Caron's Corner Transcript - 12.12.2022

The Important Differences Between Market Pricing and Fed Expectations

- Market expectations are not the same as market pricing, an important distinction ahead of the Fed meeting.
- Expectations are subjective, based on policy guidelines, model outputs, opinions and conditions-based actions and outcomes.
- Pricing is objective, based on facts, probabilities and a distribution of possible outcomes, amongst many other factors.
- It is important to understand there are clear risks associated with the differences between subjective and objective pricing
- But many investors try to connect the two, leadings to uncertainty and confusion.

Jim Caron: We can dub this week in central banking because we have the Fed, ECB and Bank of England all going this week. Now one of the key questions that I get a lot is about what the market is pricing versus expecting from the Fed. And I want to highlight that there's a difference between what the market is pricing versus what the market is expecting. I'm going to focus on the Fed and the Fed meeting.

Market expectations are not the same as market pricing. It's important to make this distinction ahead of this week's Fed meeting. Expectations tend to be a subjective measure and they're based on policy guidelines from the Fed's broad model outputs, opinions, forecasts in condition-based actions and outcomes. On the other hand, pricing is an objective exercise based on representative facts, weighing of probabilities, skews of probability distributions, the distribution of possible outcomes and the like. Now the differences between the subjective and the objective pricing of risks are clear when we think about them in those two ways. But we see many of the markets trying to connect the two and this leads to confusion. So ahead of the Fed's decision let's get into this more deeply so we can better understand the outcomes and the market reaction.

Let's first talk about the Fed's forecasts as subjective measures. By definition what the Fed is going to provide at the December meeting is a summary of economic projections and that's exactly what that is. It's a summary of economic projections that's compiled by FOMC voting members that adhere to their dual mandate of full employment and price stability. That becomes their guiding principle and is an important point to understand. What this means is that the Fed produces a range of possible outcomes for policy based on a range of these economic forecasts. The prescribed policy from the summary of economic projections is guided by the principles of their dual mandate. As a result, their long term forecasts again by definition must arrive and converge at the 2 - 2.5% core PCE inflation level and full employment. Let me highlight that again. Their forecasts must converge on those levels because that is their dual mandate and that's their guiding principle. If it doesn't, then the Fed violates their guiding principle and must therefore take policy actions today that are in line with this long term result.

That's effectively the issue perplexing the markets, the fact that the Fed's forecasts are really part of their guiding principles which makes them converge on their long term forecast. So between now and the long term you know let's say a period of about three years because that's what the Fed is going to consider within their forecast a lot can happen economic conditions can develop and things can change and if things do change the Fed changes their forecast, and subsequently their policy actions to. So does this sound to anyone like a market pricing mechanism that needs to arrive on a specific and fair and tradable price in the future? No, of course not. So then why do people try to square market pricing with economic forecasts from the Fed? It's simply the wrong measure to price risk.

Now let's talk about what market pricing actually is. Again, it's more of an objective measure and not a subjective measure. Market pricing is objective and it's understanding the multiple paths of outcomes and a probability distribution. It's also the measure of the level where a market maker is willing to make a two-way market and markets are very good at finding this balancing point. In fact, it's what markets do best, which is drive information into prices. So market pricing indicates that the Fed will hike rates towards a terminal level of 5%. And this is, you know, this is what's based on market pricing, then it's also what market pricing is also starting to say is that the Fed will start easing around June or July based on the inflection point in the future pricing of Fed funds aka the “pivot” in policy. But this pricing conflicts with consensus economic expectations that forecast that that the first rate hike, you know, might come in late 2023. So many forecasters are calling for a rate cut in late 2023. But the market is pricing that that rates are going to start to come down in mid-2023. All this basically conflicts with Fed forecasts and statements that they planned the whole policy rates high at the terminal level, say around 5%, indefinitely until inflation becomes anchored around the 2 - 2.5% level, which is not likely until 2024.

Now we have three different dates that we have to keep in our head. We've got to keep the date that the market pricing is suggesting. There's a pivot in policy where policy rates start to come down, which is the middle of 2023 economic consensus, which is calling for it to happen by late 2023. And if we look at the Fed's latest summary of economic projections table, this doesn't happen until 2024. This creates a lot of confusion in the markets. And again, what I think the markets are getting confused is market pricing versus market expectations. So the difference between market pricing and the Fed funds market expectations is really this source of confusion, but when one separates the subjective forecasts from objective pricing, it all starts to make sense. The pricing of a Fed pivot and policy reflects the probability weighted outcomes of the many paths of pricing scenarios for lower policy rates that are more numerous than the paths that indicate higher policy rates. The inflection point reflects the balance point or the pivot that's actually occurring in June or July of 2023. That's how the pivot actually gets defined in the market from a market pricing perspective. Said differently, the more the Fed hikes now, the higher the likelihood of a recession and the lower policy in the future, that makes sense. The more the Fed hikes rates today, the more likely it is that we're going to have a recession in the future and that policy rates will start to decline and that likelihood increases around that June or July period. That's what creates the pivot in pricing, not expectations, expectations or forecasts based on various measures and everything else like that. But when you're talking about pricing, it's a very, very objective probability weighted distribution. Such pricing needs to exist in order to balance the buys and sells in order to create a no arbitrage condition in the market. So let's explain the Fed pivot or inflection of policy in he June July period this way and not conflate that with expectations.

Now, let's talk about Powell versus the markets. I've used this term before because that's what it seems to be these days. Powell on Wednesday is likely to express the need to slow the pace of policy tightening from an extreme 75 basis points per meeting to a still very hawkish 50 basis points per meeting. The terminal rate reflected in the dot plot is likely to show a median expectation for the terminal Fed funds rate to move higher by 25 basis points. That's between the terminal rate going from between 4.5 - 4 75 to a terminal rate and that's going to end between 4.75 and 5.0. That's essentially what the dot plot is expected to represent and while this represents a slowing in policy tightening, it should not be seen as dovish because Powell will likely emphasize that they will keep the policy rate higher or tighter for longer. And it could be that the terminal rate lands even higher between 5 and 5.25%, which I wouldn't discount. I think that can actually happen. This is very, very much on the table. Additionally, Powell may send a message that he wants to avoid previous Fed policy mistakes, let's say from the early 1980s, where the Fed prematurely slowed their pace of tightening and even cut rates, which then allowed inflation to regain momentum and start to rise again. So at all costs, Powell likely wants to prevent a wage price spiral inflation condition from evolving. He's discussed this many times in previous commentaries where if that happens that this is where inflation expectations start to become ingrained. So if inflation does start to reemerge and does start to regain momentum, you could get that price wage spiral and Powell wants to prevent that.

The risk is, if that happens, then the Fed may need to restart their hiking cycle all over again later in 2023 or 2024, which is not what the consensus is saying or the market is pricing and that could have devastating effects on markets. This is something that we also have to be mindful of as well. The window to get inflation under control according to the Fed is now and it's closing quickly. It's better to overshoot than undershoot as Powell and the Fed may see it. So we would expect coming out of this meeting that they speak a little bit more hawkishly and give the market the view that the Fed is very, very serious about containing inflation and now is the opportunity to do it, and it's better to do too much than too little. They can always reverse course later if they need to. Let's keep all of this in mind for context, as we interpret the Fed actions at the December meeting.

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