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TRENDMACRO LIVE!

On the December FOMC

Wednesday, December 18, 2013
Donald Luskin

Bernanke hands Yellen a *fait accomplis*, and a spoonful of sugar to help the medicine go down.

As we predicted (see, most recently, "Stanley Fischer: Game of Chairs" December 12, 2013), today the Fed announced the tapering of Large Scale Asset Purchases (LSAPs). Starting in January, Treasury purchases will be reduced to $40 billion per month from $45 billion, and MBS purchases to $35 billion from $40 billion. The FOMC "will likely reduce the pace of asset purchases in further measured steps at future meetings." At the post-meeting press conference, Fed chair Ben Bernanke indicated that tapering would not likely be completed until near the end of 2014.

At the same time, the FOMC strengthened its forward guidance for the fed funds rate beyond its "Evans Rule" threshold. Now, the funds rate will stay near zero "well past the time that the unemployment rate declines below 6-1/2 percent."

- The FOMC's rationale for tapering is: "Taking into account the extent of federal fiscal retrenchment since the inception of its current asset purchase program, the Committee sees the

Update to strategic view

US FED, US STOCKS, US BONDS: At last, the taper -- combined with a strengthening of forward guidance holding the funds rate at zero "well past" 6.5% unemployment. As a policy matter, it's not important -- for now, the Fed is irrelevant. The economy is accelerating because the world is a less risky and more growth-friendly place, and that will drive stocks, mortgage rates and yields higher over the coming year. The best news today is that Bernanke handed Yellen a *fait accomplis*, setting her Fed on a less risky course, and deferring the day when she and a more hawkish FOMC come to loggerheads.

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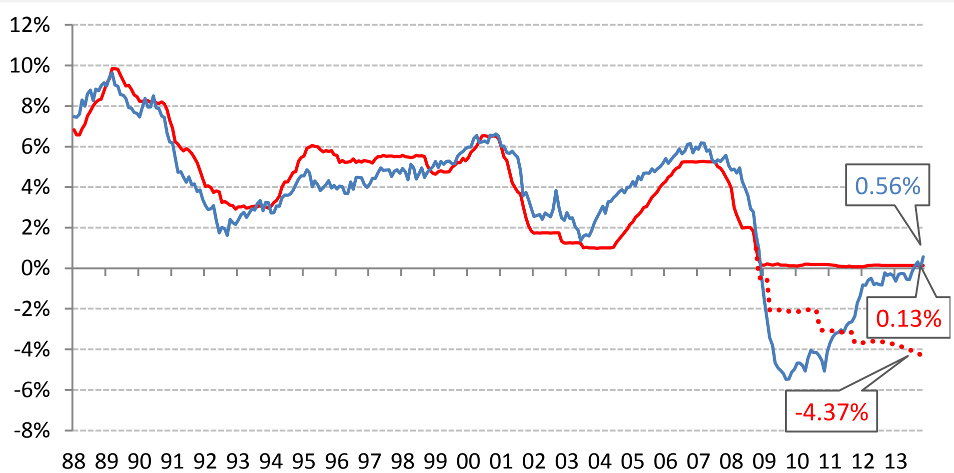
The Taylor Rule (per Rudebusch 2009)
Rule: 2.07 + 1.28 x 12-mo core PCE inflation - 1.95 x (UE - CBO natural rate)
Actual funds rate ···· Balance sheet-augmented funds rate



Source: FRB, BLS, TrendMacro calculations improvement in economic activity and labor market conditions over that period as consistent with growing underlying strength in the broader economy."

- *But there are more reasons for tapering -- good reasons: this was the right thing to do.*
- Politically, this FOMC meeting with a scheduled press conference was Bernanke's best chance to present chair-designate Janet Yellen with a *fait accomplis*. This sets her Fed on a more conservative path, and defers the day when she and 2014's more hawkish FOMC voting members will come to loggerheads (see "Yellen and Screamin' at the Fed" December 5, 2013). For the sake of appearances, at the post-meeting press conference Bernanke flatly denied acting with consideration of the hand-off to Yellen. And he said that Yellen agreed with today's decision. We'll see how accurate that latter statement was when the full transcript of the meeting is made public in five years.
- Politics aside, it's time to taper, even by the avowed standards the dovish Yellen. By the version of the Taylor Rule developed by Yellen's San Francisco Fed in 2009 -- which showed then that the ideal funds rate should be sharply negative, thus paving the way for LSAPs -- *the ideal rate is now positive 56 bp (please see the chart on the previous page). But with the Fed's forward guidance and LSAPs, policy has the effect of a funds rate lower than negative 4%. By Yellen's own numbers, the Fed should not only taper LSAPs, but reverse them entirely.*
- The economy and the labor market are indeed showing "growing underlying strength." The unemployment rate has already fallen to 7%, the point at which Bernanke had said just last June LSAPs would have stopped altogether -- a happy condition he didn't expect to be attained until "around midyear" 2014 (see "On the November Jobs Report" December 6, 2013).
- The way the Fed models work, the economy should improve further thanks to the bipartisan budget compromise developed by Representative Paul Ryan (R-WI) and Senator Patty Murray (D-WA) -- which relieves somewhat the near-term "fiscal retrenchment" of the sequesters, which the FOMC statement alluded to. At the same time, it pretty much rules out another government shutdown, the prospect for which in October was given as an excuse by Bernanke for *not* tapering at the September FOMC meeting (see "On the September FOMC" September 18, 2013).
- Well beyond the reduced possibility of a shutdown, the threat of global financial contagion no longer poses what the FOMC used to call "significant downside risks," which we think is what motivated QE3 in the first place (see "On the September FOMC" September 13, 2012).
- And even with the budget compromise's small sequester relief, federal deficits have fallen far off their highs of the last several years. The run-rate of LSAPs is now almost double the run-rate of the federal deficit (please see the chart on the following page). If the idea of LSAPs was to shield the economy from the crowd-out

