Credit Suisse Economics

Ride of the "Volkyries"

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If the current episode of monetary tightening were a scene from a movie, we'd be looking at something similar to the scene from *Apocalypse Now*, where a group of helicopters is approaching a small village on the beach with Wagner's *Ride of the Valkyries* beaming from the speakers. Parallels between central banks and helicopters are not uncommon: Milton Friedman played with the theme ("helicopter drops of money") and Chair Ben Bernanke earned a helicopter-themed moniker ("Helicopter Ben"). But then, consider…

…that helicopters are just vehicles. In helicopter analogies, it's not the vehicle, but their payloads that matter, and payloads can be either money or volatility…

As we discussed in our "*Vol*cker Moment" dispatch on February 16th (see here), there is a strong policy case for the Fed to inject volatility into markets in order to control domestic services inflation (and demand for labor more broadly) through asset prices – stocks, housing, and crypto assets too. Then on April 6th, Bill Dudley, the former president of the Federal Reserve Bank of New York, argued that for hikes to be effective, financial conditions have to tighten more – a lot more. But if the broader market expects rate hikes to undermine growth and force the Fed to cut rates in 2024, financial conditions mathematically won't tighten on their own. If financial conditions don't tighten on their own, "*the Fed will have to shock markets to achieve the desired response*", that is, "*it'll have to inflict more losses on stock and bond investors than it has so far*". If that wasn't clear enough, the former vice chair of the FOMC closed by saying: "*one way or another, to get inflation under control, the Fed will need to push bond yields higher and stock prices lower*". The message could not be clearer.

A former vice chair of the FOMC arguing that the Fed needs to shock markets is as close as we will ever get to a former Fed policymaker endorsing the need for a "*Vol*cker Moment". And it's good to share a conviction with Bill Dudley – the last time we shared a strong conviction was when he asked me to visit him for an interview during the summer of 2008 to join the Markets Group of FRBNY in response to a brief note I sent him describing my concerns about the plumbing. It was a formative experience: sitting across a market legend, finishing each other's half sentences about shared convictions about "skeletons in the closet".

In today's dispatch, we'll explore five topics: first, the Fed call versus the Fed put; second, monetary heroes and anti-heroes; third, the Fed's impossible trinity and what gives; fourth, the need to "invert" our thinking about recession risks; and fifth, the Fed's options to inject more volatility to tighten financial conditions.

Our aim today is to highlight the risk that we might be dealing with a Fed that won't be intimidated by curve inversions and asset price corrections, but will be emboldened by them to do more – a Fed that pushes against a curve inversion by hiking more than what's priced today to tighten financial conditions further, despite recession risks or perhaps even with a (covert) recession goal in mind in order to maintain price stability. To understand our thought process, and to understand the volatility you see on your screens – a volatility by design that is a desired outcome for the Fed – please consider the following observations.

First, as we argued here, the Fed is now in the business of writing a call option on risk assets – not just stocks, but housing and crypto as well. Whether we think of the FOMC's target level for the stock market and financial conditions as a call option or still as a put option just with a lower strike price is semantics. The big question of course is that if the Fed is indeed writing a call option, what is the level that it targets? Does the Fed want to see the S&P give up only a part of its post-Covid gains or all of them? Or does the Fed want to wipe off some of the gains that accumulated before the pandemic? More on this later…

Second, if one of Jay Powell's professional heroes is the legendary Paul Volcker, it must be that one of his professional "anti-heroes" must be Ben Bernanke, at least in a cyclical sense. Allow me to explain: the "art" of Quantitative Easing (QE) was forged under Bernanke's stewardship, and the original aim of QE was to reflate in order to avoid deflation: reflating house prices, reflating stocks, and reflating the price level were the goals. Asset price growth was a target and positive wealth effects were a target too to generate growth and jobs. Looking back, QE was essentially monetary policy for the asset rich, with trickle-down benefits for the less wealthy. We've had several rounds of QE, and during the most recent round, we combined QE with fiscal policy and the government implemented Friedman's notion of "helicopter drops of money". Asset price inflation on the back of traditional QE, and consumption growth on the back of fiscal QE (helicopter money), pushed the level of demand higher, and the pandemic and geopolitics have pushed the level of supply lower. Something changed. Inflation got high. Some inflation is coming from abroad, but some is coming from home (services). No one knows how to slow it down, but one thing is blatantly obvious: fiscal QE was too much and traditional QE is no longer appropriate. If the origin of QE is to lean against deflation by generating asset price inflation (positive wealth effects), leaning against inflation must involve generating asset price deflation (negative wealth effects) – the core of Bill Dudley's arguments. If the great Paul Volcker is the cyclical hero, the great Ben Bernanke must be the cyclical "anti-hero". Elon Musk's recent comments at the FT's Future of the Auto summit sum up the situation well: when asked if his planned takeover of Twitter will end up hurting sales at Tesla, Musk said "*right now, demand is exceeding production to a ridiculous degree*". The message is quite clear: QE overstayed its welcome; we need a round of negative wealth effects; we need "shock therapy"; we need a "*Vol*cker Moment".

