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FED SHADOW

It's Yellen's World, and We're Just Living In It

Wednesday, June 18, 2014

Donald Luskin

Where yields have to go down to go up, and inflation is above 2% so prices can be stable.

Today's FOMC statement, the third for new chair Janet Yellen, repeats for the third time, word for word, what we call "the Yellen Rule":

> The Committee currently anticipates that, 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.

We'll look at other elements of today's FOMC in a moment. But we must start with that long 38-word sentence embodying the Yellen Rule. *It is a revolution in the FOMC's forward guidance, revealing after more than five years stuck at the zero bound what policy will look like long-term after rates become positive* (see "The Yellen Rule is Taylor Minus Two" May 19, 2014). *The Yellen Fed is stating it believes that tighter bank regulation, globalization, retiring baby boomers, the global savings glut -- secular, cyclical, whatever! -- make easy policy appropriate even at 2% inflation and full employment. Agree or disagree with Yellen as you will -- but that's her view of the world.*

- This policy, and its repetition in explicit forward guidance, we believe is principally responsible for the drop in Treasury yields seen this year (again, see "The Yellen Rule is Taylor Minus Two").
- We continue to believe that when rates go positive, the Fed will get its most effective policy tool back -- after five years of quantitative easing, which was very useful as systemic intervention policy, but an utter failure as monetary policy.
- If the Yellen Rule ends up being excessively accommodative in the long run -- as a similar policy posture proved to be in the mid-2000s -- then this next policy cycle will end in tears. But in the meantime, we see the restoration of the Fed's policy powers and their determinedly dovish use as very positive for growth.
- *We think this year's big drop in yields means the bond market has over-focused on the first order valuation implications of a long cycle of lower-than-normal short-term rates. It has ignored the second order effect on growth. Indeed, lower long-term yields -- under the logic of "reflexivity" -- will themselves contribute to faster growth.*

Update to strategic view

US FED, US BONDS, US MACRO: Today's FOMC meeting contained little new information -- but that speaks volumes: it emphasizes the third word-for-word repetition of the revolutionary forward guidance that we call the Yellen Rule. That is the Fed's commitment to accommodative policy even after the economy has entirely returned to normal -- 2% inflation and maximum employment. The Yellen Rule explains the large drop in long-term yields this year. But the bond market is not taking sufficient regard of the pro-growth implications of a Fed that is systematically easy long after the zero bound has been left behind, and the economy is growing more robustly. The Fed and the bond market are both ignoring the conspicuous rise in measured inflation, which by almost all indicators is already back to or even above the Fed's target level of 2%.

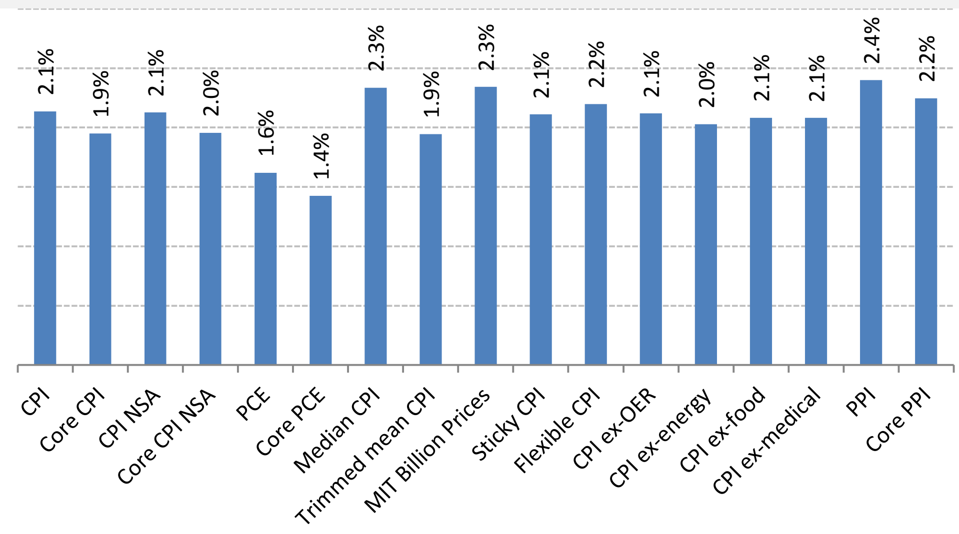
[Strategy Dashboard home]

