

Perspectives Podcast

“I Fought the Fed, and the Fed Won”

Transcript, 15 February, 2024

Adam Bass ([00:03](#)):

This is MSCI Perspectives, bringing to light insights and analysis that help global investors tackle today's challenges. I'm your host, Adam Bass, and today is February 15th, 2024. Don't fight the Fed. It's a simple adage and most investors are familiar with it. However, as today's guest, MSCI's head of portfolio management research Andy Sparks, has pointed out to us during, I'd say, most, if not all of his recent appearances on the program, some investors don't seem to believe the Fed when its statements clearly spell out its intentions.

([00:47](#)):

With the level of inflation coming down, though less than expected, and markets still digesting Fed Chair Jerome Powell's latest statements, we sat down with Andy to try and make sense of it all. Here's our conversation. Andy, welcome back to the program. We are thrilled to have you back on.

Andy Sparks ([01:08](#)):

Thank you, Adam. Always a pleasure.

Adam Bass ([01:11](#)):

So let's jump right in, Andy. For what feels like a very long time, we've been talking about whether or not the Fed would be able to orchestrate a soft landing, as we refer to it. Now, I would love to get a quick definition from you before your answer on that, if you could. But when we were preparing for this interview last week, you mentioned that it's not really a question. Soft landing achieved. What's behind that?

Andy Sparks ([01:39](#)):

First of all, what we mean by a soft landing is a situation where inflation is brought close to central bank targets, which is 2% for most developed markets, and inflation's brought down without triggering a recession, so economic growth remains pretty good. So getting back to the question of have we achieved a soft landing, the COVID crisis triggered massive fiscal and monetary stimulus primarily to offset the contractionary forces of lockdowns in a public health crisis.

([02:20](#)):

Over the past couple of years, the stimulus was increasingly removed and a primary mark concern was that a recession would follow. So think of the punch bowls being removed from the party, it's time to sober up. And there was quite a bit of concern that economic growth could be hit hard. The problem with this line of thinking is that it's not been supported by reported economic data.

([02:46](#)):

And particularly in the US, GDP growth has been surprisingly robust and employment growth pretty strong. And this has occurred at the same time that inflation has generally been falling close to central bank targets. So this is all consistent with the view that a soft landing has been achieved. I would also add that the strong equity market and tighter credit spreads in the corporate bond market support this view.

Adam Bass ([03:15](#)):

And what about outside the US, if we could? How is this playing out around the world?

Andy Sparks ([03:20](#)):

Generally speaking, in developed economies, I'd say it's similar, but not as strong. And so the US economy has been particularly strong, and in Europe, not as much. But generally, compared to a recession scenario, we aren't seeing recessions in most developed markets and we are seeing inflation coming down. So maybe the soft landing is not as soft in some of these other countries as the US, but it's moving in that direction.

Adam Bass [\(03:55\)](#):

Now, of course, whether we have achieved a soft landing or not, there are still other areas of concern. Can you walk us through some of those in terms of where central banks and investors, for that matter, may be focused now?

Andy Sparks [\(04:11\)](#):

There's a whole laundry list of things, of course, that we could go into. And in the course of this discussion, I think it'd be good to touch on about three or four of those. But let me just first of all focus on something that is really a longer-term concern, but it's interesting to note that it was raised by Chair Powell when he was recently interviewed on US television, and this longer-term concern is the growing fiscal debt burden.

[\(04:42\)](#):

And so although central banks do not control fiscal policy, central bank policymakers can and do sometimes add their voices to the debate about the sustainability of deficits. And this is the topic that Chair Powell did address. And I should also say that central banks may be asked to intervene in the event that a fiscal policy may disrupt markets. Last year, MSCI Research was pretty active looking at how markets responded to the possibility that the debt ceiling in the US would be hit and result in a technical default of US debt obligations.

[\(05:24\)](#):

At the time, Chair Powell was asked if the Fed would intervene. He basically said that the Fed cannot help and that only Congress and the president can fix the problem. Now, a recent example where a central bank did intervene in response to a fiscal policy decision was in the UK in the September-October 2022 time period. At that time, a new government in the UK announced a new fiscal policy to cut taxes in order to stimulate growth.

[\(05:59\)](#):

The market reacted very negatively to this with the result that there is a sharp spike up in Gilt yields. And the spike in turn exposed highly levered Gilt trades, which threatened the solvency of some UK pension schemes. And in response, the Bank of England suspended its quantitative tightening program and completely reversed course by saying it was prepared to buy Gilts.

