Danielle DiMartino Booth: Jay Powell is a new breed of Fed Chairman

August 30th 2018

Erik: Joining me next on the program is Danielle DiMartino Booth, author of *Fed Up*. Danielle and I spoke off the air and agreed since we already did a full-length interview on the book we're going to leave that alone.

But, before going on, I just want to suggest to all of our listeners that if you missed that interview, it was an excellent one. *Fed Up* is an excellent book. It's the inside story from Danielle's experience at the Dallas Fed talking about how the Fed works from an insider perspective. It was a fascinating book. I couldn't put it down.

We've decided not to focus on that though. You can go back and listen to that entire interview. It's still there, free of charge at macrovoices.com.

Danielle, let's move on. That book was entirely about the historical perspective of all the things that have been wrong with the Fed in your experience and you've been very outspoken in your critique.

There is a new horse in town, though. Jay Powell is a different kind of Fed Chairman, or so it would seem to a lot of people. What's your take on Jay Powell? Is this guy a different story? Are you optimistic? Or is it more of the same?

Danielle: I'm cautiously optimistic. I have not founded the Jay Powell fan club just yet, but many of the things that he has done since becoming Chair of the Fed, I predicted that he would do and held my breath. And then he did them. So I'm happy as a barking seal.

One of the first things I wrote about him was that he had no agenda at all. He did not have to be at the Fed. This is a gentleman who worked for a dollar salary to educate the Congress on the perils of the United States defaulting on its debt.

And has absolutely no political fight to pick. He has no economic agenda. He's not a PhD in economics. He doesn't sit in a Keynesian camp or an Austrian camp, for that matter. He's a pragmatist with a markets background and appreciates the intersection of the two.

And he also cares for taxpayer dollars, because one of the first things he did, which I implored him to do, was to implement a press conference after every Federal Open Markets Committee meeting, which, as we know, is beginning in January. So that means we have eight live meetings a year instead of what we have been contending with since Bernanke imposed the press conference at every other FOMC meeting policy years ago.

Erik: Now, the Jackson Hole retreat that the Fed holds in August at Jackson Hole, Wyoming, as I understand that, it's kind of a get everybody together so that the entire global community of central bankers have a chance to have a powwow and talk to one another and so forth. This was Jay Powell's first Jackson Hole, kind of an important thing. Mario Draghi, the head of the ECB, and Haruhiko Kuroda, the head of the BOJ, the two other major central banks in the world, didn't show up.

Is there a message there? Is this something that we should be concerned about? Is it a vote of no confidence in Powell somehow? Or did these guys just happen to be busy doing something else in August?

Danielle: You know, I'm really not sure, but I will say that there is no such thing in this life of ours known as coincidence. So I certainly think that there was a message to be communicated in their not being there. I don't necessarily think that the philosophy of the old-school Keynesian doves – more is more, print, print, print – I don't think that that necessarily aligns with Powell's views.

If you'll recall from just the year before – or maybe it was two years ago, I can't recall which – but one of the most famous pictures was Yellen and Draghi and Kuroda walking down a path in Jackson Hole and laughing with one another. Those were probably three of the most prominent doves in the world at the time.

So I don't know if it was something as simple as philosophical differences on how monetary policy should be made, or if it was more – this is when Trump had just called the Fed out and was definitely putting the Fed under a lot of scrutiny, and I'm not so sure that they didn't want to avoid it for political reasons, given the fact that the trade war had not been resolved at that point. And it still remains unresolved.

Erik: I want to come back to the trade war, but let's start with Powell's performance. He was there, certainly, at Jackson Hole. What did you think about the way that he conducted himself and the policy decisions and discussions that occurred there? How would you rate him as opposed to some of his predecessors?

Danielle: Well, he was extremely plain spoken. So you didn't need to get Google Translate to read his speech. You were able to read it from top to bottom and understand exactly what he was talking about, even though it was certainly nothing of a lightweight speech. He very much put on show the fact that he has become an astute student of economics since he joined the Fed in June of 2012.

But, by that same token, he also raised some issues in that speech that I think very few picked up on, one of which was the fact that he noted that the prior two downturns had been preceded by signals that were emanating from the financial markets that were not inflation-related at all. And therefore the Fed should be mindful of indicators other than inflation in helping them set monetary policy going forward. And that is truly a departure from the orthodoxy we've had since Greenspan took office over 30 years ago.

Erik: Let's come back to the trade war subject. President Trump has declared that trade wars are easy to win, making it so simple, it would seem – at least in a tweet. That kind of throws a lot of baggage into the central bankers' laps.