- *In other words, it's a paradox, but we think bond yields had to go down so that bond yields could go up.*

This topic has strongly dominated all our client conversations over the last month. We frequently get pushback that this year's drop in long-term yields might alternatively be explained by China's return as a US Treasury buyer, or to the "export" of deflation from the euro area. We don't disagree that these could well be contributing factors. *But what we hear most often from clients is a concern with incipient inflation.*

- For several years, despite seemingly expansive monetary policy, we've dismissed inflation as a concern -- there are so many rationales and, indeed, so much real evidence that low inflation, if not near-deflation, is the dominant secular pattern.
- We started to think about an inflationary resurgence late last year, thinking that a world now free from systemic contagion would be less susceptible to deflation (see "Inflation in Fashion" October 29, 2013).
- *Now, US inflation is on the rise, with some of the many measures of it reaching rates not seen since before the Great Recession* (see "Data Insights: CPI/PPI" and "Data Insights: Unconventional CPI" June 17, 2014). *And with the exception of personal consumption expenditures (PCE) inflation -- which happens to be the Fed's preferred measure -- inflation rates are all virtually back to the Fed's avowed target of 2% (please see the chart below).*

Inflation, year-over-year



Source: Various, TrendMacro calculations

Clients are asking: if inflation continues to rise, wouldn't this require Yellen to abandon the accommodative policy we say her new forward guidance regime is promising for the long term? No, for two reasons.

- First, we've never said Yellen will never tighten policy -- whether in response to inflation, or to something else. *What we're saying is:*

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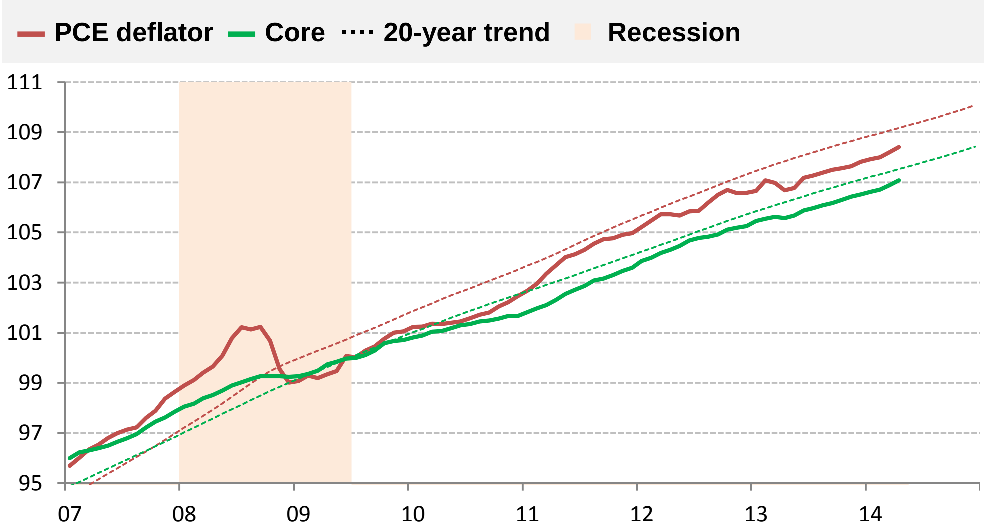
given any particular set of economic conditions, the Yellen Rule calls for easier policy than any traditional model would consider normal under those same conditions.

