

TRENDMACRO LIVE!

On the October FOMC

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Almost six years after it was born with a bang, QE dies with a whimper. We won't miss it.

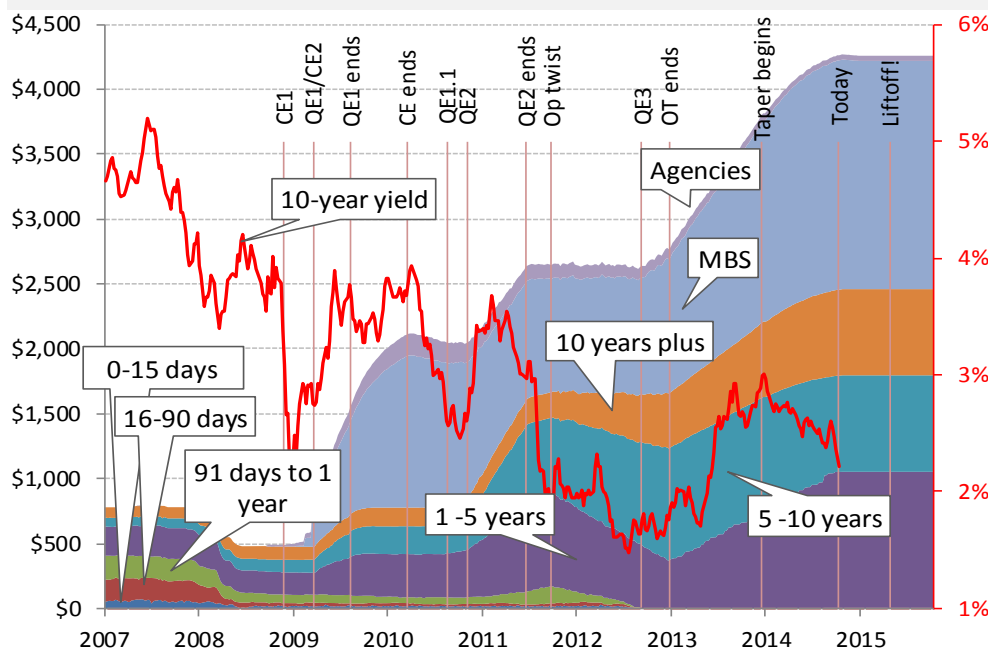
Despite a turbulent month in markets, the FOMC took an aggressive tone that knocked out the hawkish dissents of prior meetings, and drew instead a dovish dissent. More on that in a moment, but first our obituary for QE.

- QE didn't quite make it to its sixth birthday. It was born with the [surprise announcement](#) on November 25, 2008 that the Fed would buy \$500 billion in mortgage-backed securities and \$100 billion in direct obligations of Fannie Mae and Freddie Mac.
- You know the rest of the story. Over almost six years, through QE1, QE2, "Operation Twist" and QE3, Large-Scale Asset Purchases (LSAPs) have expanded the Fed's balance sheet by almost \$4 trillion, to today's record level of \$4.6 trillion (see the chart below, and ["Data Insights: Federal Reserve"](#) October 29, 2014).
- Will we miss QE now that it's done? That depends on what we believe about whether it did any good to begin with, and if so, how.

Update to strategic view

US FED: A seemingly aggressively hawkish FOMC statement celebrating a recovering labor market. It is to some extent self-congratulatory, and offered to rationalize the long-overdue demise of QE -- and to conceal its purpose all along, which was as a prudential intervention in the face of massive continuing global systemic risk. The "considerable time" language remains, with a verbose warning that it could be longer or shorter than expected. Happily, the Fed didn't cave to the recent phobia about too-low inflation, correctly noting falling energy prices as its cause, and diminishing the importance of falling market-implied measures of inflation expectations. No hawkish dissents this time, instead a dovish one from a dead-end worried about too-low inflation. But doves should not cry. "The Yellen Rule" is very much in place, a commitment to permanent policy accommodation, expressed in the same 38 words now for the sixth time.

