Trend Macro

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MACROCOSM

The Yellen Rule is Taylor Minus Two

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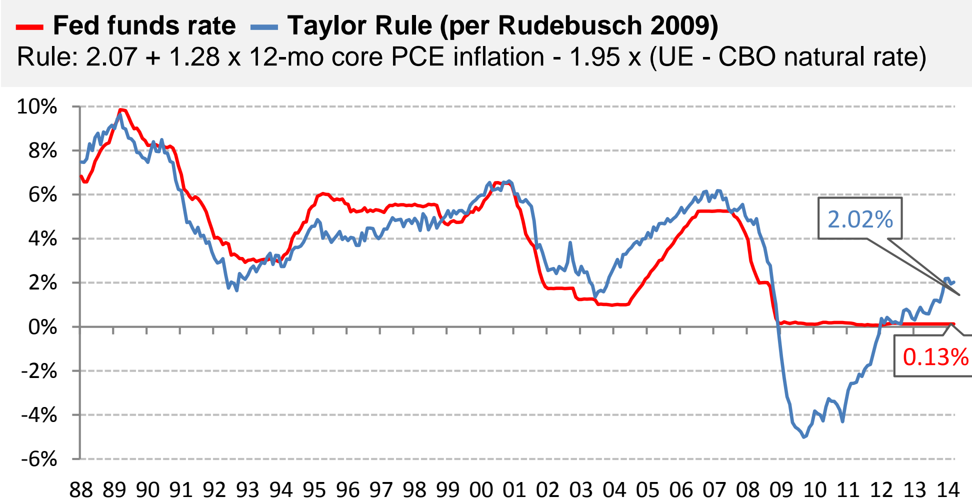
Treasuries have adapted to a dovish new Fed regime without QE or ZIRP.

At year-end we said the US 10-year yield would end 2014 at 3.5% (see "2013: The Year of Living Not Dangerously" December 31, 2013). We're not afraid to still stand by that call. But we sure never thought it would drop below 2.5% first. _What happened?_

- As we will explain, we don't think it's the market's reappraisal of prospects for growth, inflation or systemic risk.
- We think the likeliest explanation is the arrival at the Fed of a new policy framework for a new epoch, in which preventing systemic risk is no longer the central bank's prime mission.
- In this new epoch -- characterized by less systemic risk and therefore faster growth (see, among many, "A Major Upgrade to our Strategic Outlook" September 12, 2013) -- Large-Scale Asset Purchases (LSAPs) are no longer needed to de-risk the financial sector.
- *The new framework is a non-zero policy rate that will be, for many years, arbitrarily set lower than the policy rate produced by any well-known model or rule under like circumstances. It's the Yellen Rule -- and it amounts to the Taylor Rule minus two.*
- We're already there (please see the chart below), under the version of the Taylor Rule developed at the San Francisco Fed when Janet

Fed funds rate — Taylor Rule (per Rudebusch 2009)
Rule: 2.07 + 1.28 x 12-mo core PCE inflation - 1.95 x (UE - CBO natural rate)



Source: FRB, SFFRB, TrendMacro calculations

Update to strategic view

US BONDS, US MACRO, US FED: The decline this year in the 10-year yield is due to the Fed's elimination of time-based and event-based forward guidance focused on the move away from the zero funds target -- replacing it with a model that promises easy policy in perpetuity, versus any normal model or rule. This resembles the Taylor Rule minus two regime of the mid-2000s. We don't believe the decline in yields signals concerns with risk or growth. While yields have fallen during tapering as they did the last two times the Fed suspended LSAPs, equities and emerging markets have performed well, unlike the last two times when they went into severe corrections. We think the move in yields is virtually over, and expect them to move higher for the rest of the year as growth and inflation expectations improve, and financial contagion stays in abeyance.

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> Yellen was president. This is the rule that showed that the policy rate should be negative 5% or lower, the one that ended up being the clincher for getting then-chair Ben Bernanke to do QE2 (see "Fixed Income Strategy: Take The Low Road" June 16, 2010). Now that rule says the funds rate target should be about 2%. But it's zero.