Adam Bass [\(06:26\)](#):

That raises a question that comes up quite often, the differences and similarities between fiscal and monetary policy. Talk through a little bit of that for our understanding.

Andy Sparks [\(06:39\)](#):

Yeah, so technically, fiscal policy is separate and distinct from monetary policy. In most developed markets, government spending policies and funding strategies are determined by elected officials, while monetary creation and monetary policy is determined by appointed officials.

[\(07:03\)](#):

So the monetary policymakers typically have a mandate to focus on maintaining relatively stable prices and they often have a mandate to ensure a high level of employment. And very importantly, monetary policymakers are supposed to have a strong measure of independence from the legislative and executive branches of the government.

Adam Bass [\(07:28\)](#):

And I want to get back to that question of independence. But if we could just stick with this for a little while longer, when it comes to monetary and fiscal policy, is the ideal that one is subordinate to the other, or how do they coexist?

Andy Sparks [\(07:44\)](#):

Well, a standard answer to this question is that fiscal and monetary policy should not be competing against each other and they should be coordinated. The problem with this line of reasoning is that it can easily creep into the monetary authority losing its independence in monetary policy becoming subordinate to fiscal policy.

Adam Bass [\(08:08\)](#):

And again, that independence, you've talked about this a lot, especially this year, not only in the US, but specifically in the US where the election season is coming and this may indeed be an issue with the Fed caught in the middle of the two parties debating. Where does the Fed stand right now in terms of independence? [\(08:32\)](#):

I mean, you noted how Chairman Powell just recently on US television again reiterated the importance of independence. But are they where they need to be I guess is the question?

Andy Sparks [\(08:46\)](#):

Yeah. Well, of course, the chair of the Fed and other Fed policymakers are nominated by the president and must be approved by the Senate. So yes, there is definitely the possibility of elected officials exerting influence on the makeup of the Fed and on its policies. And of course, Fed policymakers read newspapers. They are highly sensitive to what elected officials are saying. And Chair Powell in particular seems to be highly adept at navigating and trying to avoid political controversy.

[\(09:23\)](#):

So he's questioners may try to pull him into the political debate, but he tries to avoid that and he seems to have pretty good relations with members of each party. Now, at the same time, the Fed, of course, is supposed to be an independent entity focused on its goals of price stability and maximum employment. And ultimately, probably the greatest protection for the Fed and its independence is a belief and a consensus that its independence is crucial for achieving stable prices in promoting economic growth.

Adam Bass [\(10:00\)](#):

How does that play out?

Andy Sparks [\(10:03\)](#):

So number one, there's a very large body of economic research from academics looking at the history of central banks, the history of situations where you did not have independence, and generally those periods where there was a lack of independence generally did not end real well. And there are, of course, a few famous examples of this historically where it did happen. For example, Germany between the World Wars.

[\(10:40\)](#):

And in quite a few emerging market countries, we had situations where there was a real lack of independence. And I think one of the most important lessons from these historical incidents is the need to avoid a one-sided market where the central bank becomes the primary buyer of government debt and the so-called bond market vigilantes that act as guardrails on the bond market and ultimately are looking carefully at how government policies can lead to bad outcomes in the bond market.

[\(11:18\)](#):

Ultimately, these bond market vigilantes only have power to influence policy if there's a two-sided market where there are buyers and sellers.

Adam Bass [\(11:27\)](#):

At times if we've seen that in the US play out where the Fed is a main buyer of government debt, how did the markets respond there?

Andy Sparks ([11:37](#)):

The Fed was formed in the early 1900s, and so the Fed was around during the Great Depression. It was around during World War II, and of course, it's been around since then. It has a very rich history of how it responded to a lot of these economic events. Frankly, in the Depression, a lot of economists feel that the Fed was not active enough at keeping inflation higher. So at that time we had price deflation. And a lot of economists, who used to be called monetarists, feel that the Fed sat on its hand when it should have been acting and actually buying and adding monetary stimulus.

([12:25](#)):

In terms of where the Fed has gone too much in the other direction, it is true that the Fed was pretty active during World War II and explicitly was trying to help finance budget deficits caused by huge government spending caused by the war. And there was a pretty good inflation back then as well. But since the early 1950s, there's been pretty much a consensus that the Fed needed to be independent. Yes, you can look at certain periods since the early '50s where the Fed may have been subject and overly subject to political intervention during the Nixon administration.

([13:08](#)):

There's a lot of pretty well documented research looking at how President Nixon had tried to influence the Fed. So it's been out there for a long time. But fortunately, the US has never come close to some of these ruinous results that we saw in other regions and countries.