If all of a sudden trade wars are easy to win and not challenging, which not too many people seem to agree with President Trump on, what are the implications in terms of monetary policy and what central bankers will face in this political environment where the president has declared that trade war is a good thing and they're easy to win?

Danielle: I think what it does for the Fed is complicate their mission, especially because the old Fed would say that they were data-dependent but they were truly model-dependent. Powell is a departure from that in that he is truly data-dependent.

And when you introduce a trade war that is going in many different directions with many different countries – the dollar is stronger, the dollar is weaker, interest rates are up, interest rates are down, Turkey is blowing up, Argentina is blowing up, inflation is up, inflation is down. This noise is one of the most distracting, debilitating factors that complicates a central banker's task of making monetary policy to ensure stability.

The way Trump has gone about fighting this trade war that he instigated has introduced volatility to monetary policy makers' tasks. I don't envy Powell and the others on the committee with what they're being tasked with, given all the noise they're having to wade through.

Erik: A lot of people had predicted that when eventually we got to quantitative tightening, the phase that we're coming into now, that would mean that the benefit – the tailwind, if you will – for the stock market that we've felt for the last several years would reverse to a headwind.

And some people have even predicted an outright crash in equity markets as quantitative easing is replaced by quantitative tightening, which, put another way, is the unwind of quantitative easing.

Are you concerned about the outlook for equity markets as we move into this? And what do you see on the horizon from the Fed, from the ECB, and the Bank of Japan into yearend in terms of policy and how it's going to affect equity markets?

Danielle: If all goes according to the plans that were laid out originally at the start of the year, we should have the liquidity that flows into global financial markets cut in half from $2 trillion in 2017 to $1 trillion in 2018. I was one of the people warning that there would be highly detrimental effects of this reversal of policy.

What I had not anticipated – I'm not so sure that anybody anticipated – was the ease with which the tax bill was passed through Congress, given it was somewhat potential political tinder, and the fact that the worrywarts who were concerned that the bulk of the money that came back onshore via repatriated profits would go into share buybacks. Really, it's happened as the people were worried that it would happen. And it's gone very quietly into the night because it benefited the stock market.

So I don't know that we can necessarily say that equity markets, that the stock market right now is reflecting quantitative tightening. But I don't think there is any doubt that the bond market is.

Erik: Let's take a look at the US dollar. Over the last few weeks, we saw the dollar break out after fighting resistance at 95 for about three months. We finally saw that decisive breakout on the 10th of August. It took us all the way up to just barely testing 97 on the dollar index. But now we're back down below 95 again.

And I think some people are starting to question whether or not the Fed is going to stay the course on tightening. I think some people are getting concerned that an appreciating dollar poses risks to emerging markets. And, of course, President Trump has been very outspoken saying that he wants to do everything that he can to avoid letting the dollar appreciate too much.

Do you think that dollar appreciation is part of what is coloring the decisions that Fed policy makers are making? And how much do you think the direction of the dollar is going to influence their decisions going forward?

Danielle: I think right now the dollar is much more a manic reflection of the day-to-day news flow in the trade talk. I think if you look at the correlation, that's where they're kind of tied at the hip. I don't think that the dollar is going to sway the Fed one way or another as much as the fact that animal spirits have run wild and inflation appears to truly be in the cards and well above the Fed's target with every single metric except for the Core PCE.

Erik: Danielle, let's tie all of these concepts together and get your overall view as to where we're headed for the rest of the year in terms of the economy. And, particularly, you mentioned some discontinuity between the stock and bond markets.

Do you expect that to continue? And what do you see on the horizon there?

Danielle: I think that the long end of the yield curve, I think the 10-year benchmark Treasury is telling us one thing about the future. And I think that the 2-year is telling us something completely different, and I can't disregard as so many people have suggested the message in the differential between the two – because it's kind of hovering around 20 basis points, which is a dozen-year low here.

I think what it is saying is that if you look at producer price indexes, even on a global basis, they look as if they've peaked and they're starting to come back down. When I think of producer prices – and I think that this is a great benchmark – I associate them with growth.

And I think that producer prices are being reflected in the 10-year. They're coming off their high. Yields are coming off of their highs. I think that that is advertising that, after the sugar high of the fiscal stimulus that we've had, after the sugar high of the repatriated profits makes its way through the share buyback pipeline, after that happens, then what for the economy? Then where are we headed?