This new policy framework was put in place in the statement of the March FOMC meeting -- Yellen's first as chair -- in which the so-called "Evans Rule" was scrapped (see "On the March FOMC" March 19, 2014). It was repeated identically in the April FOMC statement.

> "…even after employment and inflation are near mandate-consistent levels, economic conditions may, for some time, warrant keeping the target federal funds rate below levels the Committee views as normal in the longer run."

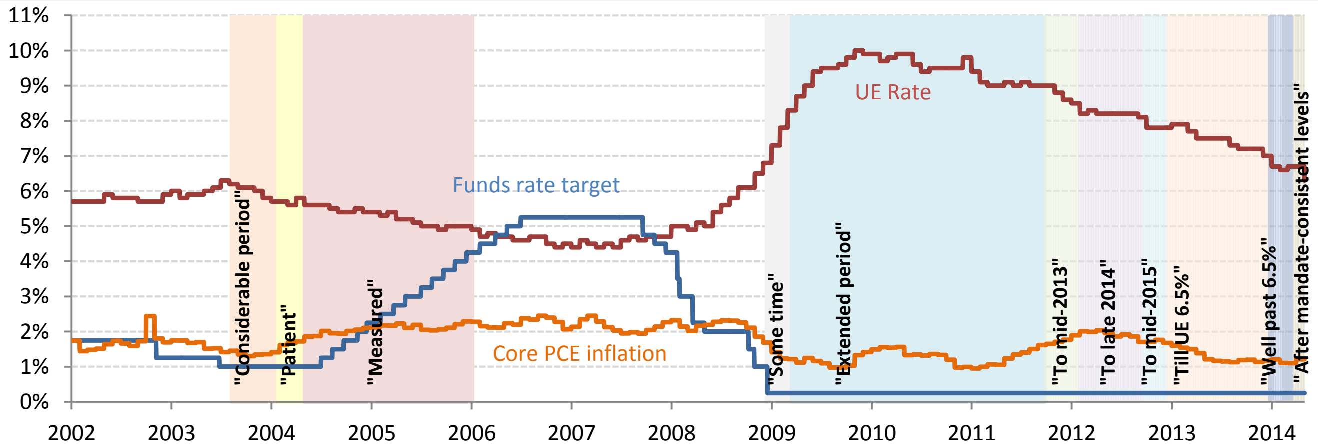
It's taken a while for markets to fully grasp the significance of this phrase. Indeed, when it was first uttered in March, long-term yields surged higher.

- No wonder, considering that it was lost in the most verbose FOMC statement on record, which itself stated that this "change in the Committee's guidance does not indicate any change in the Committee's policy intentions." Well, we've been telling you that Janet Yellen is a lousy communicator (see, among many, "Yellen and Screamin' at the Fed" December 5, 2013).

For all Yellen's communications mis-steps in her rocky debut, her new guidance language is in fact quite significant -- especially as it undoes all her own very poor work all these years as chair of the FOMC's Communications Subcommittee.

- Until the March FOMC, the Fed's evolving forward guidance throughout the Great Recession and its aftermath had two fatal flaws in common (please see the chart below).

FOMC forward guidance, versus various indicators



Source: FRB, BEA, BLS, TrendMacro calculations

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- First, all were either deadline-based ("zero rates until mid-2015") or event-based ("6.5 unemployment") or both ("well past 6.5%"). Thus they were all vulnerable to needing to be modified or abandoned when the deadline or the event got too close, each time diminishing the Fed's credibility.
- Second, all were framed with respect to the maintenance of the fed funds target at zero. Even if the deadlines or the events had been credible, they failed to inform the market about any of the Fed's intentions beyond the first rate hike from zero to non-zero.
- The new forward guidance is free of both deadlines and events.
- And it says nothing about the first rate hike that had been the sole focus of prior guidance, but instead lays out a pattern for ongoing policy evolution.
- Yellen let that cat out of the bag anyway, in her first post-FOMC press conference in March, when she stammered that "it probably means something on the order of around six months or that type of thing" from when tapering is completed, which will be in the autumn.
- And in her April 16 speech to the New York Economics Club, in which she characterized past guidance regimes much as we just have here, moving up from the zero policy rate was relegated to a mere catchphrase: "liftoff."
- *So there's nothing special about zero now. Zero is just another number on the policy path.*
- *The news is that after "liftoff," don't expect that policy will be back to what any known model would consider normal. It will stay not-normal for years, long after zero is only a memory.*

Thus the Yellen Fed is promising a policy posture that looks exactly like that of the Greenspan and Bernanke Fed from 2003 to 2007 -- Taylor Rule minus two.

