Errors of omission versus errors of commission

Blog

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There are effectively two types of errors that plague decision makers – errors of omission and errors of commission. The former represents an overly passive approach toward taking action, while the latter reflects an overtly aggressive posture toward decision-making. Although a debate still rages over which of these represents the bigger miscalculation, the truth is that it really depends upon the circumstances of the moment. Keep in mind that most decisions must be made against a backdrop of imperfect, incomplete and even inaccurate information. It's therefore difficult to know with any degree of confidence which path will yield the best outcome.

The COVID-19 pandemic represents a perfect illustration of the type of dilemma that policymakers often face. Given the fact that we had not faced a global pandemic in over 100 years, policymakers had no real experience in dealing with such a broad-based public health threat. What's more, the information that was available was fragmented, contradictory and in some cases downright misleading. So, what were policymakers to do? Move too cautiously and run the risk that the pandemic would spread uncontrolled and ravages the most vulnerable members of society; move too forcefully and suffer the consequences from economic, social and political destabilization. Even with hindsight it's still not clear which option would have yielded the best results.

Central bankers face much the same challenge. They must make decisions that will have a profound impact upon the real economy and financial markets - but with only limited information. Despite progress in data capture and analytical frameworks - as well as advances in model building and scenario analysis - there is still a high degree of uncertainty surrounding the decision-making process of central bankers. How policymakers choose to interpret this information and act (or not act) upon can have a profound impact upon business owners and investors alike. So, with policy meetings scheduled for both the Fed and the ECB this week, market attention will clearly be focused upon monetary policy.

And this is where errors of omission and commission come into play.

Early in the current business cycle, both the Fed and the ECB were hesitant to raise rates. Keep in mind that the experiences of the Global Financial Crisis were still fresh in the minds of central bankers. Each attempt to normalize policy following the crisis had to be rapidly reversed as inflation spikes proved to be temporary anomalies that were subsequently followed by growth scares and deflationary threats. Conditioned by these experiences, it's not at all surprising that central bankers were initially dismissive of the inflation risks ("transitory" became one of the most overused terms in the English language in 2021). Failing to recognize some of the fundamental differences between the nature of the financial and COVID crisis, central bankers therefore deferred action and allowed inflationary pressures to continue building.

But they quickly shifted gears once it became clear that inflation pressures were not abating and were, in fact, more structural in nature. In 2022 alone, the Fed raised the target funds rate by 450 basis points in one of the most aggressive tightening campaigns in history - and have since tacked on an additional 50 basis points for good measure. This accelerated tightening has - not surprisingly - begun to manifest itself within the banking system. First Republic became the latest casualty as depositors fled the institution amid concerns over losses within their investment portfolios due to asset-liability mismatches. FRB currently ranks as the second largest bank failure in US history behind only Washington Mutual which met its demise during the financial crisis.

The Fed therefore faces a difficult policy choice. By pausing prematurely while inflation is still well above their target rate, they run the risk of repeating their earlier misstep of being too sanguine in the face of still high price pressures. Inflation expectations could become unmoored, thereby forcing the Fed to take an even more aggressive policy approach later in the cycle. On the other hand, by continuing to raise rates even as lending conditions tighten, the Fed could trigger a much more pronounced economic slowdown. A monetary policy induced recession would almost certainly lead to a sharp contraction in corporate earnings and weigh heavily upon risk assets. So, the Fed must somehow find a way to navigate monetary policy through this exceeding narrow channel between "errors of omission" and "errors of commission."

And that appears to be the scenario that markets are now betting on.

The S&P is currently trading at nearly 20 times 2023 earnings and more that 18 times 2024 earnings. Meanwhile, the Fed funds futures market appears to be discounting both a 25 basis point rate in May as well as 50 basis point rate cut by year end. This implies that the Fed will bend the inflation curve far enough so that they will be able to ease policy, but without having raised rates so aggressively that a recession ensues. This seems like a pretty tall task. Jason Draho, Head of Asset Allocation – CIO Americas, captured it perfectly in his recent blog post by pointing out the risk that "….equities have gotten ahead in pricing cuts, but not the commensurate economic pain that would likely necessitate them."

Given the uncertain environment in which central bankers currently operate, the margin for error is exceedingly narrow and the stakes are uncomfortably high. Powell and company must therefore carefully assess the risks associated with whichever course of action they choose to take this week. The consensus view is that the FOMC will raise rates by 25 basis points this week and then signal their intent to pause the tightening cycle and allow the impact of cumulative rate hikes to be felt. So, it may well be that the Fed is able to successfully navigate this tight channel between doing too little and doing too much with regard to rate hikes.

They better be…the markets appear to be counting on it.

Appendix

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