NASHVILLE NOTES

Will the Fed Have a Big Footprint in 2024, Too?

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The Fed again will be a dominant theme in markets in 2024**,** as has been the case for much of my working career from the mid-1980s, when the financialization of the economy became pronounced. The level of rates matters when the system relies upon outsized leverage to finance assets, and free-flowing capital is important for refinancing activity because so much debt is rolled rather than amortized.

From its founding in 1913, the Federal Reserve System was charged with providing — or managing — an elastic currency to limit the damage from periodic banking panics as the lender of last resort. It fulfilled this obligation in 2023 when it liquified the banking system with the rollout of the Bank Term Funding Program after Silicon Valley Bank and Signature Bank failed in March.

Mission creep has expanded the Fed's scope of activities since its founding. The Depression and World War II brought interest rate controls, the Bank Holding Company Act of 1956 expanded regulatory oversight, and the late 1970s brought the dual mandate to manage monetary policy to achieve stable prices and maximum employment. Adjectives such as "stable" and "maximum" are subject to interpretation, which is why they were selected.

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Fed verbiage has an impact in the 24/7 news cycle, as officials make the rounds speaking to the press, Congress and other constituencies about what "the committee" is thinking and what it may do — unlike in the pre-financialization era, when Fed officials did not say much and changes in rate policies were not publicly communicated.

The Fed now affirms its commitment to returning inflation to 2%, the rate it has targeted as "price stability" explicitly since 2012 and informally since the mid-1990s, according to ex-St. Louis Fed President James Bullard.

Price stability defined as 2% annual debasement of our currency seems Orwellian to me. Six or seven years ago I got to ask Bullard the debasement question at a breakfast hosted by the Economics Club of Memphis. He responded by saying I might not believe him (I did not), but he could imagine supporting an argument for a target rate near zero in certain cases. Nevertheless, the target was 2%.

If year-over-year inflation declines to 2% or nearly that low in 2024, then Wall Street may get its wish as the Fed cuts much more than three times. If inflation does not fall much further, I would not be surprised to see the Fed raise its "price stability" target to 3% from 2%, justifying limited cuts in a win-win scenario for Wall Street that investors priced into risk assets late in 2023.

> ***Aside from inflation, the other big question for 2024 is who is going to buy the government's ever-expanding auctions now that the Fed is shrinking its bond portfolio.***

Mission creep also includes financial stability, which in one sense is why the Fed was formed. I interpret financial stability to mean a backstop of markets either directly, as occurred in March 2020, or indirectly, by taking actions that will attract capital when instability is so great that the economy is threatened.

The ultimate market to be protected is the US Treasury market. Aside from the inflation question for 2024, the other big question is who is going to buy the government's ever-expanding auctions to finance its huge deficits now that the Fed is shrinking its bond portfolio.

The consensus for now, I think, is that the market can absorb the increasing supply, supported by actions the Treasury has taken to increase the issuance of short-term bills relative to longer-term notes and bonds. But what happens if the consensus is wrong? The widespread assumption is that the Fed will have to return to bond buying, though it may have to concoct a good reason to do so other than the federal government needing assistance.

In April 2011, then-Atlanta Federal Reserve Bank President Dennis Lockhart spoke at an event I attended in Nashville. At the time, the Fed was just a couple of years into its experimentation with near-zero short-term policy rates and "large scale asset purchases," buying bonds under a $600 billion program that Wall Street called "QE2."

Lockhart said the bar for QE3 would be high, and categorically stated that the Federal Reserve would never undertake monetization of debt to fund a profligate government. I did not believe that comment either.

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