- We note that John Taylor, father of the rule that bears his name, claimed as early as 2008 that this "deviation" from tried-and-true monetary policy "may have been a cause of the boom and bust in housing starts and inflation in the last two years."

Love it or hate it, this is *very* important to bond math. And it explains why the Treasury curve has experienced a "bull flattening" over the last couple months.

- A bond's yield can be modeled, through a straightforward arbitrage argument, as a sequence of shorter-term yields.
- Yellen's new guidance points to fewer zeros early on, but then many years of lower-than-otherwise-expected rates afterward.

Quantitative easing doesn't rely on this kind of arbitrage argument -- which we regard as so effective as to be virtually an axiom. Instead, QE relies on abstruse theories such as the "portfolio balance channel" -- the idea that by re-risking the banking sector by buying long-duration assets, the Fed can inspire the economy to act as though it were more risk-tolerant.

Recommended Reading

The Inequality Puzzle
Lawrence H. Summers
Democracy
Spring 2014

Human Capital, Uncertainty, and Growth in the 21st Century
Bret Swanson
Entropy Economics
May 15, 2014

Can Information Be Locked-Up? Informed Trading Ahead of Macro-News Announcements
Gennaro Bernile, Jianfeng Hu, Yuehua Tang
Singapore Management University, Lee Kong Chian School of Business
May 10, 2014

A Selfie-Taking, Hashtagging Teenage Administration
Eliot A. Cohen
Wall Street Journal
May 12, 2014

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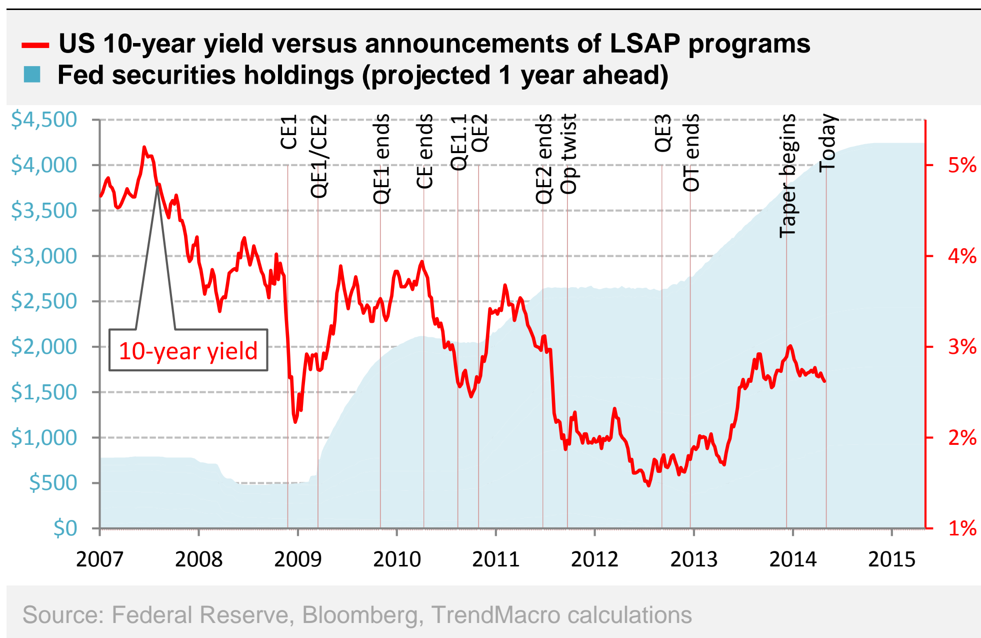
- In this sense, QE was an appropriate tool during the crisis era during and after the Great Recession.
- It began as a classic 19th century Lombard Street central bank intervention *for the sake of market stability, not monetary policy as such*. The idea of the first LSAPs -- which were mortgage-backed securities and agency obligations, not Treasuries -- was not to manipulate interest rates or bank reserves, but to extract pariah assets from the marketplace to avoid a vicious cycle of panicked fire-sale dumping. This is why Bernanke at the time was careful to call it "credit easing," as distinct from "quantitative easing."
- While subsequent LSAPs were advertised as QE, and positioned as unconventional monetary policy designed to lower long-term rates, we think that in fact they never operated that way. We believe, instead, that they were only extensions of the original "credit easing," designed to de-risk rather than stimulate (see "Rethinking QE3" September 18, 2012).
- Indeed, all the Fed's LSAPs have impacted markets consistent with that view.
- Every time the Fed has announced an LSAP program, long-term yields have moved *higher, not lower* consistent with a lessening of risk-aversion *(please see the chart below, and* "US Fixed Income Strategy: The Fed Irrelevancy Hypothesis" July 2, 2013).
- And every time the Fed has announced the end of an LSAP program, long-term yields have risen -- consistent with an increase in risk-aversion (again, please see the chart below).