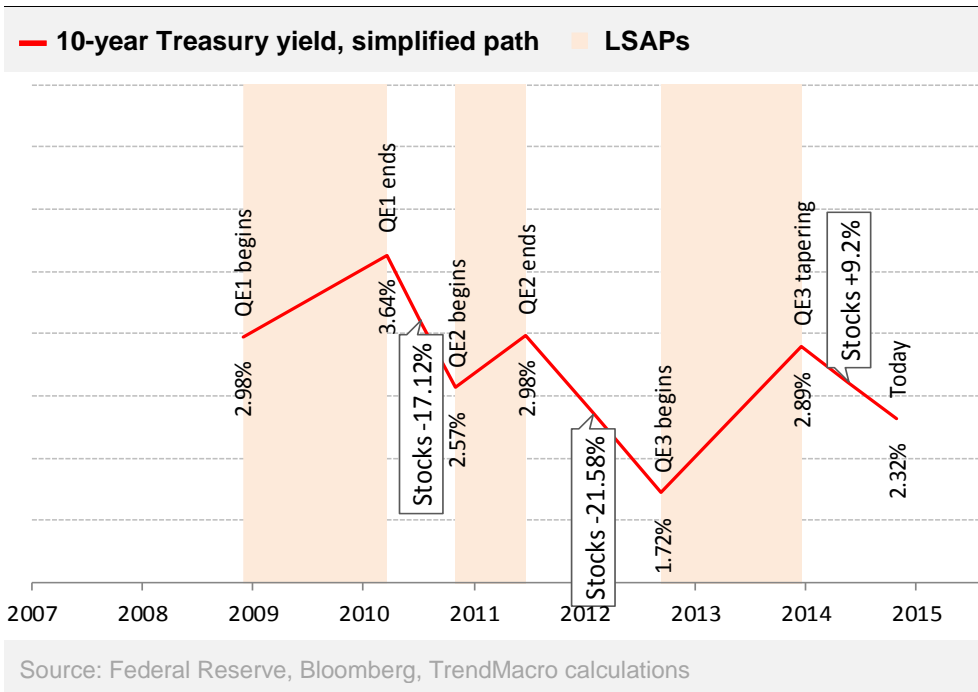
Federal Reserve holdings: Treasuries, MBS and agencies USD billions



Source: Federal Reserve, Bloomberg, TrendMacro calculations

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- At first look, and in the absence of counterfactuals involving no QE, it's not obvious that QE has worked.
- Bernanke, Janet Yellen, and many other Fed officials have said repeatedly over the QE era that its purpose is to lower long-term interest rates. To be sure, long-term yields have generally been low over the QE era. *But yields have invariably risen while LSAPs were active, and fallen when LSAPs have been stopped or tapered -- implying that the actual effect of QE was for some reason the opposite of that which was intended* (please see again the chart on the previous page, the simplified version below, and "[US Fixed Income Strategy: The Fed Irrelevancy Hypothesis](#)" July 2, 2013).



- A competing rationale offered by Fed spokespeople has been that QE raises asset prices via the "[portfolio balance channel.](#)" The idea is that LSAPs transfer risk from the market to the Fed's balance sheet, forcing the market to re-risk by redeploying capital away from relatively riskless assets to more risky ones. Until a year ago this theory seemed to be borne out empirically, with the US stock market rising during periods of LSAPs and falling when LSAPs were stopped (see again the simplified chart above, and "[Is the Fed Moving the Stock Market?](#)" March 11, 2013). But that pattern has been broken in 2014, with stocks rising to new all-time highs while QE has dwindled to insignificance.
- And then there is the entirely conventional idea that QE stimulates credit creation by expanding the quantity of bank reserves. Considering that the overwhelming majority of the reserves created by QE are laying inert on the Fed's balance sheet as excess reserves, it's not at all obvious that this has worked.
- We have come to think for quite some time that the real purpose of QE was systemic intervention -- first to save the US mortgage market, and later to liquefy the world banking system to reduce the

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Investors Business Daily
October 24, 2014

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Ed Crooks
Financial Times
October 22, 2014

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risk of cascading failures in Europe and the break-up of the euro currency (see ["Rethinking QE3"](#) September 18, 2012).

- *If rescue was indeed the purpose of QE, then despite all the conflicting empirical evidence from long-term yields, the stock market and excess reserves, we'd have to conclude that QE has succeeded. Further, we would judge that QE is no longer necessary, as the world at this point no longer needs rescuing, and in fact hasn't for quite a while* (see ["2013: The Year of Living Not Dangerously"](#) December 31, 2013).
- It is in the nature of things for crises to be sudden and attention-getting -- driving massive and rapid response, such as the Fed's in the midst of the post-Lehman banking crisis. Healing, and the restoration of confidence, takes longer. So the rescue response is withdrawn gradually, with respect for the possibility that the crisis hasn't really passed. So QE was born in *sturm und drang*, and now, something like Douglas MacArthur's old soldier, it just tapers away.
- So to the Fed -- *bravissimo!* Or rather, to new Chairwomen Yellen, *bravissima!* Our applause is for intervening with QE in the first place and saving the world, and then for recognizing that this massive intervention -- fraught with risks and costs and unknowns, even though we think it was entirely necessary at the time -- had to come to an end.
- Let's agree it has done its job. With that job done, we won't miss it now that it's gone.
- *That said, in an important sense QE is not gone. Those \$4 trillion in assets are still there on the Fed's balance sheet... but that's another story for another obituary.*

Now let us turn to other elements of today's FOMC.

Overall, at first blush, [today's FOMC statement](#) comes off as quite hawkish, especially against the backdrop of a month of turbulence in global markets that might have been expected to draw out a more conciliatory tone.