- So if some given acceleration in inflation would typically cause the Fed to move the funds rate from, say, 3% to 5%, under the Yellen Rule the funds rate will move from 1% to 3%.
- Would such a policy tightening succeed in arresting an inflation acceleration? By the standards of historical evidence that inform the traditional models, no -- the Fed would be forever behind the curve. But the Yellen Rule is informed by a belief that the curve itself has moved.
- Second, Yellen may actually not wish to arrest an inflation acceleration. From the Fed's strategic standpoint, the *level* of prices may be more important than the *growth rate* of prices. As Ben Bernanke advised the Japanese a decade ago, deflationary tendencies can't be rooted out of an economy *until the price level returns to trend* -- which, from a depressed starting point, would require several years of *above-trend growth rates for prices*. Implicitly, this viewpoint is reflected in Yellen's doctrine of "optimal control," which requires a seeming over-correction to make up for past policy errors.
- *In other words, inflation has to rise above the Fed's 2% target to meet the Fed's mandate for "stable prices."*
- The US price level is still well below trend, having never recovered from the brief bout with outright deflation in the worst of the Great Recession (please see the chart below).
- To be sure, systematically looser-than-normal policy similar to the Yellen Rule led to an *above*-trend price level prior to the Great Recession (again, see the chart below). If that happens again -- and from here, that's a very big *if* -- then Yellen might have to revise the Yellen Rule and really tighten. But right now, Yellen no doubt thinks that would be a very high-class problem. Her counterparts in Japan and the euro area surely feel that way.

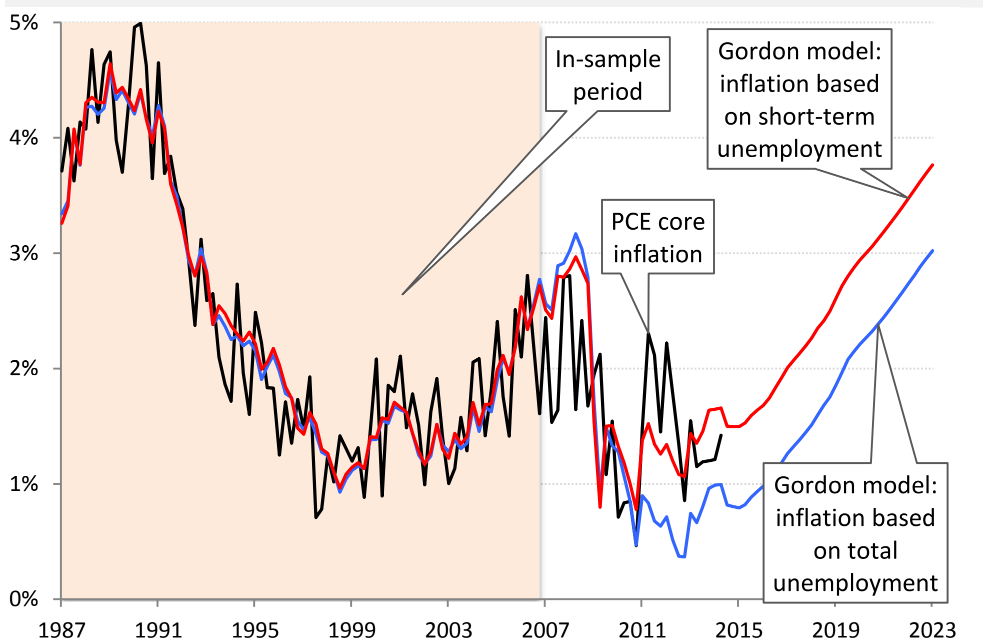
Our clients are evenly divided on whether inflation is a serious threat here.