Occam's Razor would seem to command that we explain the year-to-date drop in yields as a consequence of the Fed's tapering QE3.

- *The timing is pixel-perfect. The fall in the 10-year yield began on the first trading day of 2014, the very day that the Fed started*

And incidentally...

We don't mention in this report the effect that the Fed's large balance sheet will have going forward. The Fed estimates that even without ongoing LSAPs, the stock of accumulated assets on the Fed's balance sheet exerts an easing influence that makes the funds rate today, effectively, something like negative 4%. The models that produce such numbers are theoretical, complicated and very dubious. They rely, *ex ante*, on an article of faith -- that QE lowers long-term rates, which the models then translate into a short-rate equivalent. Given our lack of faith in that article of faith, we're not sure at all that a continuing large balance sheet will make any difference at all going forward.

[About us]

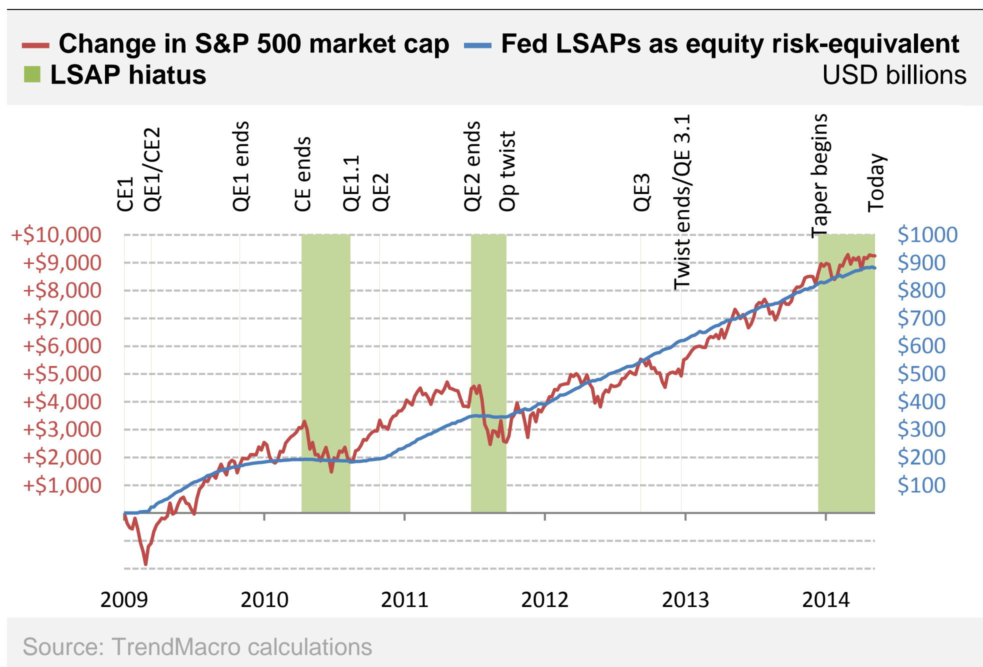
implementing the tapering it had announced in December (see "On the December FOMC" December 18, 2013).

