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TRENDMACRO LIVE!

On the September FOMC

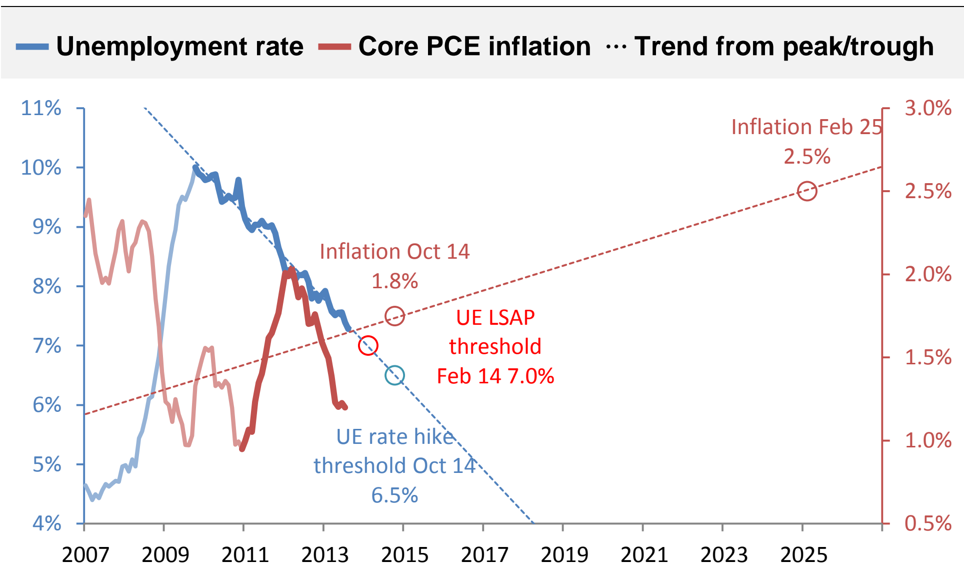
Wednesday, September 18, 2013

Donald Luskin

No taper -- but QE3 never lowered yields, so why risk prolonging it now that they've risen?

Quite a surprise. We had expected the tapering of the Fed's Large Scale Asset Purchases (LSAPs) to begin at today's FOMC (see "On the July Jobs Report" August 2, 2013). In fact, we thought it would be big (see "On the August Jobs Report" September 6, 2013). It strikes us that there is no very good reason for delay, certainly nothing contained in today's FOMC statement. Perhaps, as we speculated over the weekend, the noise from the withdrawal of Larry Summers' candidacy for chair may have made the FOMC more risk-averse toward any change in policy (see "On Larry Summers' Withdrawal" September 15, 2013).

- The FOMC is concerned that "the tightening of financial conditions observed in recent months, if sustained, could slow the pace of improvement in the economy and labor market." But other than rising long-term rates world-wide -- something that's been going on for almost 14 months as systemic risk has subsided, before QE3 even began -- what is this "tightening"?
- If QE did nothing to lower long-term yields -- demonstrably it did indeed do nothing (see "US Fixed Income Strategy: The Fed Irrelevancy Hypothesis" July 2, 2013) -- how will delaying help?



Source: BLS, BEA, TrendMacro calculations

Update to strategic view

US FED, US MACRO, US BONDS: The taper is deferred, and so is the beginning of the end the age of extreme accommodation after the Great Recession. This surprises us, but this should not change trends already in place in markets -- long-term Treasury yields should continue to work higher. With systemic threats receding, if the Fed doesn't roll back that accommodation, then it will create its own systemic threat of inflation. The Fed's own Taylor Rule calls for a positive funds rate for the first time since 2008 -- so it's time. We accept Yellen as the default for chair now, and see that Kohn is running second. But we see Roger Ferguson as a politically attractive choice for Obama after the Summers fiasco. Ferguson is an eclectic pragmatist like Bernanke, eminently more likely than the dogmatic dove Yellen to successfully manage the removal of accommodation when it is no longer needed.

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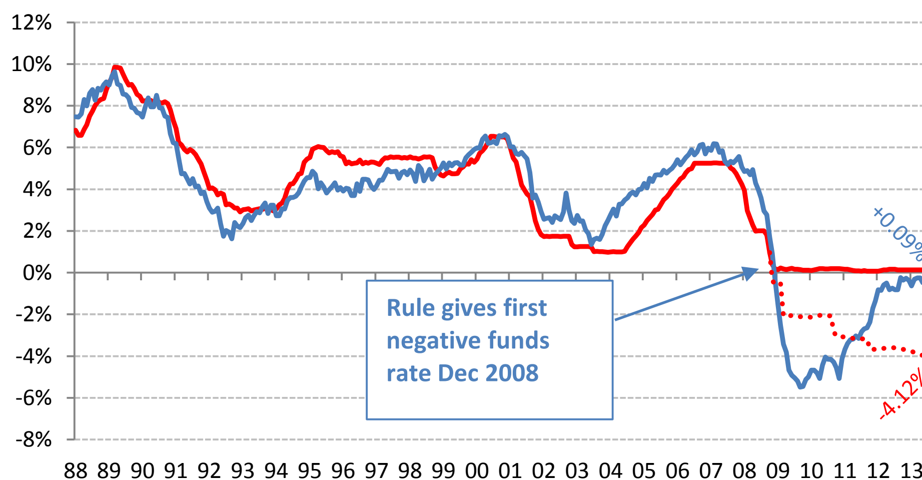
- The FOMC said today it wants "to await more evidence that progress will be sustained before adjusting the pace of its purchases." Yet in terms of the labor market, the gradual drop in the unemployment rate has been amazingly sustained now for almost four years, pointing with a highly correlated linear trend toward a rendezvous with the 6.5% threshold in the so-called "Evans Rule" in October 2014 (please see the chart on the previous page).
- This trend will take the unemployment rate to 7%, which had been Ben Bernanke's announced target at which LSAPs were to be terminated, by February 2014 (again, please see the chart on the previous page). But unless we missed it somehow, that 7% target wasn't even mentioned today.