Source: BEA, NBER, TrendMacro calculations

- Some adhere strongly to Milton Freidman's famous maxim that "inflation is always and everywhere a monetary phenomenon." They are mystified that inflation hasn't already been stronger, given more than five years of massive base money creation by the Fed -- and many believe that inflation is, in fact, stronger than reported in government statistics.
- Others take the view that weak labor market conditions -- especially low wage growth -- predispose the economy to low inflation, or even deflation. Without a "wage/price spiral" mechanism to transmit Fed policy into actual consumer prices, seemingly very easy policy will have little inflationary impact.
- But a new wave of influential research is throwing that view into question (see, for example, Kruger 2014: "Are the Long-Term Unemployed on the Margins of the Labor Market?" and Gordon 2013: "The Phillips Curve is Alive and Well: Inflation and the NAIRU During the Slow Recovery"). The key insight is that in this and the previous business cycle there has been a strong divergence between long-term unemployment and short-term unemployment. Now, with short-term unemployment down to 4.1%, we may be very close to what amounts to full employment under today's circumstances.
- Using short-term unemployment -- that is, an unemployment rate that discards persons unemployed for more than 27 weeks -- econometric modeling based on the Phillips Curve relation of inflation and unemployment is able to account well for the otherwise inexplicable inflation dynamics in the Great Recession and its aftermath. This modeling predicts rising inflation from here (please see the chart below).
- To be clear, we don't fully subscribe to the logic underlying such modeling. It is based on the assumption that unemployment alone

Gordon model of Phillips Curve relation of inflation and unemployment



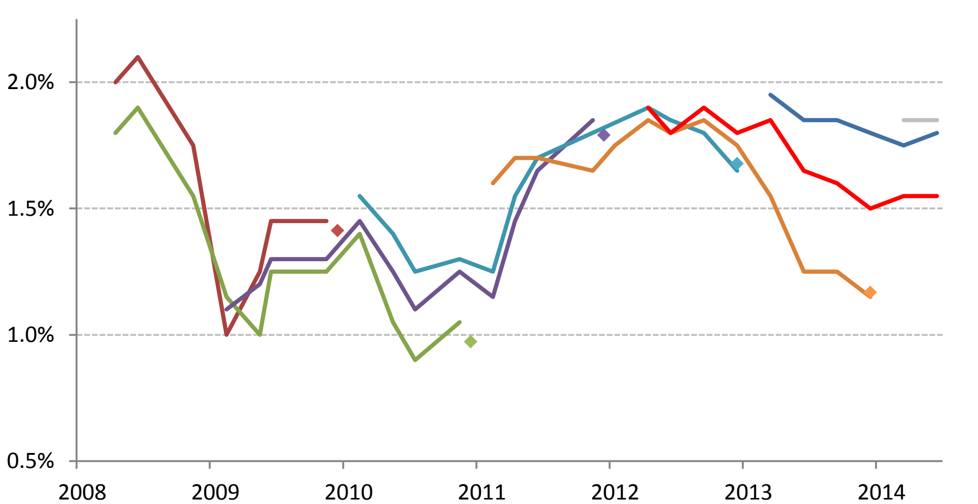
Source: Gordon 2013: TrendMacro calculations explains inflation -- that inflation is nowhere and never a monetary phenomenon. *We think that inflation is the joint product of the economic environment and the way the Fed reacts to it.*

- But the point made by this modeling is still salient. Monetary policy needs a transmission mechanism -- and the labor market may be a part (among others) of that mechanism.
- *If we take from this modeling that the labor market transmission mechanism is not as broken as we may have previously thought, then we would have to consider that easy monetary policy that would not otherwise be inflationary could in fact be inflationary.*
- *To loop this back to our discussion on the future of long-term yields -- clearly an eventual recognition by the bond market that inflation will not be infinitely quiescent would converge with the higher growth expectations we anticipate to move yields higher.*

Let us turn now to some of the details of today's FOMC statement and press conference, and the new economic forecasts prepared by the staffs of the FOMC's members.

