than the consensus believes. This was the case in the late 1940s, and it continues to be the case today. The forecasts by central banks suggest that inflation, the core PCE, will be 2.3% by the end of 2023 — a far cry from the inflationary shock experienced in the post-WWII era.

The Post-WWII Example: The Risk of Tightening Despite Three Years of Patience


POST WWII INFLATION

Date	Annual Inflation Rate
1945	2.3%
1946	8.5%
1947	14.4%
1948	7.7%
1949	-1.0%
1950	1.1%
1951	7.9 %
1952	2.3%
1953	.8%

Minneapolis Federal Reserve

What Does This Mean for Investors?

As we have suggested in the past, investors need to continue to separate the signal from the noise. Our 2022 playbook is based on the simple assumption that central bankers will maintain their political independence and be data dependent. The world will continue to gradually learn to live with Covid-19, economic growth will slow, inflationary pressures will decline and the economy will achieve a soft landing.

We expect markets to continue to be volatile in the first half of the year until enough data is revealed to answer the simple question: are long-term inflationary expectations spiralling out of control? If so, it warrants a fast and extreme episode of raising interest rates and contracting the Federal Reserve balance sheet. Yet, an impatient implementation of monetary policy tightening, without any data to support inflation being out of control, will significantly increase the possibility of a hard landing. Namely, a recession and deflation.

However, we suggest that inflationary pressures will temper as the months pass by. If the Fed remains true to their proclamation that they are, indeed, data dependent, consensus will likely be found to have been too aggressive in pricing in rate hikes and the contraction of the balance sheet. Until the credit markets process enough data to make this determination, a defensive posture within a portfolio is recommended. The good news for President Biden is that inflationary pressures, left to their own devices, will be substantially lower by the mid-term elections, which should help him in the polls. Many will be surprised at how quickly they will decline. Yet, in this instant gratification world, waiting until the late spring or early summer seems an eternity.

The data will allow the Federal Reserve to walk back on its hawkish posture and have a light touch to ensure growth continues. Once the Fed pivots, there will be a focus on reducing income inequality and providing an environment for the economy to evolve into a digital green economy. Investors should consider the rebalancing of portfolios in the latter half of 2022, moving away from defensive sectors and towards growth sectors, including technology and green names. By our accounts, by year end 2022, the S&P 500 will achieve our target of 5,300.

In the midst of a continuing pandemic — one that has lasted much longer than many of us expected, and has tested our patience and resolve — can Mr. Powell and the Federal Reserve grin and bear it?

— James E. Thorne, Ph.D.

1 CNBC interview of Alan Greenspan, Mathew J. Belvedere, October 6, 2016.
2 CBS January 16, 2022 poll: President Biden has a 70% disapproval rating on his administration handling of inflation.
3 John Maynard Keynes is seen as the economist who fundamentally changed the practice of macroeconomics and the economic policies of governments.
4 March 1951, the U.S. Treasury and the Federal Reserve reached an agreement to separate government debt management from monetary policy.
5 Minutes of the Federal Open Market Committee, December 14-15, 2021, released January 5, 2022.
6 5-Year-5-Year Forward Inflation Expectation Rate of 2.07%. This measures the expected average inflation rate over the five-year period that begins five years from today.
7 The relationship between the 2-year and 10-year treasury yield.
8 The Fed did contract its balance sheet between 1946 and 1948, translating to around a $300 billion reduction in today's dollars.