By having signaled so clearly that tapering would begin today and then not doing it -- and then, by moving the goalposts by not mentioning the 7% target -- the FOMC is seriously eroding the value of its forward guidance.

- *Short-term, once the noise of the first-blush reaction to this surprise is over, we really don't think the physical act of buying no fewer assets will make any direct difference to markets. We think intermediate-term Treasury yields will continue to work higher through the end of the year, taper or no taper, simply because safe-haven assets are worth less as the world becomes a less systemically risky place* (see, most recently on this theme, "A Major Upgrade to our Strategic Outlook" September 12, 2013).
- *But the failure to remove excess accommodation promptly -- and now the diminishment of the believability of its signaling -- could have real consequences.*
- Remember, QE3 was undertaken a year ago specifically as a pre-emptive strike and insurance policy against threats of systemic

The Taylor Rule (per Rudebusch 2009): Is the Fed tight or loose?
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, BEA, TrendMacro calculations

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Recommended Reading

Perils for Both Sides in the Debt-Ceiling Duel
William A. Galston
Wall Street Journal
September 18, 2013

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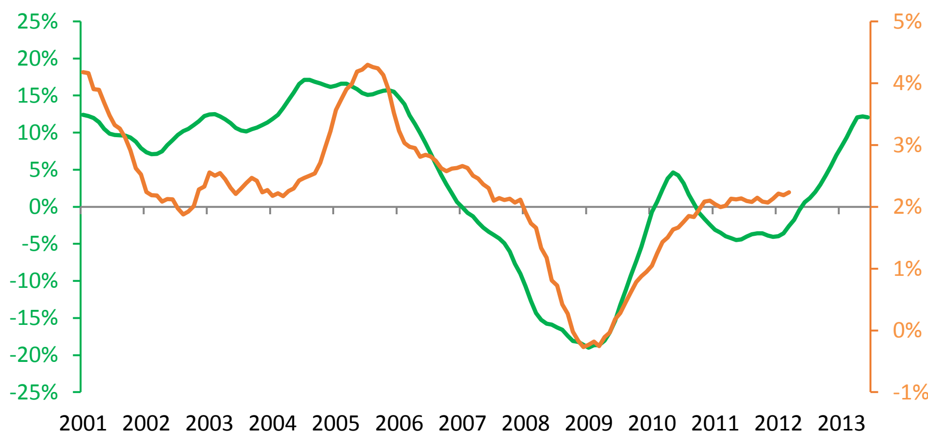
failure (see "Rethinking QE3" September 18, 2012). Now that those threats have passed, QE3 should be phased out.

- In today's post-FOMC press conference, a rather flustered Ben Bernanke alluded to remaining systemic risks arising from what he called "fiscal debates" -- presumably concerning the upcoming renewal of the continuing resolution that funds the federal government, and raising the debt ceiling that permits payment of principle and interest on government bonds.
- *Yet if that risk doesn't actually materialize, as all the other systemic risks this year didn't* (see, for example, "The Crisis Score is Four for Four" March 4, 2013), *then the insurance provided by QE3 will become even more useless.*
- It's something of a coincidence, perhaps. But it so happens that now is the first time since December 2008 -- when the FOMC first lowered the funds rate to zero -- that the version of the Taylor Rule favored by the Fed is calling for a greater-than-zero funds rate (please see the chart on the previous page).
- So versus the rule, *any* policy accommodation provided by *any means* other than the policy rate of zero is excessive. *Quite excessive -- augmented by the Fed's forward guidance and its enormous balance sheet, the funds rate now is, effectively, negative 4.12%. The gap between the Rule rate and the augmented rate is now the greatest it has ever been.*
- As we've spoken to clients over the last week concerning our more optimistic strategic outlook (again, see, "A Major Upgrade to our Strategic Outlook"), we keep getting the same reaction, and it's a good one: *as growth accelerates in the absence of systemic threats, the Fed itself could create the next systemic threat -- the threat of inflation.*
- It needn't actually happen, but it could if the Fed doesn't remove liquidity that will become surplus in the face of less money-demand in a less risky world. And wouldn't it be deliciously ironic -- just when all the inflation-hawks have been lulled into complacency by

Case-Shiller Composite 20-city Home Price Index YOY change
Owners' equivalent rent component of Consumer Price Index 18m lag



Source: Case Shiller, BLS, TrendMacro calculations

years of benign price signals in the face of record central bank accommodation following the Great Recession.