Again, I think that that is the quandary that we're seeing in the 10-year's inability to cross 3%, to say nothing of the fact that every time it does, an emerging market blows up. But, by the same token, the other benchmark that I look at to gauge the Fed is the consumer price index, which lags far behind the producer price index. You can think of a pig going through a python.

So what we're seeing with the 2-year being very resilient is the fact that it looks like the Fed is going to be chasing inflation. We know September the 26th is going to happen. It's fully priced into the markets.

The question then becomes one of is it going to be December or is it going to be January? Because I do think it's going to be one or the other. Unless, as Jay Powell says in his data dependency, we see the economy fall off a cliff in the fourth quarter. And I'm increasingly concerned that that is going to happen.

The two leading sectors of the economy – automobiles and residential real estate – have already begun to advertise that the best for the cycle has come and gone. And that typically presages economic slowdowns.

Erik: So you have a fairly bearish outlook for the fourth quarter. And it sounds like your view is that the Fed is – if they see this in their data – likely to change course.

I want to come back, though, because you started this with a discussion of consumer and producer prices. A lot of guests that we've had on the program have said they think that this inflation scare that we're seeing is a head-fake, that it's not going to last. Others have said, no-no, it's the beginning of a secular increase in inflation.

How do you see this?

Danielle: I would like to think that the economy could withstand a period of rising prices. And that the economy could withstand the higher interest rates that went along with it. But, again, I think that I would put myself a little bit more in the head-fake camp. Again, because of what producer prices are doing.

So producer prices are advertising loud and clear that, as soon as the supply chain disruption is rectified, as soon as the inventory rebuild has come and gone – we've seen extraordinarily strong inventory numbers, just these last few days in fact – and that's going to filter its way through to stronger than expected third-quarter GDP growth.

But as soon as you have that inventory rebuild – and because we've seen a lot of prices come off of the super-high levels as resolution is found with Europe, as resolution is found with Mexico, and it looks like resolution will be found with Canada – at some point it really is going to just be a big fight going on between the United States and China.

As the tariff scare comes off of a high boil, so will the panic buying that accompanied it come off of that same thing. And so the impetus is going to be for prices to come back down.

Erik: And you say as soon as we come off of a high boil it sounds like you think that the trade conflict with China is mostly at a negotiating phase right now. We're going to get to the point where everybody calms down and backs off of the strong positions that they're talking.

Am I interpreting you correctly?

Danielle: Well, I think what some sage advisor has told the President is a fact. And that is that we can afford the trade war much better than China can. And, because they depend as much as they do on being a critical cog in the global supply chain, and because they continue to depend as much as they do on their export sector, I think that somebody has told the President that he has the upper hand in negotiations and that if push comes to shove in this game of "chicken" that China will back down.

Now, we don't know that that's going to be what the end result is. But I think that that is how he is being advised and that is why we're seeing other opponents with whom he had a trade or tariff beef begin to fall like flies. And, again, I think the last man standing is China.

Erik: And what other risks does this pose to smaller emerging market economies as this game of "chicken" is playing out?

Danielle: I think that countries that depend on China having a robust economy at all times, which they can typically engineer if they're not fighting a trade war on the side, I think that the real risk is to commodity exporting nations such as Australia, such as Chile, and what the implications hold there.

But as far as emerging markets go, I would go back to our earlier discussion about the dollar and about whether or not the 10-year can break 3% to the upside.

Because, again, when you're talking about emerging markets, at least in my view, if you're talking about a country like Turkey, you're talking about dollar-denominated corporate debt that got it in trouble. In other countries it is dollar denominated sovereign debt.

But, again, the common denominator here is the fact that it is an overabundance of dollar-denominated debt. So I think it is the 10-year that people are going to key off of, and/or how aggressive they believe the Fed is going to be, and whether or not that strong dollar causes a teetering emerging market to be toppled.

Erik: Danielle, let's move over to Europe and look at the situation the ECB is in. They have at least advertised their intention to wrap up their tapering and move toward a quantitative tightening phase which the Fed has already begun.

What does that mean for the ECB? And, particularly, for Mario Draghi's successor?

Danielle: I think that the situation is becoming increasingly tenuous for the ECB, for Europe. There are several different moving pieces, one of which is the fact that the Germans, even the most hawkish Germans, contend that we won't even see the first rate hike – assuming the taper ends by December – that we won't even see the first rate hike until the end of next summer.

So we could be talking a year from now and still have their discount rate at a negative 0.4%. And, even after that first rate hike, the assumption is that they would only take it up to negative 0.2%.

