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Economy Macro Update

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"Clarity of thought is a must for clarity in speech."

Cicero

After the negative market reaction to Chair Warsh's July 29 press conference, it was only a matter of time before he tried to regain control of the narrative. The effort has now begun.

The Damage Control

According to a report in the Financial Times, "People close to Warsh said he acknowledged that he had made mistakes in his first 10 weeks at the helm of the world's most important central bank, including failing to reinforce his key messages on price stability and sowing confusion over whether his longer-term plans to reform the Fed could affect near-term policy decisions."

Most importantly, the report suggests "Warsh would be prepared to raise interest rates at September's meeting if inflation readings released in coming weeks are hot, and markets ratchet up their expectations for increases in borrowing costs, the people familiar with his thinking said."

Further muddying the waters, however, the FT writes "But they insist those errors do not warrant reversing course on his shake-up of the Fed, which has missed its 2 per cent inflation goal for more than five years. A pillar of Warsh's strategy is drastically reducing policymakers' guidance to markets, a plan he has repeatedly emphasized following last Wednesday's Fed meeting." It remains to be seen whether Warsh can satisfy the markets and still stick to his plan of reduced Fed guidance.

In that regard, other Fed officials have been talking tough on inflation since the July meeting. These include not only the three July dissents (Logan, Hammack, and Kashkari), but other voters (Paulson, Cook) that might be shifting into the hawkish camp. An interesting dynamic has developed whereby the Chair foregoes forward guidance even as many other Fed officials continue to embrace it. As we have stressed many times, the FOMC is made up of members and Chair Warsh is just one of twelve.

That said, this exercise in damage control will all come down to the upcoming data and their impact on market expectations for Fed policy. We get two months of topline data before the September FOMC meeting and much will depend on how those reports come in. Much will also depend on whether the bond market forces the Fed's hand.

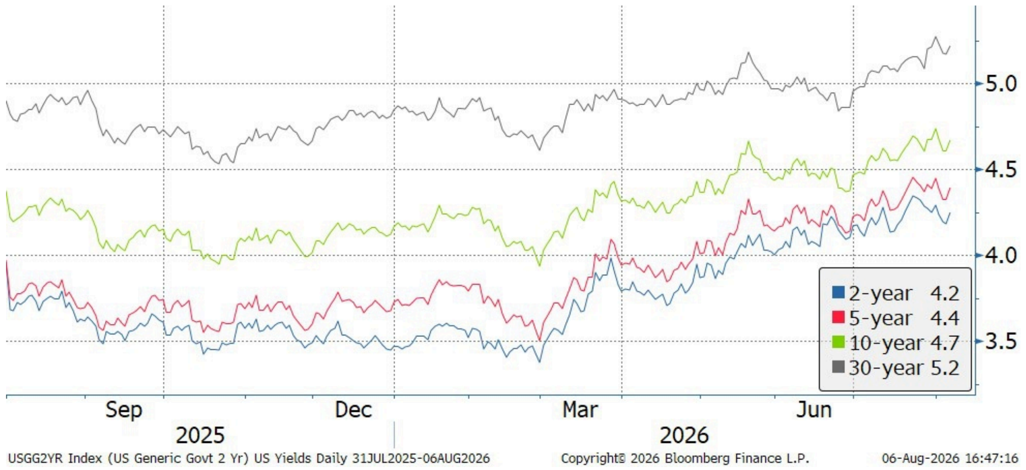
US Rates

Jackson Hole in Focus

Given the six-week gap between FOMC meetings, Warsh's next opportunity to hone his message will come at the Kansas City Fed's Jackon Hole Symposium that will be held August 27-29. This year's theme is "Financial Innovation: Implications for Payments and Policy" but of course, Chair Warsh's keynote speech will be the highlight.

When asked about his Jackson Hole speech at the July press conference, Warsh admitted that he had "made no decisions at this point," and that it was still "a blank piece of paper." The markets have given him quite a bit to write about now. Of note, Warsh said that "If possible, I would also like to raise some big questions. With frequent meetings and press conferences, we tend to fall into near-sighted debates."

