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MACROCOSM

"I Really Didn't Say Everything I Said" *

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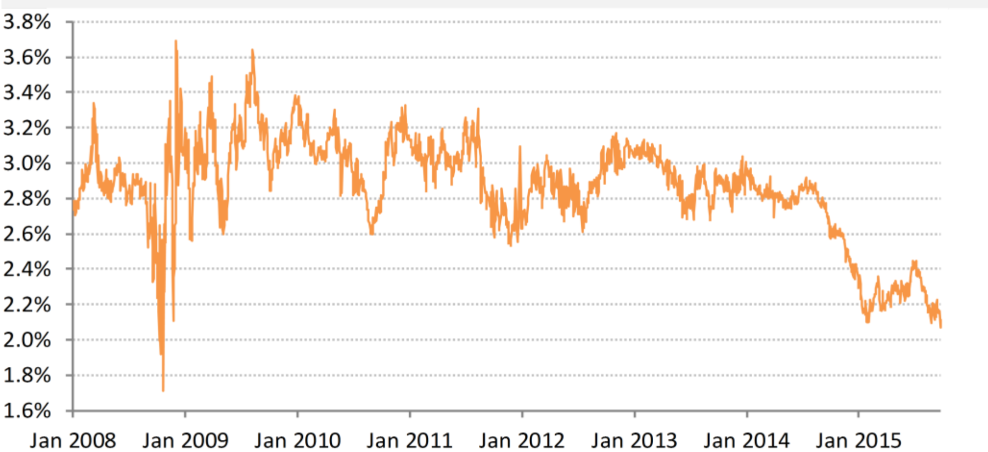
Donald Luskin

It's risk-off since Yellen flubbed last week's FOMC. Now QE4 may come before "liftoff."

For 48 happy minutes after the release of last week's long-awaited and heatedly discussed FOMC decision, markets breathed an exuberant sigh of relief -- the S&P 500, for example, rallied almost 1%. Then, 18 minutes into the post-meeting press conference, Fed Chair Janet Yellen must have said something terribly wrong. From there, global markets fell into a risk-off spasm. For example, as of this writing, the S&P 500 has fallen as much as 4.5% since Yellen said whatever it was that she said. Swap-implied forward inflation expectations have broken to new lows not seen since 2008 (please see the chart below). *So what did she say? Or not say?*

- We went to the 18-minute mark in the recording of the press conference. When asked whether "liftoff" could come at the October FOMC -- when there is no press conference scheduled -- Yellen said, "…yes, October remains a possibility."
- Okay, you can say that was a boilerplate response, just keeping options open. But then it got worse.
- *At the 23-minute mark Yellen responded to a question about whether she thinks "you've gotten closer to or further away from the Fed's inflation goals." Here, too, the answer was boilerplate. She said that disinflationary effects of lower energy prices and a strong dollar will "be transitory and with well anchored inflation expectations, we expect inflation to move back to 2 percent."*

Swap-implied 5-year inflation, 5 years forward



Source: Bloomberg, TrendMacro calculations

Update to strategic view

US STOCKS, US FED, US MACRO: Stocks have dropped as much as 4.5% since mid-way through the FOMC press conference, in which Yellen bobbled questions about "liftoff" in October, unanchored inflation expectations and the unlikelihood of additional accommodation. Swap-implied 5-year forward inflation has broken to new lows not seen since late 2008. Credit spreads continue to widen, capital investment remains stagnant, and forward earnings are flat as we near the one-year anniversary of their peak. Recession-risk is very real, and stocks won't pull out of the present correction until either the risk abates or the Fed indicates that it takes this seriously. The longer it waits, the more likely it becomes that QE4 will have to happen before "liftoff."