- ***This makes it three times out of three that the 10-year yield fell following the announcement of ending a Fed LSAP program.***

Obviously we knew that tapering was coming when we called for higher yields at year-end. And we were well aware that in past LSAP hiatuses yields fell because the bond market knew that the Fed was quitting too soon, failing to provide needed sufficient liquidity in a world still beset by the threat of imminent systemic financial contagion. ***We thought that this time would be different****, because we believe the world is now substantially free from threats of systemic contagion* (again, see "A Major Upgrade to our Strategic Outlook").

The decline in yields hasn't changed our mind about our basic secular thesis. That's because in one very important way this time *has* been different.

- Notably, unlike the previous two announcements of ending LSAPs, this time stocks have not experienced a substantial correction (please see the chart below).

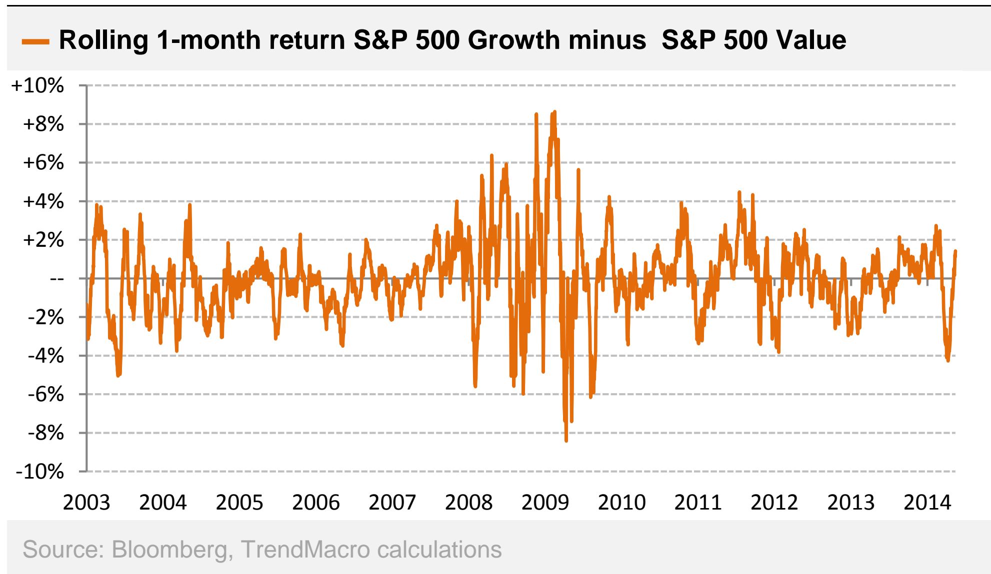


Source: TrendMacro calculations

- ***That stocks have not corrected more -- indeed, they have moved to all-time highs several times year-to-date -- implies that whatever else the bond market might be reacting to here, it's not the prospect of systemic contagion, deflation, or markedly slower growth.***
- A number of clients strongly disagree with this inference, noting that all-time highs for stocks have come only despite sharp underperformance by growthier sectors.
- True -- but sharp growth-versus-value retrenchments have occurred approximately annually during this bull market, and with about the same magnitude as this year's (please see the chart

below, and "Growth: Over Valued and Under Attack" April 9, 2014). And now that retrenchment has reversed, amidst a surge in forward earnings upgrades in growth sectors (see "Earnings to the Rescue" May 12, 2014).

- Be that as it may, this time stocks overall have held up, unlike in the two prior LSAP hiatuses, which marked significant corrections for all stocks (please see the chart below, and "Is the Fed Moving the Stock Market?" March 11, 2013).



Source: Bloomberg, TrendMacro calculations

- In a similar vein we note the performance this year of emerging markets equities. Most of them experienced very sharp corrections last summer when tapering was first discussed (see "A Little Distant Gunfire" August 29, 2013). Now after another correction in January in which we called the bottom, most emerging equity markets have recovered sharply, several breaking out to new highs (see "I Shall Fear No Taper" January 27, 2014).