Adam Bass ([13:30](#)):

Always appreciate that historical perspective from you. I would like to come back to today, however, and actually Chairman Powell and some of his remarks. So in the backdrop of everything we've been talking about, at the last Fed meeting, which as we're recording this was just about two weeks ago, he mentioned how he doesn't want to take too long to start cutting rates again as we approach the 2% target.

([14:00](#)):

His reasoning being it takes a while for rate cuts or rate hikes to filter through the economy. And if you wait until we're at 2%, the moment has probably passed. And yet at the same time, the yield on the 10 year has gone up from where it was not too long ago. I checked before recording here and it was close to 4.19% coming up from 3.85. So what does this tell us about what the market sees and are they just not listening to the Fed again?

Andy Sparks ([14:36](#)):

Well, there has been this almost game between the market and the Fed reaching back to, oh, about almost two years ago. So let's roll back to when the Fed first started raising rates in the most recent rate-raising cycle, going back to March of 2022. Inflation was unexpectedly high. Prior to that, the Fed had a very optimistic view coming out of COVID and a lot of the stimulus intended to battle potential weakness of the economy from COVID. The view had been by the Fed that inflation was going to come down quickly.

([15:21](#)):

It was going to be temporary. And by early 2022, that seemed to be incorrect. And so the Fed began this pretty aggressive stance to raise rates. And at MSCI, we pay close attention to what the market is thinking about how rates will evolve. And generally speaking, the market kept on thinking that the Fed tightening would be more moderate than it turned out to be. Chair Powell in many different situations kept on reminding the market that, "Hey, you're not right." Effectively he was saying, "You're not right. We're really serious about this."

([16:05](#)):

And generally speaking, the market has thrown in the towel whenever there was that difference. And so the most recent meeting and press conference that he gave, he reminded them of that. And this concept of hire for longer, he seemed to be saying, "Don't think that we're going to be as aggressive at lowering rates as the

market at that time was thinking." And partly in response to that, there has been a sell-off. So the market does pay close attention to what the Fed says. But for a fair amount of the past two years, the market has gotten too far in front of the Fed.

Adam Bass ([16:46](#)):

And on that note, even though he is starting to talk about it and giving very clear signals about what probably will be next in terms of looser policy, there are still, as you mentioned earlier, challenges out there, some of them even around inflation, which, of course, is one of their primary concerns. I'm thinking issues like the effects of what's happening in the Red Sea right now and how it's affecting shipping costs.

([17:16](#)):

I know that the team at MSCI Research has recently put out a piece that talked about an IMF finding that when global freight rates double, let me look here, inflation has tended to pick up by 70 basis points, and that's over the next year to year and a half. My question after all of that is could this be part of the reason at least why we haven't yet seen the rate cut from the Fed?

Andy Sparks ([17:45](#)):

The Fed definitely follows international developments very, very closely. The Fed likes thinking in terms of scenarios and what could happen, what may happen. So they're following the situation closely, but I think it's probably not the case that that possibility of a spike of inflation coming from the Red Sea is overly influencing their current policy. An alternative view of what's partly motivating their current policy is that we have just experienced the highest inflation rates for the past 40 years.

([18:27](#)):

As I mentioned, going into this bout of inflation, the Fed had an overly optimistic view. And as a result, the Fed ultimately lost a lot of credibility. And one view about their current stance on rates is that they may be willing to err on the side of keeping rates high for too long rather than starting to ease before inflation is at its 2% target.

Adam Bass ([18:54](#)):

Now, we're talking a lot about the markets writ large. I'm curious though, in conversations that you may be having with clients, et cetera, other investors, where do their heads seem to be at? What are they saying? What kind of questions are they asking you?

Andy Sparks ([19:12](#)):

So it's sort of back to basics I'd say. It's ultimately concern about economic growth, as well as inflation. I think those are still right at the very top of things and concerns that the market has. And at MSCI, again, I just mentioned this, but we do like looking at potential portfolio positioning according to investor beliefs around scenarios and, in this case, macro scenarios. So our macro scenarios are centered around potential outcomes for economic growth as well as inflation.

([19:56](#)):

And so we recently wrote a blog looking at how four different macro scenarios could impact returns on a multi-asset portfolio. The first was the soft landing scenario, which like we said at the beginning of this discussion seems to be pretty much what the current market is pricing in. The second scenario we looked at was a hard landing scenario. This is where in the Fed's and the central bank's efforts to tame inflation, they go too far and push the economy into recession.