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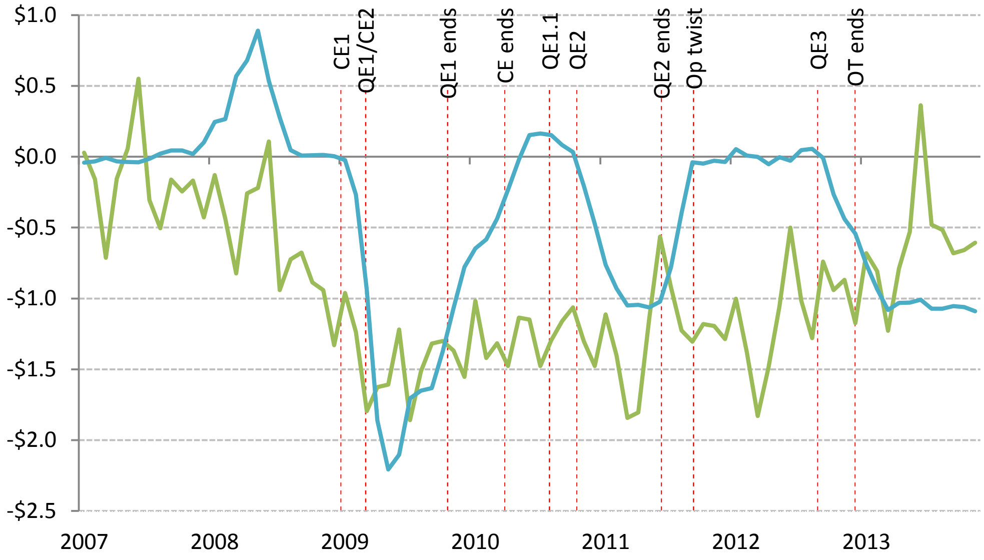
Recommended Reading

The Energy Boom and Manufacturing in the United States: A First Look
Will Melick
Federal Reserve Board
IFDP Notes
December 3, 2013

ATR Analysis of Budget Proposal
Ryan Ellis and Mattie Duppler
Americans for Tax Reform
December 13, 2013

[Reading home]

Federal deficit **LSAPs (inverted)**
3-month moving average, annualized, USD billions



Source: FRB, Treasury, TrendMacro calculations

effect of the deficit, now even tapering by about half would leave the Fed absorbing the whole thing.

- Finally, LSAPs have outlived their usefulness, if indeed they ever had any (see "US Fixed Income Strategy: The Fed Irrelevancy Hypothesis" July 2, 2013). We agree with Bernanke's characterization in July when he said their efficacy was "pretty small," merely "providing some near-term momentum." And we also agree with his characterization last month that LSAPs have "drawbacks… including the risk of impairing the functioning of securities markets and the extra complexities for the Fed."
- The only argument against tapering is that inflation is low. In one sense that presents the doves with a free option -- why not continue with maximal policy ease so long as inflation is not acting as a binding constraint? And at the same time, low inflation might indicate the risk of deflation, in which case maximal ease is called for as a preventive -- as is believed by St. Louis Fed President James Bullard.
- Bullard did not dissent in today's decision -- perhaps it was the strengthening of the forward guidance that earned his vote. The promise to keep rates at zero "well past" 6.5% unemployment was said to apply "especially if projected inflation continues to run below the Committee's 2 percent longer-run goal."
- But is inflation truly low? The Fed's purported favorite measure, core Personal Consumption Expenditures inflation, is running at a very low 1.1% year-on-year rate. But the core Consumer Price Index is running at 1.7% year-on-year, which is very near the Fed's target of 2.0%. Which to believe?
- The Greenspan Fed (when Bernanke was a governor, not chair) believed core PCE in 2004 when it was at a similarly low level, while core CPI was slightly higher than it is now. This led the Fed to

keep policy quite loose even as the economy was growing robustly, and according to credible critics caused a credit and housing bubble. As Bernanke has subsequently confessed, core CPI was right -- the low core PCE data was completely revised away. It is possible that a massively consequential policy error, therefore, was triggered by bad data.

- We think Bernanke is very cautious about being seduced again into a false deflation emergency, and that this element was not a serious counter-argument to today's taper decision.

So we see today's action as a small but welcome move in the direction of goodness.

- We don't think LSAPs have been doing much to support the economy, so it doesn't scare us to see them tapered (again, see "US Fixed Income Strategy: The Fed Irrelevancy Hypothesis").
- In the immediate aftermath, markets seem quite comfortable with the taper -- at least in combination with the strengthened "forward guidance."
- What counts here is that era of global financial contagion is over, and we are beginning to make technological and political progress on ending the era of history's highest oil prices (see "A Major Upgrade to our Strategic Outlook" September 12, 2013).
- For now, the Fed is irrelevant. Stocks -- and rates and yields -- are headed higher over the coming year because the world is a less risky and more growth-friendly place now than it has been in six years.

Bottom line

At last, the taper -- combined with a strengthening of forward guidance holding the funds rate at zero "well past" 6.5% unemployment. As a policy matter, it's not important -- for now, the Fed is irrelevant. The economy is accelerating because the world is a less risky and more growth-friendly place, and that will drive stocks, mortgage rates and yields higher over the coming year. The best news today is that Bernanke handed Yellen a *fait accomplis*, setting her Fed on a less risky course, and deferring the day when she and a more hawkish FOMC come to loggerheads.