Red Cedar Investment Management

When Doves Cry

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Earlier this week, I asked our team whether the resignations of Federal Open Market Committee (FOMC) members Kaplan and Rosengren—two inflation hawks—had anything to do with the market suddenly invoking the bear steepener into the fixed income markets. We already believed this was in the cards due to rich U.S. Treasury valuations and rejecting the transitory narrative of inflation as espoused by the Federal Reserve (Fed). My question over the last few trading days regarding the U.S. Treasury sell-off was: Why now? In other words, what was the catalyst for the market's sudden shift in sentiment? Well, now I think we have our answer.

As it turns out, the dual resignations were no coincidence—there just might be a scandal at the Fed. Well, maybe "scandal" is too harsh of a word, but the optics of this are not good. After 30 years in the business, it never ceases to amaze me that I can learn something new all the time. My working assumption going back to the Greenspan days was that all FOMC members held their personal investments in a blind trust because Chairman Greenspan himself did it. I just assumed, logically, that this was part of the ethics rules regarding bureaucrats who regulate financial institutions and have the authority to set monetary policy. As if that's not enough, over the past decade or so, they have increased their power over the capital markets by having the ability to not only set interest rates but also to purchase financial assets. Talk about a conflict of interest! As it turns out, these elite bureaucrats were not prohibited by law or some sort of Federal Reserve Code of Ethics from trading their own accounts and profiting from those trades due to the actions they were taking as monetary policy setters. Federal Reserve Bank Presidents Kaplan of Dallas and Rosengren of Boston were profiting from trading S&P 500® futures and mortgage REITs at the same time they were enacting policies that would benefit those assets.

Over the last few days, we have had two casualties from the light being shined upon this self-serving act. We must now consider whether or not Jerome Powell will be the third. As Jefferies' Chief Market Strategist David Zervos points out, Chairman Powell owned between $1.25 and $2.5M of municipal bonds at the same time we were heading into the COVID crisis. He then led the FOMC to deliver on a municipal bond credit facility that would directly benefit his holdings. At a minimum, Mr. Powell probably failed in his oversight of Messrs. Rosengren and Kaplan as they profited from their trading activities with the knowledge that Fed actions would bail out those securities. He further benefited with the potential bailout of his personal municipal bond holdings.

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This situation could be a catalyst for a complete Fed makeover. As of a few weeks ago, both Rosengren and Kaplan were expected to serve out their terms as Federal Reserve Bank Presidents and FOMC members. Rosengren was scheduled to rotate in as a voting member of the FOMC in 2022 with Kaplan's turn in the voting rotation set for 2023. Chairman Powell's odds of a re-appointment to a second term and confirmation were 90% a few weeks ago according to some betting websites. His odds now appear to be dropping as quickly as President Joe Biden's approval ratings.

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Now that the Fed's integrity has been called into question, we look for Congress and the administration to seize the moment and remake the Fed in accordance with their political agenda. In addition to the potentially three additional uber dovish FOMC appointments from the Biden administration, there will probably be a groundswell of support for more oversight of the historically independent institution that is the Federal Reserve. In other words, the regulator gets regulated. As former Obama White House Chief of Staff Rahm Emanuel once said, "You never want a serious crisis to go to waste." This certainly could have the potential to call the Fed's independence into question moving forward. Could presidential administrations and/or the U.S. Treasury—both political institutions—now have more oversight of the Federal Reserve? This has potential for politics to permeate the Fed's decision-making process, meaning the aforementioned uber doves and an expansion of the Fed's mandate to include whatever the party in power wants to accomplish. In the case of this administration and Treasury Secretary Yellen, it could mean ultra-easy monetary policy and expansion of Fed policies that could further push the social agenda of labor economist Yellen and the progressive wing of the Democratic Party. To quote Prince, "This is what it sounds like when doves cry." (Tears of happiness!) Ultimately, it could mark the introduction of partisan politics and populism—from both ends of the political spectrum, depending on who is in power—to the Fed.

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For now, we believe this is the reason the U.S. yield curve began steepening in earnest—and we expect an even more dovish Fed as this plays out. This could translate into more inflationary policies with reflationary-themed trades potentially playing out.

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