So I have written in my weeklies, I've written in my dailies, about the prospect for economic textbook writers of a major economy going into recession potentially following other countries as they teeter going into recession with negative interest rates. That will present policy makers in Europe with a huge conundrum.

Because one of the reasons that they are having to push through with the taper – because Draghi is the most dovish person on Planet Earth, but one of the reasons that they are having to push through with the taper is mechanics. They are simply buying too much of these markets.

And they are learning that they potentially have other ticking time bombs – like the company that was downgraded to debt and it looks like it's going to be liquidated – that they had bought and put onto the ECB's balance sheet.

There is so much uncertainty going forward because they're moving so, so slowly.

And then you look at the lead German contender, who is now in fourth place. A few months ago he was in first place. Again I think that replacing Mario Draghi is becoming an increasingly unattractive proposition. And that's just one of the moving pieces.

The other one – my maiden name being DiMartino, so I can say exactly what I want about those crazy people in Italy because I'm one of them. But the other problem, I think, is Italy. And they've recently polled the public, and public support for the new government has not wavered one bit.

And they continue to heighten the rhetoric. And we know that the economy in Italy is slowing anew, that youth unemployment remains a huge problem, and that the new leadership remain focused on the Euro and the debilitating outcome of Italy having moved to the Euro and the fact that it can't therefore print its way out of its massive debt load.

So I worry about the future of Europe, given the fact that their bond market is so much more overvalued than ours is. And the fact that so few investors really pay attention to that dynamic and how it could possibly bleed into our market one day. And why we should pay close attention to places like Deutsche Bank and their derivatives books.

I can't believe I'm saying something like this as we approach the 10-year anniversary of Lehman Brothers.

Erik: Let's talk a little bit more about that situation. Because I couldn't agree with you more that the European debt situation – and it's not just sovereign debt. There was a story on Zero Hedge – I can't remember the name of the company, but there are actually European junk bonds, corporate junk rated bonds, that are yielding lower than the US 10-year. And it's just shocking that you have that kind of overvaluation.

It seems to me like European junk corporates are the bubble – I guess what I'm really asking is what is the thing that's most ready to pop? If you had to short something – and, of course, shorting any kind of high-yield is dangerous because you've got such a big carrying cost – what's most ready to pop?

What's the thing that it is most at risk? Is it European sovereigns, the negative-yielding sovereigns that we have in Europe? Is it the very low-yielding junk that we have? Where is the real low-hanging fruit for a short seller who is waiting for this all to blowup?

Danielle: To your point I would add that European corporate junk bonds are not just on their face extremely overvalued, it's also an infantile market. In prior cycles, the European corporate sector depended predominately on the banking sector to provide most of the funding and financing.

So it's not just a matter of the price and the overvaluation of the paper and how rickety the underlying collateral potentially is. It's also the fact that this is an untested, very young market to have had investors crowd into it as they have.

I'm not so sure that Mom and Pop investors here in the United States don't sleep well at night thinking, well, gosh, that's Europe. I go to Europe. I don't worry about going to Europe, so surely European bonds are good too.

Again, I think that there is a lack of awareness among US investors in terms of what they own and where it is and what the potential is for capital losses. Because in a generation we haven't had to contend with capital losses in bonds, because we've had interest rates ticking down towards the zero balance for as long as anybody in their careers can remember.

Erik: And as long as anyone has ever had experience with. We don't have anyone living in professional finance now who's been through this in the other direction. I guess that really makes me wonder, when this does turn around and we see that secular change in interest rates, which a lot of people think is just around the corner, it really is going to introduce a new paradigm for everyone to get their heads around.

Do you have any thoughts on where the trade is here? Is it a pairs trade that's long US 10-year and short European sovereigns? Or is it European long sovereign versus short junk? Where is the trade?

Danielle: I wouldn't be long much of anything in the European bond market, whether it be sovereigns or not. Just because, again, the situation that you outlined in Italy. I am intrigued by the naysaying. In fact, this is what I'm going to write about in my next weekly newsletter.

Right now, we're being told to discount two things as investors. We're being told to discount the yield curve. There have been reams of reports that come off of Wall Street that have said the yield curve does not matter, we need to disregard it and carry on.

And now we have another school of thought that says that we need to disregard the record short position in US Treasuries, specifically the 10-year.

I get really worried when stories that say "it's different this time" begin to multiply like bunnies.