- There's not much to say about the text of the statement, which was little changed except to remove allusions to recovery from this year's harsh winter (see "Data Insights: Federal Reserve" June 18, 2014).
- There wasn't a single new word on inflation, nothing to recognize its rise since the prior FOMC meeting, and its present year-on-year rate at the Fed's target of 2% by almost all indicators.
- The FOMC members' forecasts left inflation unchanged for 2014 and 2016, and upped it only 5 bp for 2015 (please see the chart below, and "Data Insights: Federal Reserve").
- At today's post-meeting press conference, the first question held Yellen's feet to the fire on the FOMC members' sanguine inflation forecasts. CNBC's Steve Liesman noted that inflation is likely to

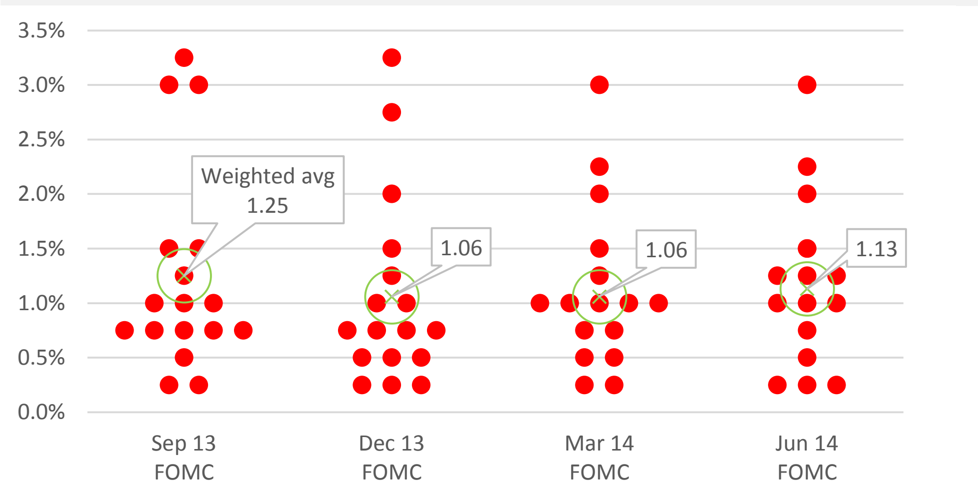
— Forecast versus ♦ actual: economic projections of FRB and presidents
for 2009 · 2010 · 2011 · 2012 · 2013 · 2014 · 2015 · 2016



Source: Federal Reserve, TrendMacro calculations "blow through" the 2014 forecast at the very next data release. Yellen handled the question without becoming flustered as she had at her first press conference in March. But Yellen's answer was without real content. She protested that "It's important to remember that broadly speaking inflation is evolving in line with the committee's expectations." *Broadly speaking, that is, except for the data.*

- Liesman followed up with an inquiry about the FOMC's tolerance for above-target inflation, probably trying to probe on Yellen's doctrine of "optimal control" that seeks above-mandate *rates* of inflation in order to get back the *trend level*. Yellen said only that nothing has changed in the FOMC's unwillingness to accept "permanent deviations from our objectives." *So it is willing to accept temporary deviations.*
- Forecasts for GDP growth were not significantly changed, but estimates for unemployment improved.
- Forecasts for the funds rate -- the infamous "dotplots" -- were upped slightly on average. We assign no particular importance to this. The changes are small -- and indeed the present higher forecast for 2015 is actually lower than it was three FOMC meetings ago (please see the chart below, and "Data Insights: Federal Reserve").

FOMC participants' estimate of "appropriate" target fed funds rate 2015
● Vote by individual participant



Source: Federal Reserve, TrendMacro calculations

Overall, we interpret the conspicuous lack of new information in today's FOMC materials as evidence of Yellen's intention to put front and center her revolution in forward guidance -- the Yellen Rule.

Bottom line

Today's FOMC meeting contained little new information -- but that speaks volumes: it emphasizes the third word-for-word repetition of the revolutionary forward guidance that we call the Yellen Rule. That is the Fed's commitment to accommodative policy even after the economy has entirely returned to normal -- 2% inflation and maximum employment. The Yellen Rule explains the large drop in long-term yields this year. But the bond market is not taking sufficient regard of the pro-growth implications of a Fed that is systematically easy long after the zero bound has been left behind, and the economy is growing more robustly. The Fed and the bond market are both ignoring the conspicuous rise in measured inflation, which by almost all indicators is already back to or even above the Fed's target level of 2%.