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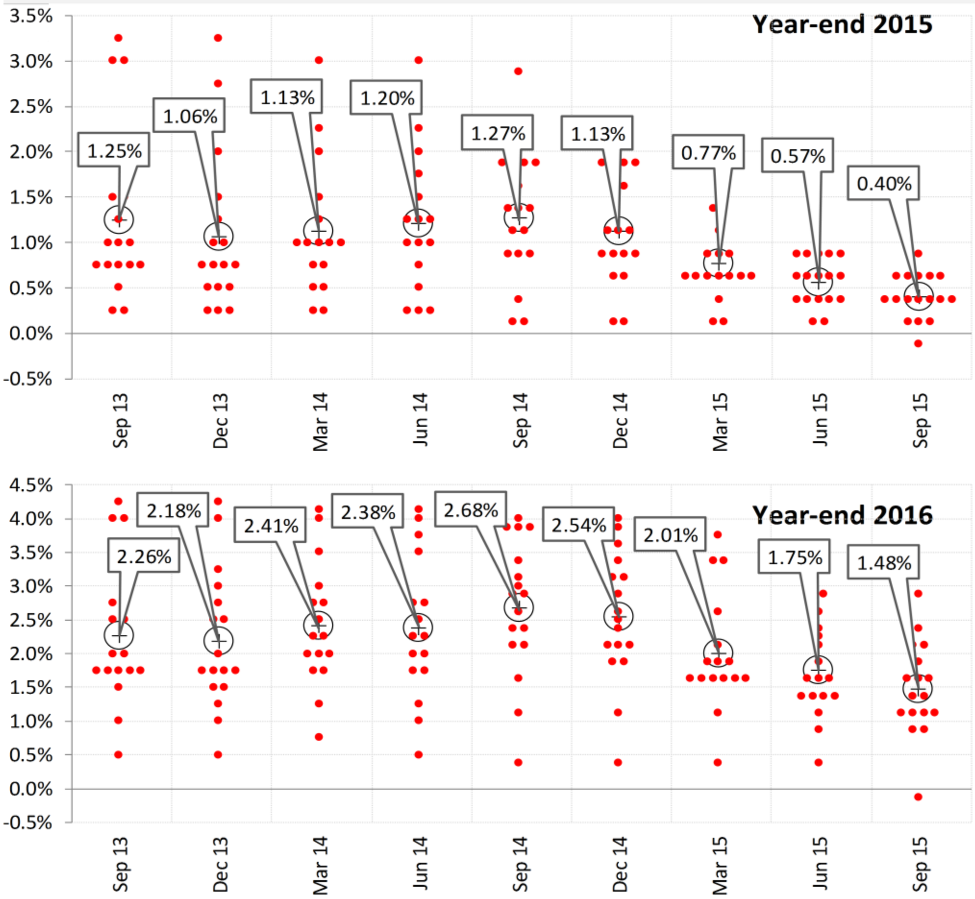
* Yogi Berra 1925-2015

- *The problem is that this particular boilerplate was a tone-deaf negation of the elephant in the room that the FOMC had already acknowledged in its statement, and that Yellen herself had acknowledged 15 minutes earlier in her prepared remarks: that market-based inflation expectations are at risk of becoming unanchored* (see "On the September FOMC" September 17, 2015).
- Then toward the end of the press conference, Yellen made a third mistake. She was asked about the two negative "dots" in the FOMC members' projections for the "appropriate" funds rate at year-end 2015 and year-end 2016 (please see the chart below, and "Data Insights: Federal Reserve" September 17, 2015). Yellen said "negative interest rates was not something that we considered very seriously at all today."

FOMC participants' "appropriate" funds rate **Average**



Source: Federal Reserve Board, TrendMacro calculations

- Okay, that's just one policy option, and not one that the Fed has ever particularly embraced. But then a few seconds later Yellen contradicted herself and said, "It's not something we talked about today." *Well, did you or didn't you talk about it?*
- Immediately after that stumble, she broadened her response considerably, moving way beyond just not taking seriously -- or not talking about at all -- negative rates, saying, "I don't expect that