([20:28](#)):

So I mentioned earlier that one reason why the Fed maybe isn't easing right now is that they want to err on the side of being overly cautious because they lost this credibility. So in our scenarios, that's represented in this hard landing scenario where ultimately rates stay high for too long and they push the economy into a recession. The third scenario that we looked at was a resurgence of inflation. And although there have been encouraging signs on the inflation front, we aren't out of the woods yet.

(21:02):

And if you look at year-over-year inflation, it's still much above the 2% target. And there are still some uncertainties about inflation. So that third scenario, we thought it made sense to look at a potential resurgence of inflation. And the fourth scenario is what some might call the Goldilocks scenario where we have strong economic growth and inflation remains contained. Although there are many, many other possibilities, we think these four scenarios are a reasonable representation of the scenarios that investors may want to consider.

Adam Bass (21:41):

And under those scenarios, let's just go with the last one you said, let's be hopeful, the Goldilocks scenario, what was the impact on a multi-asset class portfolio?

Andy Sparks (21:51):

So this was a composite portfolio and included bonds, equities, private assets. And in that scenario, the overall portfolio gained about 12%, so very significant, and leading the way were equities across regions. US Treasuries did poorly. I don't want to say they did super poorly, but they had a noticeable negative return. And corporate bonds actually, although they also had a negative return, they weren't as bad as Treasuries were.

(22:30):

That's partly because in our scenario we were assuming that with this strong economic growth and with strong equity performance that corporate bond spreads would tighten. And so the place to be within fixed income was the corporate bond sector and away from US Treasuries.

Adam Bass (22:50):

So of course, we've looked at where we are. You as always provided this great historical backdrop. Let's go the final direction. Let's go forward as much as we can. What will you be watching? What are market participants watching out for?

Andy Sparks (23:07):

Of course, they'll be looking carefully at all of the normal economic reports, but I think the market's also going to try to understand better the unknown. And there's no shortage of that. Geopolitical risk is definitely a tail risk. There's no end of things that we could worry about with that. So I think at the end of the day, you need to weigh the risk versus the opportunity, and the opportunities could be very significant.

(23:39):

So number one, just in the bond market, real yields continue to be, although a little lower than they were say going back last September-October, real yields are still quite high by the standards of the past 15 years or so. And that's good for capital market participants in terms of looking at forward-looking opportunities in return on investments after inflation. Of course, there's been no shortage of discussion around AI and the potential for robust economic growth being driven by technological innovation.

(24:19):

But on the other side, you could have a slowdown in the economy. And like I said, the bond market, we're still not out of the woods yet on inflation and particularly as we focus on the new set of issues. So like I said, we think that soft landing scenario has been pretty much priced in, but new issues will be, or I should say old issues will be re-emerging and being put more in the spotlight. The debt and growing debt is I think definitely right up there at the top of longer-term concern. And this issue around the sustainability of the debt, it reaches far beyond the current and upcoming political cycle.

(25:03):

This reaches out over multiple political cycles. It's not just limited to the United States, of course. And I think it is interesting to go back to what happened in the early 1990s. This was when the term the bond market vigilante really gained a lot of usage. And the background here is that bond yields surged in roughly around end of '93-'94. They surged a lot. And this occurred at the same time as budget deficits were rising. And the concern was that high yields were related to high levels of debt.

(25:50):

And ultimately, this concern probably did contribute to fiscal constraint. It probably did contribute to policies and legislation. And in fact, the fiscal situation improved during the rest of the 1990s to the point where the US was running a fiscal surplus towards the end of the decade. So this is just one example of how ultimately one of the strongest protectors against bad policy is the bond market and this idea that these vigilantes, these bond market vigilantes are out there and they're important players.

(26:30):

And if they don't like a policy, they can say, "I'm going to sell bonds. I'm going to raise yields." And by itself that can act to constrain behavior that may be contributing to economic uncertainty and to ultimately bad economic outcomes. There's this great quote by James Carville, and you and I were talking about this the other day, Adam, and he said, "I used to think there was a reincarnation, and I wanted to come back as the president or the pope. But now I'd like to come back as the bond market. You can intimidate anybody."

Adam Bass (27:10):

That's all for this week. Our thanks to Andy and all of you for listening. For more insights from Andy and his MSCI Research colleagues, visit [MSCI.com](https://www.msci.com). And next up on the program, after an especially difficult 2023, real estate investors remain hopeful that this year will be better. We'll take a look at key real estate trends that will help determine whether those hopes are realized. Until then, I'm your host Adam Bass, and this is MSCI Perspectives. Stay safe, everyone.

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