Honesty, it's not always the best policy

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Wealth Management

Every three months, Fed officials provide their individual projections for key economic variables including inflation, unemployment, and real economic growth, as well as that policymaker's forecast of the appropriate policy rate. Officially known as the Summary of Economic Projections (SEP), it's more commonly referred to as the "dot plot," from the graphical presentation of the data with dots representing individual forecasts. In theory, this is a powerful communication tool that provides rich context around the complex question of setting monetary policy. In practice, it's little better than noise, in our view, and its primary use is to generate potentially profitable entry points for long-term investors as more short-term-focused investors react to ephemera.

Fatally flawed

The dot plot suffers from two fatal flaws, in our opinion.

First, it's often inaccurate and unstable. We don't need to look any further than the current rate hike cycle. At the end of 2021, not a single Fed policymaker saw rates rising by more than 1.25% over the year ahead; in actuality, rates rose almost three times that amount in the fastest rate hike cycle in four decades. Even if the Fed's dots were accurate in more normal times—and usually they're not—it's useless to investors to be right nine out of 10 times for 25 basis points (bps) and then be wrong by 300 bps the 10th time. It's still a money loser.

Fed projections also fluctuate unpredictably. In the last update, the Fed raised its 2023 year-end rate projection to 5.1% from the 4.6% level seen back in September. This was apparently based on anticipated higher inflation, as the Fed's updated projection now sees consumer prices rising at a 3.1% clip in 2023 from the 2.8% forecast last quarter.

The trouble is that it's difficult to find any data between September and December 2022 that supports an upward shift in year-ahead inflation projections. Government statistics show a marked decline in inflation over that period and market indicators of future inflation almost uniformly declined over that period. So whatever drove the Fed's inflation projection higher is subtle, to say the least.

They would say that, wouldn't they?

The second strike against the dot plot is common to all Fed commentary: central bank communications are first and foremost a policy tool, and policy considerations effectively constrain what the Fed can—and cannot—say at any given moment.

For instance, imagine that Fed Chair Jerome Powell clearly states that the central bank believes policy rates are at or close to the peak and that inflation will be declining to target in the near future, a view often referred to as "dovish." We believe—and we think it would be difficult to find opinions to the contrary—that rates would decline on such a comment, with shorter-maturity bond yields in particular dropping quickly. We would also expect an equity market rally, as investors anticipate the foot coming off the brakes. In short, market prices would adjust to these remarks by immediately loosening financial conditions on most consumers and corporations.

This is the exact same result that one would expect, in our view, from a surprise rate cut, making the difference between talk and action so slight as to be basically irrelevant. And since dovish remarks can act like a rate cut, the Fed has to maintain a public façade of hawkishness—emphasizing restrictive monetary policies—until it is ready to actually reduce rates. That is true regardless of policymakers' views on what is really the most likely future path for rates.

There are institutional considerations as well as policy considerations when discussing policy shifts. If Powell were to sound dovish, Congress would, in our view correctly, question why the Fed leader is in such a rush to declare victory when the institution's mandate is full

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employment consistent with price stability. Employment by nearly all measures is quite robust, while prices are far from the stability represented by the Fed's 2% inflation goal. Congressional overseers may also wonder why the Fed chair would again trust the same models that erroneously predicted "transitory" price rises.

The bottom line is that even if the Fed is actually dovish, we believe it has overwhelming incentives to communicate hawkish policy intents. An investor who takes that hawkish discourse at face value is, in our view, falling into the potentially expensive trap of believing that the Fed would sacrifice policy for transparency.

Connecting the dots

Several commentators in the financial press have discussed the difficulty of understanding recent hawkish Fed commentary in light of improving data. We believe that the answer is relatively simple: the Fed had to present a hawkish face to the market and it backed into the projections that would justify such a view.

We believe investors follow such forecasts at their peril. To be fair, these comments do have some impact on market prices, so leveraged and short-term investors may need to pay some mind to them. But in our view, the biggest potential investment opportunity comes from investors who can take a longer-term perspective.

Our take is that the economy is slowing, inflation is on the way down, and the Fed will be switching to a less restrictive stance in 2023. Backing up that view is a slew of recent data, including multiple Consumer Price Index reports, retail sales, and Purchasing Managers' Index reports. On the other side stands the Fed's comments and forecasts. The former is colored by broader policy and institutional considerations, and the latter has been consistently incorrect. We view fixed income market pullbacks predicated on a long-term hawkish Fed as attractive entry points for long-term investors focused on the data and not the discourse.

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