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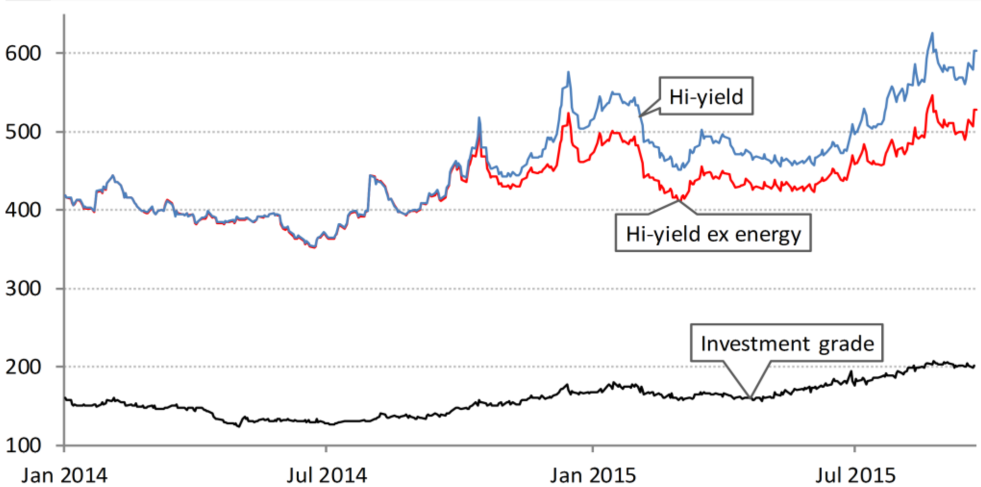
we're going to be in the path of providing additional accommodation."

- *So in the face of what she calls "heightened concerns about growth in China" and "tightened overall financial conditions" and "recent declines in market-based measures of inflation" she's still talking about "liftoff" perhaps as soon as five weeks from now, and pointing away from "additional accommodation."*
- Then since the FOMC, four regional Fed presidents have gone on record urging "liftoff" -- Williams (San Francisco), Lacker (Richmond), Bullard (St. Louis) and Lockhart (Boston), three of whom are FOMC voters in October and December.
- To our knowledge no Fed spokesperson has taken the other side of the debate. Yellen, for her part, hasn't made a public statement other than the FOMC press conference since her congressional testimony in mid-July. We're beginning to wonder whether she has health issues that she has not disclosed, in which case America's top banking regulator would be holding herself to a lower standard than that of America's top banker, Goldman's Lloyd Blankfein.
- *Yellen's speech scheduled for this evening, titled "Inflation Dynamics and Monetary Policy," is her opportunity to address all these issues.*
- In the meantime, we continue to fear that the global economy is slipping into the first-ever recession caused by *low* oil prices (see, among many, "Is This the Oil Shock Tipping Point?" August 20, 2015). The transmission of a "reverse oil shock" is already well underway, through widening credit spreads (please see the chart below), falling capital investment (see "Data Insights: A Few of Our Favorite Things" September 24, 2105), and falling forward earnings (see "Data Insights: Global Equity Risk Premia" September 21, 2105).

US corporate bonds, spreads to Treasuries Basis points



Source: Bloomberg, TrendMacro calculations

- We think the present long-awaited correction in stocks -- after three years, two months and 20 days without a 10% decline -- is a direct reflection of this dynamic. We think it has a while yet to run its course, and is unlikely to end until the recession-risk abates on its own (the key signal for which will be a substantial and sustained recovery in oil prices) or the Fed signals that it is not as much asleep at the switch as Yellen makes it seem right now.

- The longer the Fed waits, the stronger the signal will have to be.
- Unless it comes soon, then it may have to be more than a signal -- the Fed may have to actually act in order to revive inflation expectations and prevent the embedment of a deflationary mind-set (again, please see the chart on the first page). *Naturally, from here, the only policy option would be another Large-Scale Asset Purchase (LSAP) program -- QE4.*
- It sounds incredible at this point, but right now that feels more likely to us than "liftoff" as a next step.

Bottom line

Stocks have dropped as much as 4.5% since mid-way through the FOMC press conference, in which Yellen bobbled questions about "liftoff" in October, unanchored inflation expectations and the unlikelihood of additional accommodation. Swap-implied 5-year forward inflation has broken to new lows not seen since late 2008. Credit spreads continue to widen, capital investment remains stagnant, and forward earnings are flat as we near the one-year anniversary of their peak. Recession-risk is very real, and stocks won't pull out of the present correction until either the risk abates or the Fed indicates that it takes this seriously. The longer it waits, the more likely it becomes that QE4 will have to happen before "liftoff."