Daiwa Securities

Daiwa's View

Stuck at a dead end

- Found a way out of a difficult situation

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Found a way out of a difficult situation

The market reaction after the Jackson Hole conference was one of across-the-board buying. With the S&P 500 Index hitting a record high, US Treasury yields declined for a second straight day. Credit spreads also fell back to a record-low level. As this across-the-board buying is a typical market reaction when central banks' monetary easing strengthens, the market regarded Fed Chair Jerome Powell's speech at the Jackson Hole conference as dovish.

Was this reaction a result of a well-considered interpretation of the Jackson Hole speech? The answer is, "Yes and no."

Many prominent economists, including Mohamed El-Erian, sternly criticized the speech by Powell. Given the current situation, in which a surge in real estate prices is leading to higher rents, we think that emphasizing existing views of transitory inflation and downplaying upside risks lacks the sense of caution and balance that are needed for monetary policy operations. It's probably natural for experts of a certain caliber, not just Mr. El-Erian, to express concerns regarding the lack of risk balance in the speech and possible risks in the future (financial imbalance and a surge in volatility). (Yesterday, our senior economist Kenji Yamamoto also pointed out similar risks in this report, albeit modestly.) In that sense, the answer to the question above is "No."

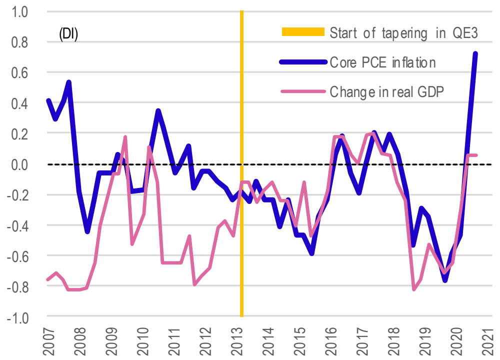
However, what else could Powell have done? In the Jackson Hole speech, which was his final test for getting reappointed as chair, he needed to avoid arousing antipathy from left-wing radicals in the Democratic Party (who are recommending Lael Brainard as chair). Therefore, the speech inevitably had to be supportive of the policies on which the left-wing radicals are focused. If he had expressed excessive consideration for inflation risk, that would have created discrepancies with the dovish stance that had to be expressed now in order to gain approval from the left wing. In that sense, Powell appeared to have been stuck at a dead end from which he couldn't extricate himself on his own.

Was there a way out? It would seem that he managed to find one. Some hints are provided by the fact that several regional Fed presidents, such as Esther George and Robert Kaplan, suddenly made hawkish comments one after the other ahead of the Jackson Hole speech. Some market participants seem to be ignoring them as assertions by regional Fed presidents with extreme views and no voting rights. However, such remarks make sense if we see them as a kind of implicit division of roles with Powell, who was in a difficult situation—he needed to downplay inflation risk regardless of his actual opinion.

One thing we can refer to is the hawkish comments on 4 August by Fed Vice Chair Richard Clarida, one of the troika members, which acted as a check against the excessive receding of rate-hike pricing. (At the time, the 5-year US Treasury yield was about to fall below 0.6%.) If the Jackson Hole speech were based on this 'division of roles,' focusing solely on Powell's remarks would lead to a misjudgment about the key point.

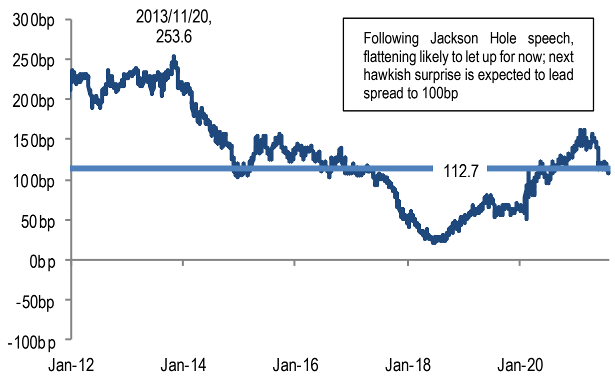
In addition, Powell used more than one third of the speech to provide a detailed explanation of his view that current inflation was transitory. He then emphasized a stance of separating the timing of tapering from that of an interest rate lift-off. If one were to try to draw an insightful observation from this, one could view him as having laid the groundwork for revision of the rate-hike stance if inflation projections diverge from what they are now. (If he is really downplaying inflation risk, what was the surge in the DI of risk weightings for inflation indicated in the June FOMC meeting?)

DIs of FOMC Participants' Risk Weightings (GDP, inflation)



Source: Fed; compiled by Daiwa Securities.

5Y/30Y US Treasury Spread



Source: Bloomberg; compiled by Daiwa Securities.

All considered, it is possible that Powell created the speech to gain reappointment and approval from left-wing radicals by strategically and intentionally downplaying inflation risk, and also finished laying the groundwork for his next move. If he finds solid proof of the materialization of upside risks to inflation, all he has to do is revise his stance. If he doesn't find such proof (if inflation is really transitory), all he has to do is maintain a dovish rate-hike stance. In that sense, the impression I get from the Jackson Hole speech is that he skillfully found a way out of a difficult situation. With the initial projection that inflation is transitory changing, we need to be cautious about a hawkish surprise in the future, regardless of the fact that Powell emphasized a dovish stance in Jackson Hole.

Based on the thinking above, what kind of investment behavior is appropriate? It should be noted that "when there's nothing clever to do, the mistake lies in trying to be clever" (Howard Marks). While the music continues to play, we are forced to follow this trend (while paying as much attention as possible to inflation trends that could trigger a sudden change in stance), even if prices exceed the fair value. This kind of investment behavior can also occur as a result of thoughtful and rational consideration, rather than shallow thinking or credulousness. In that sense, the answer to the question at the outset of this report is "Yes."

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