TrendMacro

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FED SHADOW

The Fed's Growth-Friendly "Dot" Gap

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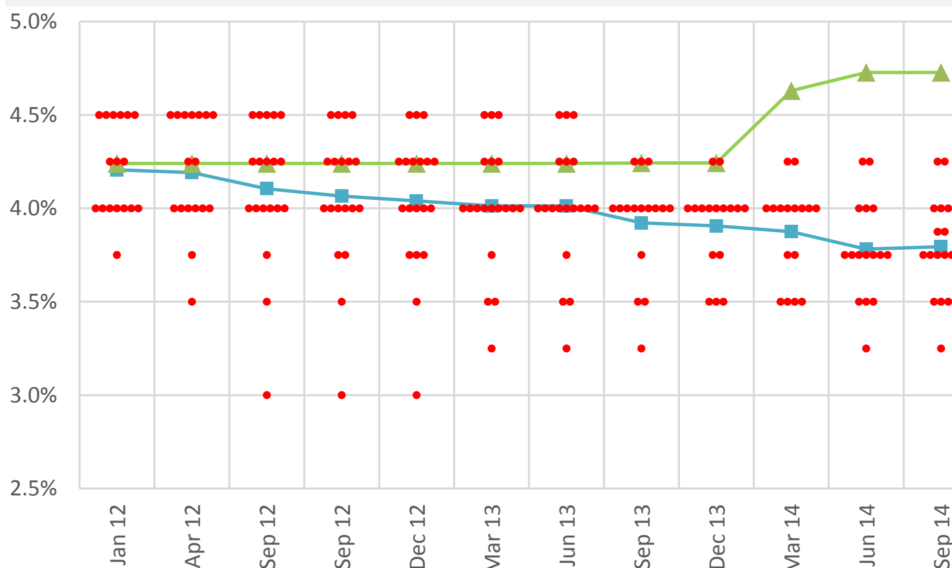
Treasuries are waking up to what stocks have known all year: "the Yellen Rule" could work.

Much attention was paid to the uptick in FOMC participants' projections for the fed funds rate over the next two years quarterly economic projections (see "On the September FOMC" September 17, 2014). The chatter has overlooked the long-standing opposite trend in the "longer run" projections. We think that connects to a market paradox -- a sharp back-up in Treasury yields over the last month, while stocks make new all-time highs.

- Projections of the "longer run" fed funds rate -- the often discussed "dots" -- have *steadily fallen* (please see the chart below).
- And yet at the same time, the matching "longer run" projections for unemployment have improved -- with a jump when Janet Yellen became Fed chair. Along with inflation projections that have remained about unchanged, when used as variables in Yellen's Taylor Rule model, they imply a *steadily rising funds rate*.
- So a gap has opened up. In January 2012, when the projections

"Longer run" funds rate • Each FOMC participant ■ Average
▲ Taylor Rule with participant's "longer run" UE and inflation projections
Rule: 2.07 + 1.28 x 12-mo core PCE inflation - 1.95 x (UE - 5.4% full emp.)



Source: FOMC, TrendMacro calculations

Update to strategic view

US FED, US MACRO, US STOCKS, US BONDS, EMERGING MARKETS STOCKS: FOMC participants' "longer run" projections for the fed funds rate -- the "dots" -- have been falling for three years. But since Yellen arrived, "longer run" expectations for unemployment have improved. This has opened up a gap between the projected funds rate and the Taylor Rule -- a gap which perfectly captures "the Yellen Rule" with its commitment to below normal policy even when the economy has fully recovered. Stocks are at new highs and emerging markets have sprung to life at the same time as long-term Treasury yields have retraced half this year's drop -- all consistent with the idea that markets are finally appreciating the growth-friendly implications of a Fed soon able to target rates above the zero bound, but at the same time keeping policy loose virtually forever.

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were first made available, the average projected funds rate perfectly matched the Taylor Rule rate. Today, the average projected funds rate of 3.79% is 93 basis points below the Rule rate.