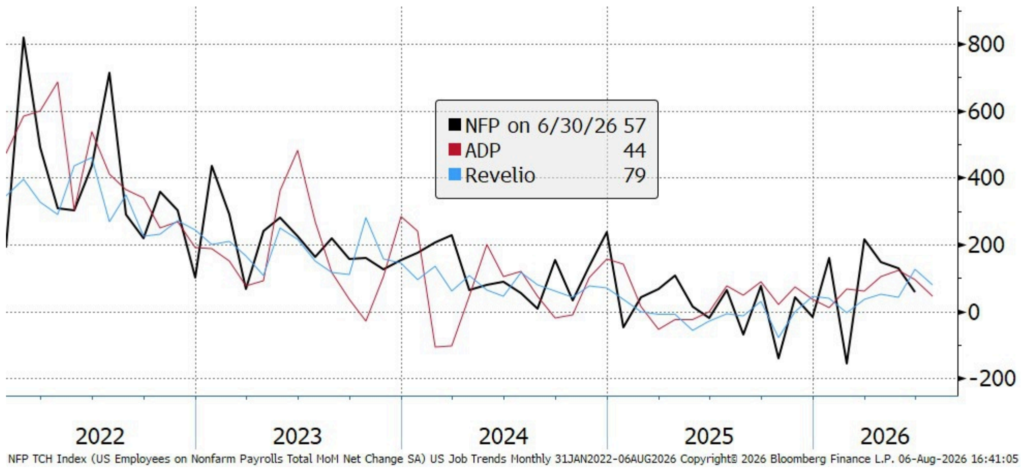
US Yields, %



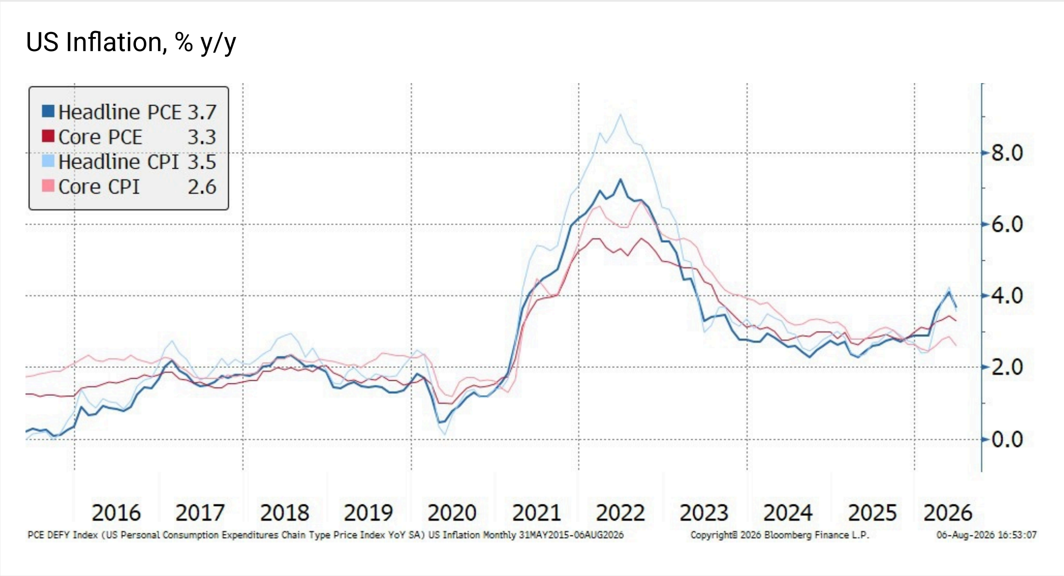
The Upcoming Data

Since the July 28-29 FOMC meeting, UST yields remain elevated but have fallen back into a holding pattern ahead of key US data for July this week (jobs) and next (CPI, PPI, and retail sales). Right now, the Fed has the luxury of focusing mainly on its inflation mandate since we are close to full employment. However, if the labor markets continues to soften, a policy dilemma may be brewing. Of note, NFP growth peaked in March and has fallen three straight months to 57k in June. Bloomberg consensus is 80k and its whisper number is 78k, while the ADP and Revelio estimates point to modest downside risks.

US Jobs, 000s



Inflation is likely to prove sticky. The Cleveland Fed Nowcast model estimates July CPI headline at 3.4% and core CPI at 2.5% (which is right at consensus), followed by August CPI headline at 3.5% and core CPI at 2.4%. If so, that would mean the Fed meets in September with another two months of above-target CPI inflation on the books and the pressure to hike should grow. Elsewhere, the Cleveland Fed Nowcast model estimates July PCE headline at 3.7% and core PCE at 3.3%, followed by August PCE headline at 3.8% and core PCE at 3.4%. July PCE data will be reported August 26 but the August PCE data won't come out in time for the September 15-16 FOMC meeting.



The Policy Outlook

The market currently puts about 55% odds on a September hike. These odds are quite likely to shift in the coming weeks, depending on how the data come in. If market pricing for a September hike moves higher to around 70-80% (or higher) and the Fed doesn't hike, its credibility is likely to take a big hit. If so, the yield curve would likely continue to steepen as the long end underperforms. Equities would likely fall on the belief that delaying hikes means more tightening later, while the dollar would likely weaken.

US Curve, bp