Third, a note on the Fed's mandates. Since we first wrote about the need for a "*Vol*cker Moment" one thing became quite clear from the Fed's communications: the Fed has a singular mission, which is slaying inflation. Central banking with a multitude of mandates is a bit like the life of a working parent: it is impossible to deliver 110% at work, 110% at home playing with Barbies or doing dishes, and 110% at the tennis court as well (if you are lucky to find the time to play). It's an impossible trinity, but we are trying to do our best. The same for the Fed: price stability, full employment, and financial stability are not possible to achieve all at the same time. Something has to give. The Fed appears to have chosen price stability as the priority: it wants slower growth and higher unemployment; further, tighter financial conditions mean some financial instability by definition – nothing systemic, but turmoil still (see tech stocks and the crypto sell-off).

Fourth, the market is ripe with narratives about whether rate hikes and commodity price spikes will tip the U.S. into recession. I find it puzzling that some argue that the reason why there won't be a recession is because household and business balance sheets (and in the case of businesses, profits) are so strong. I think the opposite. There can be a recession precisely because balance sheets are so strong, and if we follow the line of argument above, strong balance sheets mean the Fed needs to lean against the wind harder to shock demand lower. If low rates, QE, and low volatility healed balance sheets, the opposite will hurt balance sheets – by design. The negative wealth effect means pain for balance sheets. As Charlie Munger said: "*Invert. Always invert*". Strong balance sheets are a "cyclical bad", not a "cyclical good". It means more discipline from the Fed. More hikes and more volatility injected by the Fed – by design – until financial conditions tighten more and demand slows enough.

Fifth, how is the Fed going to inject volatility? Back to the helicopter analogy, Wagner's Ride of the Valkyries full blast, the Fed has two types of buttons to push to release its payloads of volatility: talking tough (a string of rate hikes, a string of 50 bps hikes, and maybe even 75 bps if things don't cool down), and shifting from passive QT to active QT, where the Fed controls the amount of duration each dollar of balance sheet shrinkage delivers into the market, as opposed to the refunding decisions of the Treasury. In our "*Vol*cker Moment" piece, we argued for the Fed to do the latter, but the former (verbal) strategy is working wonderfully for the moment. Yields and mortgage rates are higher, stocks are lower, but a comment from President Daly just crossed my screen:

*DALY: WANT TO SEE MORE TIGHTENING OF FINANCIAL CONDITIONS

So we are not quite there yet. As one astute market participant once told me: "*volatility is the best policeman of risk assets*". And volatility and illiquidity is everywhere: liquidity in Eurodollar futures is shockingly poor – "*non-existent*", as one market participant put it. Non-existent liquidity in Eurodollar futures is exacerbating moves in rates markets. The market does not know what to price – have we priced in the peak for fed funds yet, or is the peak at 4% or 5%? This uncertainty is feeding volatility and a sell-off in equities and crypto assets.

And that is a good thing…

…from the perspective of a Fed that wants to see financial conditions tighten. The Fed is keeping the market on the edge. As we argued back in February (see here), the best thing the Fed could do to achieve its goals is to "stop talking": hike 50 bps and sell $50 billion of 10-year notes the day after, and put an end to press conferences – to keep the market on its toes and keep 'em guessing.

Our message today is this:

Consider the possibility that the Fed, on a singular mission to slay inflation, won't rest in its pursuit of tighter financial conditions until yields shift higher, stocks fall more, and housing turns as well. The crypto sell-off is just an unexpected bonus, albeit one to watch for spillovers into STIR markets through the "par problems" of some stablecoins. Furthermore, consider the idea that the Fed is pursuing demand destruction through negative wealth effects: if low rates, forward guidance, QE, and low volatility nurtured risk assets and demand by design, then hikes, constructive ambiguity, QT, and higher volatility will hurt risk assets and demand by design too. Finally, consider the idea that strong private balance sheets raise the risk of a recession, for they may force the Fed's hand to shock risk assets more to make sure we get a recession, or at least a very hard landing, so that the Fed can slow down inflation enough.