- *This reflects what we've come to call "the Yellen Rule" -- a widening gap, even when the funds rate has escaped from beneath the zero bound, between policy norms and actual policy*.
- We've said that "the Yellen Rule" is the equivalent of Taylor minus two -- a catch-phrase meant to imprecisely symbolize a large and long-lasting decrement to whatever funds rate history would have led us to expect for any given future economic scenario (see "The Yellen Rule is Taylor Minus Two" May 19, 2014).
- Well, based on the 93 bp gap between the "longer run" dots and the Taylor Rule rate, we're about halfway there. The most dovish dot in the most recent projection is a funds rate of 3.25% -- which is 1.48% below Taylor. That one puts us three quarters of the way there.
- There's a good chance that the most dovish dot is Yellen's -- which would make it a very important dot indeed. A reporter asked her which dot was hers at Wednesday's post-FOMC press conference. Yellen, rather suspiciously we thought, said "I don't want to identify myself." Be that as it may, the gap to Taylor is clearly an emerging policy consensus reflected increasingly in the *average* projections.
- *For that matter, it's more than fully reflected in the current policy posture, which will stay in place for a "considerable time." At the zero bound, today's funds rate is 2.59% below the Taylor Rule, even with unemployment and inflation far from full recovery. So we're already more than all the way there!*
- Besides, it's official: "the Yellen Rule" has been enshrined repeatedly in a 38-word sentence that first appeared in the March FOMC statement, Yellen's first FOMC as chair. It has recurred verbatim in her four subsequent FOMC meetings -- April, June, July and September. Here are the 38 words, with the critical policy intention called out in red:

> **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.**

As we've discussed "the Yellen Rule" and its 38 words with clients over the last several months, a recurring question is *why* -- *why does the Fed believe now that historical norms no longer apply?*

- A frightening answer -- for which, happily, there is no evidence at all -- is that the Fed has developed increasing confidence in the power of accommodative policy. If participants believe that the lower dots *cause* the better economic performance that drives higher Taylor Rule rates, then they will want to keep lowering the dots in order to amp up the performance. This would amount to a

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return to the Fed's belief system in the 1960s, when it was thought that the Phillips Curve trade-off between unemployment and inflation meant that allowing more inflation would create more employment.

- A more likely answer is that the Fed doesn't think of its falling projections for "longer run" unemployment as representing economic improvement at all -- rather, only a statistical aberration driven by workers dropping out of the labor force. Such slack in the labor market would drive a lower funds rate -- first as a means of stimulating as much employment as possible under the circumstances, but also, second, as a free option on the Phillips Curve assumption that slack will prevent an abnormally low funds rate from leading to excessive inflation.
- But labor market slack is only a symbol -- chosen because "maximum employment" is enshrined in the Fed's statutory mandate -- of a wider complex of post-crisis impediments, which Yellen always refers to as "headwinds" -- as she did again in Wednesday's press conference. "Headwinds" is simply code for her particular version of the widely believed "secular stagnation" scenario.

The Treasury market swiftly embraced "the Yellen Rule" as it emerged this year -- at least superficially.

- It's easy enough to do the bond math, and move current yields lower to reflect a lower discount rate at each point up to maturity (again, see "The Yellen Rule is Taylor Minus Two").
- But at the lows for long-term yields last month, it seemed Treasuries were also deeply buying into the idea that Yellen's headwinds would be insurmountable -- that her policy of permanent accommodation would fail to accelerate growth or inflation. After all, if "the Yellen Rule" were to succeed, surely the miniscule 30 bp inflation premium in the 10-year yield at mid-August would be horribly inadequate. Treasuries seemed to be writing off as mere flukes 2014's strong labor market and inflation performance.
- We rationalized that several weeks ago by arguing that the bond market had forgotten how effective policy can be when it's not trapped beneath the zero bound (see "Attack of the 15 Basis Point Deflation Monster" September 2, 2014).
- Now it seems to be remembering. Since the mid-August lows, there have been disappointing reports both on jobs (see "On the August Jobs Report" September 5, 2014) and inflation (see "Data Insights: CPI/PPI" September 17, 2014). Yet the 10-year yield has backed up as much as 35 bp -- erasing almost half of 2014's drop in a little more than a month.
- *Having fought falling yields all the way down all year, we are delighted that it now seems that the mid-August lows were a speculative overshoot. Or to put it another way, and to be completely candid with our esteemed clients, we feel only half as stupid today as we did a month ago.*