So we conclude that this move in the 10-year is not about tapering *per se*, as we believe it was in previous LSAP hiatuses. The relatively good performance of stocks implies that LSAPs are no longer required to sustain the market's risk appetite.

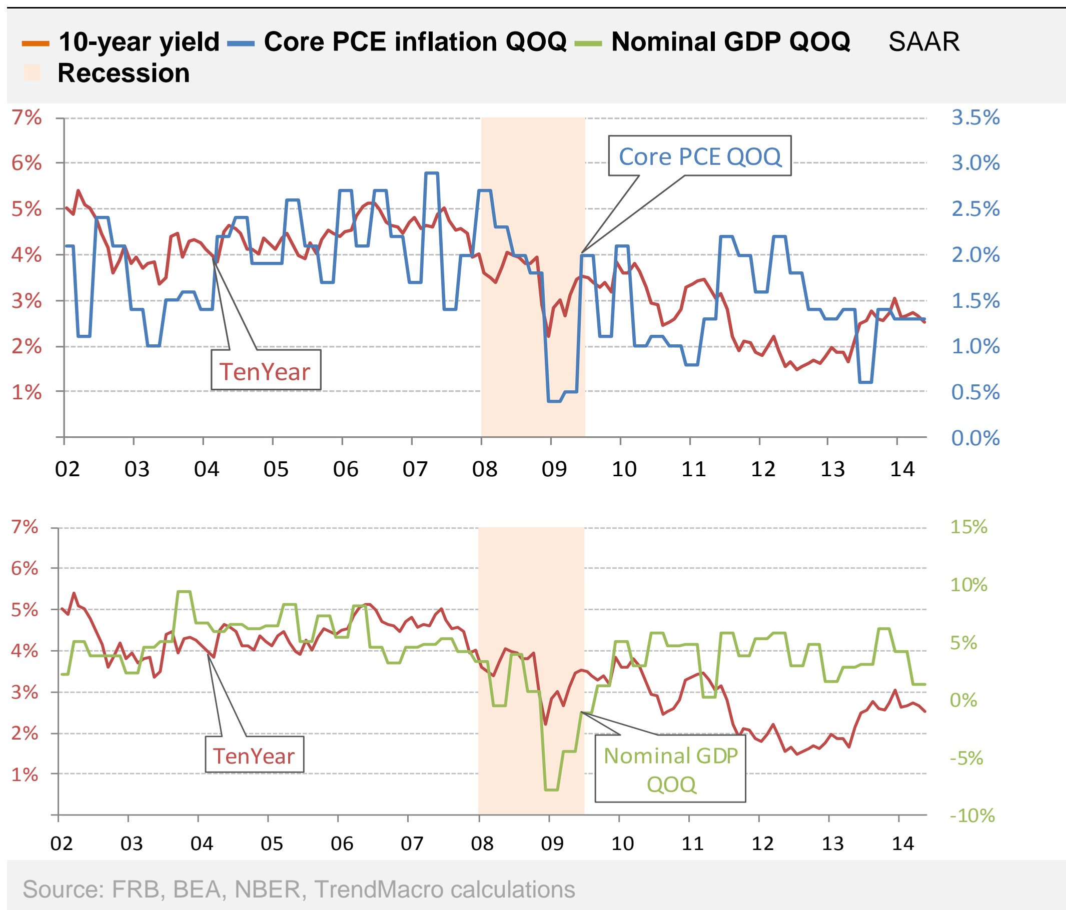
- All the more so in light of the risk factors that have arisen this year-to-date -- the depreciation of the Chinese yuan (involving the unplanned evacuation of carry trades), capital flight to escape risks of China's slowing economy and fragile shadow-banking system, and capital flight arising from sanctions against Russian banks.
- Any or all of these factors could contribute a technical cash-flow explanation for the drop in long-term Treasury yields, but apparently they have not driven a global return to risk aversion.

Where do we go from here?

