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TRENDMACRO LIVE!

On the October FOMC

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Donald Luskin

An increasingly Yellen-dominated FOMC takes a victory lap. Why aren't markets happier?

As expected, today's FOMC indicated little inclination to shift policy away from the deferral of tapering Large-Scale Asset Purchases (LSAPs) -- and we believe this shows outbound chair Ben Bernanke is giving extreme deference to chair-designate Janet Yellen (see "Inflation in Fashion" October 29, 2013).

- Virtually the only substantive change in today's FOMC statement versus last month's was the elimination of a phrase noting that "tightening of financial conditions observed in recent months, if sustained, could slow the pace of improvement in the economy and labor market."
- Apparently the FOMC regards the 40bp drop in the 10-year yield and the 35bp drop in 30-year mortgage rates since the prior meeting as sufficient relief from "tightening."
- This drop in yields and rates could be attributed to the surprise decision at the prior meeting not to commence tapering -- although it was underway before that.
- So as we read it, this change in language is Yellen's victory lap -- she, we believe, was the force behind the surprise no-taper decision.
- We're not sure why the immediate reaction of markets to the FOMC statement is a bit negative, with stocks falling and Treasury yields rising. On the face of it, you'd think this was a "party on!" signal from Yellen.
- Perhaps markets were expecting something more expansive, or at least more explicit. Or maybe it's just a classic case of "sell on the news."
- But from our perspective here there is absolutely nothing to celebrate.
- As we've said so many times this year, the historical record does not support the idea that LSAPs result in lower yields and rates (see "US Fixed Income Strategy: The Fed Irrelevancy Hypothesis" July 2, 2013). One candidate alternative explanation could be the similarly-scaled drop in headline inflation over the last couple data releases (see "Data Insights: CPI/PPI" October 30, 2013).
- But be that as it may, what counts here is what the FOMC believes, not what the facts are. *This single change in language today would seem to confirm that the Fed believes, right or wrong, that rising*

Update to strategic view

US FED, US BONDS: On the face of it, markets ought to be celebrating Yellen's victory lap today, as the FOMC eliminated language worrying about "tightening of financial conditions." With Treasury yields and mortgage rates notably lower since the prior FOMC meeting, this would seem to vindicate her no-taper surprise and suggest its continuation, and a signal from her to "party on!" The slightly negative reaction in markets may be no more than a classic case of "sell on the news." But we see nothing here to celebrate. The FOMC is failing to see that higher yields and rates are signs of health, and that lower ones recently could just as easily been explained by a similarly-scaled drop in reported inflation. And it overestimates its ability to keep them low, in the face of much evidence that it cannot -- and underestimates the risks of unintended consequences.

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yields and rates are impediments to growth, and that it must prolong policies it believes, right or wrong, will keep them low.

- *Both beliefs are wrong. Low yields and rates don't cause faster growth -- they are the sad effect of slow growth. Rising yields and rates don't slow growth, they are the happy effect of faster growth.*
- *And, again, either way, the Fed's LSAPs probably don't make much of a difference -- and only create unforecastable risks of unintended consequences.*

Bottom line

On the face of it, markets ought to be celebrating Yellen's victory lap today, as the FOMC eliminated language worrying about "tightening of financial conditions." With Treasury yields and mortgage rates notably lower since the prior FOMC meeting, this would seem to vindicate her no-taper surprise and suggest its continuation, and a signal from her to "party on!" The slightly negative reaction in markets may be no more than a classic case of "sell on the news." But we see nothing here to celebrate. The FOMC is failing to see that higher yields and rates are signs of health, and that lower ones recently could just as easily been explained by a similarly-scaled drop in reported inflation. And it overestimates its ability to keep them low, in the face of much evidence that it cannot -- and underestimates the risks of unintended consequences.

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