Federal Reserve Update 26/8/2022

During the economic policy symposium "[Reassessing Constraints on the Economy and Policy]" in Jackson Hole, Fed Chair Powell spoke for 9 minutes out of his allocated 30. In this short Signal, I will break down what he said along with possible ramifications.

Disclaimer: Not financial advice. Please conduct thorough research before making investment decisions.

Powell's key statements

- The Federal Open Market Committee's (FOMC, the committee that decides the interest rate) overarching focus right now is to bring inflation back down to our 2 percent goal.
- The Fed is "data dependent" for September's FOMC meeting
- July inflation numbers (CPI) are not enough to change Fed's views (they won't pivot their policy, yet)
- The Fed will require a more restrictive policy for some time (Interest rate will keep increasing)
- The Fed is likely to slow the pace of rate hikes at some point as the stance of monetary policy tightens further (severity of interest rate increases will decrease the higher interest we reach, i.e. instead of a 0.75% interest increase, we might get a 0.5% interest increase, etc..)

Analysis

When a currency inflates, confidence in the currency decreases. The Fed has been inflating the dollar for the past 15 years with a 0% interest rate creating an unsound boom. The Federal Reserve reversed its inflationary policy around the time the Ukraine war started by increasing interest rates which resulted in high confidence in the dollar, as we can currently see by the DXY (U.S. dollar index, price of dollars compared to other currencies), making new highs on most currencies. Today, Powell gave away his endgame strategy, that the Fed is ready to reflate the dollar (by lowering interest rate) sometime in the future (when they decide that inflation is at an acceptable level).

The news of the Fed retaining its tightening policy for longer (keep increasing interest rates) is the opposite of what the market has anticipated, causing the selloff in stocks & crypto. More info on what the market expected from the Fed can be found in the Market Insight of our August 2022 members-only newsletter.

Until now, we are noticing that the U.S. economy is weakening faster than inflation, which means an increased chance of higher unemployment and stock & bond markets crash. A big enough crash/unemployment would force Powell's hand to reflate regardless of the inflation numbers (If a stock market crash occurs due to an increasing interest rate, the Fed will be forced to lower the interest rate even if inflation is still above their 2% target).

If CPI (inflation) numbers increase unexpectedly, even with the current deflationary policy, the market will likely crash bonds, stocks, and the dollar without the Fed having to pivot its policies.

The argument that inflation won't come down because of a too strong economy and that inflation is a byproduct of a strong economy is invalid. Inflation is caused by the reckless printing of money and **NOT** magically caused by having a strong economy. The economy is shrinking as a result of the Fed's deflationary policy (increasing interest rates), starving malinvestments and zombie companies (malinvestments & zombie companies being the result of a decade of artificial boom caused by the Fed's inflationary policy) from liquidity, at the expense of growth. Following this unsustainable growth in zombie companies & malinvestments, when the Fed increases interest rates to lower inflation, these zombie firms will eventually shut down and thus shrink the economy.

Summary

To summarise, the market expected the Fed to give up and inflate (lower interest rates) after a couple more rate hikes, which is why the markets rallied after the last FOMC meeting. Today Chairman Powell "burst the market's bubble" by telling everyone of the Fed's plans which is that they will have to keep increasing interest rates till inflation is controlled, and only after then would they lower interest rates. The market assumed that the Fed would taper (flip their policy and lower interest) at around 3% interest, but Powell told them that the current interest is 2.5%, and inflation is still 3 times that (meaning there are still a lot of hikes to go).

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