- The Fed's new promise that the funds rate will be held forever below a normal model or rule rate is a one-time event. It is a single

step-function lower in rate expectations across time. It is saying: "Don't think policy will be normal just because the funds rate is above zero. Whatever you expected the economic background to be after that, the Fed will be easier than you thought."

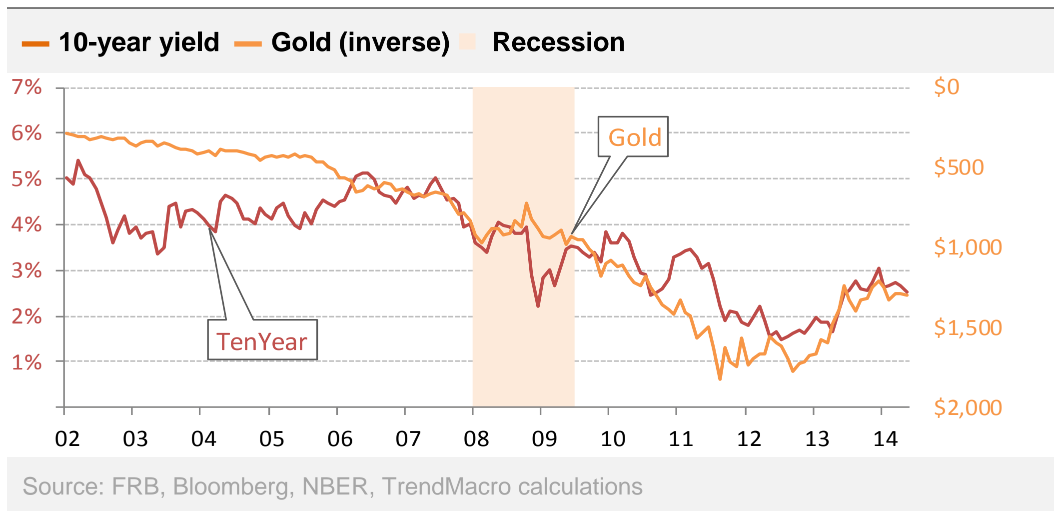
- Has the value of the step-function now been mostly discounted across the curve? We can't know, because we don't know what the market knows and what it doesn't, and because the Fed hasn't disclosed by how many basis points it will hold the policy rate below whatever model or rule it uses. We've said 2% in this report pretty much arbitrarily, recognizing that it's *already* 2% (and likely to be much more when "liftoff" happens, presumably early next year). And we don't even know what model or rule the Fed will use.
- Using crude approximations, the one-time step-function looks about complete. We say that because we know from the mid-2000s experience about where the 10-year yield wants to live relative to major macroeconomic inputs in a Taylor Rule minus two environment. It's about there now with respect to core inflation, and it's already too low versus nominal GDP (please see the charts below).



Source: FRB, BEA, NBER, TrendMacro calculations

- For what it's worth, of all the macroeconomic indicators we've examined, the 10-year yield has been most highly correlated since the Great Recession with the inverse of the gold price. This makes sense, if we think of both gold and bonds as safe havens in a world

of systemic risk. The 10-year yield now is exactly on target with gold (please see the chart below).



Source: FRB, Bloomberg, NBER, TrendMacro calculations

- And if we are right about the global economy -- that the end of the era of global contagion will facilitate more risk appetite, faster growth and higher inflation -- then we have to think that from this new lower starting point, yields are headed higher, pretty much as we thought at year-end.

Bottom line

The decline this year in the 10-year yield is due to the Fed's elimination of time-based and event-based forward guidance focused on the move away from the zero funds target -- replacing it with a model that promises easy policy in perpetuity, versus any normal model or rule. This resembles the Taylor Rule minus two regime of the mid-2000s. We don't believe the decline in yields signals concerns with risk or growth. While yields have fallen during tapering as they did the last two times the Fed suspended LSAPs, equities and emerging markets have performed well, unlike the last two times when they went into severe corrections. We think the move in yields is virtually over, and expect them to move higher for the rest of the year as growth and inflation expectations improve, and financial contagion stays in abeyance.