- Consider what has already happened in home prices, even while the US economy is recovering only sluggishly (please see the chart on the previous page). Changes in home prices are associated with changes in owners' equivalent rent with an 18-month lag. With home prices up more than 10% year-over-year now, the growth rate of OER -- the single largest component of the Consumer Price Index, weighted at 22% -- is already poised to rise over the coming 18 months from about 2% to about 3.5%.
- To be clear, we're not saying that a recovering housing market (or any other real economic activity) causes inflation. Inflation is everywhere and always a monetary phenomenon -- the product of central bank policy, set against the backdrop of real economic developments.
- So this is not a prediction of an inflation break-out. We are only pointing out that today's decision to defer tapering ought to have no important effect on markets once the immediate post-meeting dust settles, nevertheless in the larger strategic framework it is a failure to make a timely down-payment on the withdrawal of accommodation that can prevent that break-out.

How well the timely withdrawal of accommodation will be managed will be, obviously, mostly in the hands of the Fed chairman to succeed Ben Bernanke. We know now that this chairman will not be Larry Summers (again, see "On Larry Summers' Withdrawal"), and the consensus now is that -- by default -- it will be the current vice chair Janet Yellen.

- We agree with the popular portrayal of Yellen as a dove. We believe that she and New York Fed President William Dudley were driving forces moving the relatively conservative Bernanke to continued LSAPs after QE2 had run its course (see "On the March FOMC" March 13, 2012).
- Yellen is indeed the default choice now. But we know she's had some run-ins with senior White House advisors, if not the president himself. And to the extent that President Obama was forced to abandon Summers, his preferred nominee, because of revulsion in the Senate at Summers' anti-woman comments as president of Harvard, he might feel it would be a sign of political weakness to now nominate a woman.
- Rumors are flying today that former vice chair Donald Kohn is running second to Yellen. But as we've been saying in client conversations all year, we think the most likely choice other than Yellen would be another former vice chair, Roger Ferguson, presently the CEO of TIAA-CREF.
- His political credentials are impeccably neutral. He was appointed as a Fed governor in 1997 and then as vice chair in 1999 by Bill Clinton, and then re-appointed as vice chair in 2003 by George W. Bush.
- He earned a doctorate in economics at Harvard, so his training is, sadly, in the usual neo-Keynesian mold. But he also earned a law degree from Harvard -- like President Obama -- and his Wall Street

experience was as an attorney. The bulk of his pre-Fed career was as a consultant at McKinsey. With this background as a "business economist," he would come to the Fed chairmancy with a broad practical background similar to that of Alan Greenspan. In fact in 2005 Greenspan reportedly lobbied for Ferguson to succeed him as chair.

- We don't think he's as reflexively dovish as Yellen, for whom dovishness is an extension of an interventionist political philosophy. Nor is he as doctrinaire a neo-Keynesian as Kohn. Ferguson is more the eclectic pragmatist, like a Bernanke minus the academic veneer. Indeed, in 2003 Ferguson gave a speech remarkably like Bernanke's famous 2002 "helicopter speech," detailing the feasibility of unconventional central bank policies at the zero-bound, such as LSAPs.
- Oh -- and he is an African-American, which shouldn't matter, but does.
- His name has always been at the far periphery in the universe of candidates. This may make him all the more likely a choice now, if Obama wishes to bounce back from the Summers fiasco with something of a surprise, which would re-establish his credentials as "the decider."
- On the other hand, Obama's taste in appointments tends away from people with deep private sector experience -- and Ferguson has a great deal of that. Yellen and Kohn have virtually none (Kohn served a life sentence in the Federal Reserve system, and was let out to retire for good behavior).
- If we are right that it's time to begin to rein in what is becoming excessive accommodation, then we would expect markets to celebrate the selection of a flexible pragmatist like Ferguson, rather than a dogmatic dove like Yellen.

Bottom line

The taper is deferred, and so is the beginning of the end the age of extreme accommodation after the Great Recession. This surprises us, but this should not change trends already in place in markets -- long-term Treasury yields should continue to work higher. With systemic threats receding, if the Fed doesn't roll back that accommodation, then it will create its own systemic threat of inflation. The Fed's own Taylor Rule calls for a positive funds rate for the first time since 2008 -- so it's time. We accept Yellen as the default for chair now, and see that Kohn is running second. But we see Roger Ferguson as a politically attractive choice for Obama after the Summers fiasco. Ferguson is an eclectic pragmatist like Bernanke, eminently more likely than the dogmatic dove Yellen to successfully manage the removal of accommodation when it is no longer needed.