- After having in [the prior FOMC statement](#) bemoaned the poor state of the labor market, today the FOMC spoke of "solid job gains" and said that "a range of labor market indicators suggests that underutilization of labor resources is gradually diminishing" -- as we ourselves have been saying now for several months (see ["The Low Hanging Fruits of Our Labor"](#) July 15, 2014).
- We suppose there's some degree of self-justification there. The FOMC goes on to note that the "substantial improvement in the outlook for the labor market" has been "since the inception of its current asset purchase program." That serves both as the Fed's self-congratulation for doing QE, but also a comforting rationale to help markets accept its ending. The Fed has never been eager to tell the truth about QE -- that is, to admit that it was a prudential intervention in the face of very large global systemic risks. This [just-so story](#) about the labor market is a credible-seeming distraction.

- As we expected, the FOMC perpetuated the language promising that zero interest rate policy would be left in place for a "considerable time" after LSAPs end (see ["Don't Let a Good Oil Crisis Go to Waste"](#) October 21, 2014). The recent turbulence in markets -- arguably something of a tantrum about QE coming to an end -- made it impossible for the FOMC to say anything more highly committal than that. At the same time, the FOMC expended 59 words -- a degree of verbosity notable even for the Yellen Fed -- to say that "liftoff" could come sooner or later than expected, depending on conditions.
- We still think "liftoff" from zero is on schedule for next summer.
- In Yellen's [first post-FOMC press conference in March](#), she blurted out in response to a question about the meaning of "considerable time" that "you know, it probably means something on the order of around six months or that type of thing." *Yellen doesn't like to be wrong* (see ["Yellen and Screamin' at the Fed"](#) December 5, 2013), *and in this matter she has the power to make herself right. That means, all else equal, that the first rate hike above the zero-bound will be executed at the June 2015 FOMC meeting.*

We were delighted to see the FOMC not fall into line behind the pre-meeting media chatter predicting that the statement would raise the level of alarm about too-low inflation, bowing to the global deflation scare set in motion two months ago by ECB President Mario Draghi's dramatic speech at Jackson Hole (see ["Whatever It Takes' Comes to Jackson Hole"](#) August 25, 2014).

- Instead, the statement reiterated [the prior statement's view](#) that "the likelihood of inflation running persistently below 2 percent has diminished."
- Today's statement did note -- quite correctly -- that "inflation in the near term will likely be held down by lower energy prices."
- This is very much in line with our view, focused by the recent sharp drop in energy prices, that the relentless obsession with too-low inflation ever since the Great Recession has something between a misconception and a hoax -- the whole thing is explained by the drop in energy prices from all-time highs in July 2008 (again, see ["Don't Let a Good Oil Crisis Go to Waste"](#)).
- The FOMC even went so far as to not so obliquely critique Draghi's evidence for too-low inflation -- swap-implied 5-year inflation expectations five years forward -- saying "market-based measures of inflation compensation have declined somewhat; survey-based measures of longer-term inflation expectations have remained stable."
- Minneapolis Fed President Narayan Kocherlakota wasn't impressed by these subtleties. His dissent used language more appropriate to popular financial media, citing a "recent slide" in market-based expectations, and urging that the current level of QE continue until that reverses. What -- like that's going to help?
- Silly as that is, it speaks volumes that the hawks on the FOMC like Philadelphia Fed President Charles Plosser and Dallas Fed President Richard Fisher chose to sheathe their dissent pens for

today. They appear to be delighted to be pall-bearers for QE -- while doves cry.

But at the end of the day, Kocherlakota's tears are unnecessary. The only words that really count in today statement are the very dovish 38 words that articulate what we call "The Yellen Rule." They were repeated today for the sixth time in six Yellen FOMCs -- verbatim, just as they were in the [March](#), [April](#), [June](#), [July](#) and [September](#) FOMC statements (it is below, 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.

- *Please forgive us for repeating, but this is really all we need to know about the Yellen Fed going forward.* These words mean just what they say -- that policy is actually not data-dependent, that the Fed will keep policy easy even once the economy has more than completely recovered (see, most recently, ["The Fed's Growth-Friendly 'Dot' Gap"](#) September 19, 2014, and originally ["The Yellen Rule is Taylor Minus Two"](#) May 19, 2014).
- As to inflation, it is very much sidelined as a risk for the Fed's consideration. So long as inflation is too low -- or just low -- whether or not just because of energy -- or even if it is high for a while, restoring its long-term trend level under Yellen's "optimal control" doctrine -- accommodative policy will be seen as having no cost. It may or may not create jobs, but from the Fed's viewpoint it might as well give it a try, since too-high inflation is not seen as a constraint.

Bottom line

A seemingly aggressively hawkish FOMC statement celebrating a recovering labor market. It is to some extent self-congratulatory, and offered to rationalize the long-overdue demise of QE -- and to conceal its purpose all along, which was as a prudential intervention in the face of massive continuing global systemic risk. The "considerable time" language remains, with a verbose warning that it could be longer or shorter than expected. Happily, the Fed didn't cave to the recent phobia about too-low inflation, correctly noting falling energy prices as its cause, and diminishing the importance of falling market-implied measures of inflation expectations. No hawkish dissents this time, instead a dovish one from a dead-ender worried about too-low inflation. But doves should not cry. "The Yellen Rule" is very much in place, a commitment to permanent policy accommodation, expressed in the same 38 words now for the sixth time. ▶