In this dance, the Fed leads the market, it does not follow it. It cannot by definition. That is a "*Vol*cker Moment" in and of itself. A Fed that is writing a call option of the stock market needs to see a deeper correction, a correction big enough to slow demand and push unemployment higher. We have never achieved a soft landing, so let's not pretend that the fastest pace of hikes in a generation and an unprecedented shrinkage of the balance sheet will yield one.

As I see it, the risk of recession, whether it is real or merely implied by an inversion of the yield curve, won't deter the Fed from hiking rates higher faster or from injecting more volatility to build up negative wealth effects, and signs of a recession might not mean immediate rate cuts to ramp demand back up…

…cuts may have to wait until the Fed is certain that inflation is surely dead.

Back to the level of the stock market under the Fed call.

According to President Daly's comments, the recent stock market correction and the rise in mortgage rates is "great", but not enough ("want to see more"). Chair Powell also noted in his press conference that he wants to see further tightening in financial conditions still. At face value, that implies that the Fed won't stop shaping expectations until we see more damage to stocks and bonds.

Rallies could beget more forceful pushback from the Fed – the new game…

We won't provide a target for stocks. Our dispatches are about providing a framework for an investor to think about all the noise and volatility that they see on their screens at the moment. Our message is that all the noise and volatility is by design and is probably welcomed by the Fed and that the Fed will boldly fan more of it. What's the Fed's target for the S&P in light of all of the above?

At 4,000, the Fed does not seem content, and in the grand scheme of things, this is where the Fed would change its tune if it would still be writing a put. At 3,500, we would have lost all of the post-pandemic gains in market wealth, but that level for stocks still feels like a put option, just with a lower strike price. At 2,500, we would lose not only all of the post-pandemic gains, but would eat into some of the pre-pandemic gains too. And if something indeed happened to the supply of labor post-pandemic (and some of that is wealth related), then to cool price pressures, maybe a pre-pandemic wealth level is appropriate indeed.

Stocks of course are not the only egg in the proverbial wealth basket. Housing and crypto assets are in the basket too, and wealth declines there should determine how much damage will need to be done to stocks, that is, how much more financial conditions will have to tighten. It's blatantly clear that this is not an average business cycle. This is not an average inflation backdrop. And this is not an average hiking cycle. And this is not about whether balance sheet health and low debt service costs serve as hedges against a recession, but whether balance sheet health and low debt service burdens mean much more pain for stock and bonds – by design – as the Fed tries to slay demand materially.

Lastly, another image and a quote from *Apocalypse Now*. The below scene follows immediately after the helicopters released their payload on the village. Lieutenant Colonel Bill Kilgore surveys the village and says to a fellow soldier…

Kilgore: *Smell that? You smell that?*

Lance: *What?*

Kilgore: *Napalm son. I love the smell of napalm in the morning…*

Volatility is like napalm for risk assets. Consider at least the possibility that the extreme volatility and lack of liquidity you see in markets is by design, and the Fed will not be deterred by it, but rather that it will be emboldened by it in its singular pursuit of price stability. If an asset price correction is a desired outcome of hikes, and a big slowdown in growth is necessary to slay inflation, the more the curve inverts on the Fed, the harder it will push back against it.

Again, if this was a "monetary motion picture"…

…Bill Kilgore's character played by Robert Duvall would be my perfect image of a monetary hero – in the cyclical sense. We need to at least start thinking about learning to think that the "*Fed loves the smell of volatility in the morning*".

Talk of 75 bps is like Wagner's Ride of the "*Vol*kyries" playing full blast…

Chair Powell remarking at the latest press conference that "*we need to look around and keep going if we don't see that financial conditions have tightened adequately, or that the economy is behaving in ways that says […] that we're not where we need to be*" is like the Ride of the "*Vol*kyries" on full blast too…

Ah, that will never happen because it sounds like a wealth grab you say…

De-basing comes in many shapes and forms. President Roosevelt did it with gold – he made everyone sell gold to the Fed at $20.67 per ounce in 1933, and then in 1934 the government's price of gold was increased to $35 per ounce, i.e., the dollar was devalued. President Nixon closed the gold window for good. Chair Bernanke reflated stock prices. We see Chair Powell as trying to deflate them, and that he will keep pushing against rallies and curve inversions until he succeeds.

Finally, consider the fact that the White House is backing the inflation fight…

As President Biden remarked earlier this week, "*inflation is a challenge for families across the country and bringing it down is my top economic priority; […] this starts with the Federal Reserve; […] I will never interfere with the Fed's independence […] and I agree with what Chairman Powell said last week that the number one threat to [the economy] – is inflation*". To me, that sounds as if President Biden closed the "wealth window", much like President Nixon closed the gold window. President Biden's comments this week mean that he announced the end of the Fed put, and endorsed the Fed call to slay inflation…

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