Erik: Well, it certainly is a very difficult question on my mind as to what's going to happen with this 10-year yield next. Because it is record short interest. But, frankly, Danielle, I think sometimes people lose sight of the fact that those Commitment of Traders Reports are describing the short or long interest in Treasury futures.

The Treasury market itself is much bigger than the Treasury futures market. And I think that that misleads some people. But I still wonder what's going to happen here because there's a good case for Treasury yields to move higher. But there's plenty of strong argument for a short squeeze. I've been waiting for one and I've been surprised that it hasn't happened yet.

Danielle: Yeah, I have as well. But, again, sitting at 20 basis points differential between the 2-years and the 10-years just tells you that, even though the 10-year hasn't come crashing down, that the 2-year has maintained a lot of support holding that 2-year yield up.

So, again, I look out towards the fourth quarter. And, absent some massive DC-based stimulus, and given the fact that we just had another disappointing pending home sales figure, buyers are truly stepping back. Drive around any neighborhood in America and you'll see that the For Sale signs are popping up everywhere.

And sometimes – as Warren Buffett once said, you need to be able to kick the tires – some economic data should be *prima facie*. It should be in your face and start to communicate to you: Okay, something is wrong with this picture.

And, again, I can't see over the horizon into the fourth quarter and tell you with any conviction what is going to propel, fundamentally, the US economy into the next stage.

Erik: Danielle, we introduced you to our audience as the author of your excellent book, *Fed Up*. But that was backward looking, at what the history of the Federal Reserve has been.

You have, since your last interview, launched a new business, which is Quill Intelligence, that's more forward-looking than backward-looking. Please tell us about it. What have you got in the works?

Danielle: What I learned from being on Wall Street about Wall Street research, and especially about economic research, was that it tended to look backward. If you can't seasonally adjust the data series, well then it's disqualified automatically. What good does that do investors?

So Quill Intelligence is a company that has been founded on trying to anticipate and find where we are, constantly ask the questions, look for the leading indicators to see where we are in the cycle – good, bad, or in between.

And that's why some of the discussions that you and I have had today – a lot of it's been guided by what I learn on a day-to-day basis. That the number of buyers who are encouraged by home prices has come crashing down while the number of sellers who are anchored by rising prices has gone way up, that tells you a lot more about, for example, where the housing market is headed than any kind of a lag existing home sale report might. To say nothing of what a realtor's opinion is going to be.

I could go on and on, but my point is the reason that we founded Quill Intelligence was to provide individual Mom and Pop investors – it's called the "Daily Feather" – with something that's going to be written in plain English that does not look backwards, but rather looks forward into investing and economic trends, that is an easily digestible four-and-a-half- or five-minute read with a chart they're not going to see anywhere else.

The uptake has been absolutely tremendous, as well as the feedback. I was on the floor of the New York Stock Exchange and somebody walked up and said, hey, you're that "Feather" woman. And I said: Yes I am.

So I like to say that we are launching a research revolution. And there is no hyperbole there. We're going to change the way research is conceived and delivered.

Erik: I don't know that I would dare to walk up to a Texan and say, "You're that 'Feather' woman aren't you?" I would fear the consequences.

I want to thank you, though, for being as generous as you've been. Not only have you launched this new business which, obviously, is a paid subscription. But you have made several issues of the "Daily Feather" available to our MacroVoices listeners.

Listeners, you'll find download links in your Research Roundup email for some sample issues. You've got several of them here. One is about auto price shock in the making. You've got another one about credit cycle word association. You've got another one about the journey to the core of inflation. And so forth.

Give our listeners a sense of what they can expect to find when they check out these sample issues that you've included for us.

Danielle: They can expect to find a tiny bit of history on a given economic indicator. And then, hopefully, at the end of every "Feather" that you read you come away saying, gee, I never thought that X was connected to Y, but I'll never forget it going forward.

That's what we want. We want readers to attain financial literacy but, at the same, time start – like Russell Crowe in A Beautiful Mind – start to connect areas of economic data and financial markets that they didn't really think about before.

Erik: Once again, the name of the newsletter is the "Daily Feather." There are several links.

I want to thank you again for a fantastic interview, Danielle. And I also want to remind our listeners to go back and check out Danielle's prior interview which is entirely on the subject of *Fed Up*, her book about her experience as an insider at the Dallas Fed, which was a fascinating interview.

Danielle, thanks so much for another great interview. We look forward to having you back sometime soon. Meanwhile, Patrick Ceresna and I will be back as MacroVoices continues, right here at macrovoices.com.