Stocks have been faster to embrace "the Yellen Rule" and its growth-

friendly implications, making new all-time highs now four times this year.

- And it's not just because "the Yellen Rule" implies a future path of lower than normal long-term yields, meaning bonds will be less competitive with stocks -- or in other words, that there will automagically be a more attractive than normal equity risk premium.
- After all, when long-term Treasury yields fell to their lows for the year in mid-August, stocks underwent a simultaneous correction -- and as yields have sharply risen over the last month, despite the seeming competition from higher yields, stocks have come out of that correction and moved to new all-time highs.
- Emerging markets equities have, in particular, responded to the emergence of "the Yellen Rule." After a three-year coma in which the dominant narrative was that quantitative easing was supporting emerging markets, now that QE has virtually disappeared EMs have come abruptly to life -- as we expected early on (see "I Shall Fear No Taper" January 27, 2014). It's because of "the Yellen Rule," which by its very structure guarantees spread-stability between short financing rates and long investment opportunities -- the carry trade the EMs feed on.

To sum up, we think markets are beginning to understand that there are four keys to the growth-friendly essence of "the Yellen Rule."

- First, "the Yellen Rule" is about a funds rate above the zero bound, but lower than normal. On the day the Fed sets the funds target above zero, as of that moment it will be a "tightening" versus the moment just before. But that won't happen until mid-2015, and by then the economy will have improved further (that is, lower unemployment and higher inflation). *So versus the Taylor Rule, a 50 bp funds rate next year at "liftoff" from zero would be far easier than the zero funds rate is today.* And if growth and inflation *don't* improve, it won't happen anyway.
- *Second, moving above the zero bound restores to the Fed its best-proven policy tool -- rate targeting.* Stuck below the zero bound now for almost six years, the Fed has been limited to carrying out policy with QE -- demonstrably a success in rescuing the banking system, but just as demonstrably a failure as monetary policy (see "US Fixed Income Strategy: The Fed Irrelevancy Hypothesis" July 2, 2013).
- Third, "the Yellen Rule" really is a rule -- Taylor minus two, if you will -- and as such, reduces policy risk for the global economy. *It enables firms and individuals to take more risk with growth-creating investments because they don't have to wonder about the Fed.*
- Fourth, if "the Yellen Rule" succeeds -- by accelerating growth and inflation -- then interest rates and bond yields will have to move higher. *But that won't choke off growth -- rather, it will be a residual effect of growth. And while rates and yields will be higher than they are today, they will be lower than normal for any given growth scenario.*

Going forward, we think the markets' understanding of "the Yellen Rule" will continue to deepen -- all the more so when it actually starts to work!

Bottom line

FOMC participants' "longer run" projections for the fed funds rate -- the "dots" -- have been falling for three years. But since Yellen arrived, "longer run" expectations for unemployment have improved. This has opened up a gap between the projected funds rate and the Taylor Rule -- a gap which perfectly captures "the Yellen Rule" with its commitment to below normal policy even when the economy has fully recovered. Stocks are at new highs and emerging markets have sprung to life at the same time as long-term Treasury yields have retraced half this year's drop -- all consistent with the idea that markets are finally appreciating the growth-friendly implications of a Fed soon able to target rates above the zero bound, but at the same time keeping policy loose virtually forever.