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FED SHADOW

One Small Step -- In the Wrong Direction

Monday, November 23, 2015

Donald Luskin

The Fed seems committed to a deflationary policy error. Hopefully it will be a small one.

Markets are funny things. Stocks fell following a strong US jobs report, "retrenching" just as we expected, as much as 4.55% (see "On the October Jobs Report" November 6, 2015). Then in the aftermath of the Paris terrorist attacks, stocks rallied -- also just as we expected, as much as 3.85% so far (see "On the Paris Terror Attacks" November 16, 2015). It's not that equity markets hate people working and like people dying. It's that -- on the one hand -- equity markets are justifiably concerned that the Fed's plans for a December "liftoff" have been rendered virtually a *fait accomplis*, while -- on the other hand -- the world's reaction to the Paris atrocity has been at least a brief period of global political coherency.

- It remains to be seen how economic activity, on net, will be perturbed by the Paris attacks. There will be costly spasms of fear, as in Brussels over the weekend. But there will be a salutary surge of "animal spirits" as there was after the September 2001 attacks.
- *The imminence of December lift-off will likely be the main event now. We don't by any means rule out that it could be deferred yet again*. Another terror attack could do it, or my likely, poor macro data flowing from what we think is already the first-ever recession caused by too-low oil prices (see, among many, "Is This the Oil Shock Tipping Point?" August 20, 2015).
- *But markets, it seems, are assuming that the Fed is go-for-launch*. Given that assumption, we're actually somewhat surprised that they are holding up as well as they are -- especially considering that we think it is a fairly obvious mistake for the Fed to hike rates into the teeth of what is fairly obviously an oncoming recession (see "On the October FOMC" October 28, 2015). That said, it depends which markets you are looking at.
- *Gold is giving an especially alarming appraisal*. It's been a while since we've paid a lot of close attention to gold, either as an investible market or as a gauge of the world's liquidity posture. But we can't fail to notice with concern that as December "liftoff" has become increasingly certain following clear hints at the October FOMC, gold has fallen as much as $120, to levels not seen since 2010. With financial conditions already tightening as spreads in the energy sector of the US bond market linger at distress levels, gold is indicating that "liftoff" will likely reduce liquidity, and be deflationary. Commodities, across a broad front, would seem to

Update to strategic view

US BONDS, US STOCKS, EMERGING MARKETS MACRO, GOLD, FX, US FED, US MACRO: Bad data (or another large terror attack) could derail December "liftoff," but it seems to be a *fait accomplis*. Gold and the dollar are indicating a large deflationary error. But other markets, including inflation compensation markets, don't seem to care much. The Fed has been diligent in promising a "shallow" hiking regime -- indeed Yellen's "38 words" have been promising it ever since she arrived. We don't expect a lot of fallout in emerging markets, for whom this is old news, and who can be the beneficiary of passive devaluations. The Fed's beloved Phillips Curve is a myth, and with housing cooling off, there's no reason to expect core inflation to rise. So bond yields needn't back up with even a "shallow" hiking regime, which leaves the equity risk premium safe from a yield shock.

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agree -- as would the dollar, which has strengthened considerably over the same period.

- But it's not that simple. Over the same period, five-year five-years-forward inflation compensation implied in TIPS and swaps has modestly improved. 10-year real Treasury yields are unchanged -- nominal yields are modestly higher (because inflation compensation has slightly improved). Hardly a deflationary signal.
- World equity markets aren't much changed, though developed markets have outperformed emerging markets generally.
- *Overall, while gold and the dollar appear to be giving a loud-and-clear deflation signal, other markets seem to be generating just noise -- but that noise, it must be said, is in the opposite direction. We suppose we could conclude that everybody has gotten used to the idea of a December "liftoff," and moved on.*
- Or perhaps "liftoff" *per se* just doesn't matter all that much. What's 25 basis points?
- Perhaps a lot, as Jean-Claude Trichet's European Central Bank found out with a disastrously premature rate hike in 2011 (see "EUicide" April 7, 2011). Memories of that very costly policy error are still very fresh in the ECB's collective mind, as was made abundantly clear in an extraordinarily dovish speech by Mario Draghi last week, hinting not at "liftoff" but at additional easing.
- And the Fed has been abundantly clear that "liftoff" will be something like "one and done" -- or maybe two or three, but certainly a "policy trajectory after liftoff" that "could be shallow," as the minutes of the October FOMC put it last week. Indeed, that shallowness is being advertised as a rationale for hastening "liftoff" so as to not get behind the curve, requiring steeper hiking later.
- Markets seem to believe this story. The swaps curve now expects a funds rate of only 75 basis points a year out, and 167 basis points three years out.
- And why not? As we have pointed out countless times (see, among many, "The Yellen Rule is Taylor Minus Two" May 19, 2014), from her first FOMC statement as chair in March 2014, Janet Yellen has promised exactly this at every meeting. In a nutshell, when the economy is back to normal, the funds rate will stay below normal. Her familiar 38 words are below, with the essence of the policy message 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.

With this assurance in mind, why would a December "liftoff" really be the kind of mistake the ECB's 2011 rate-hike was?

- *It probably won't be, but the only truth is: you never know. So in our view, the case for "liftoff" is not strong enough to overcome the risks and the unknowns -- especially given the Fed's entirely new*

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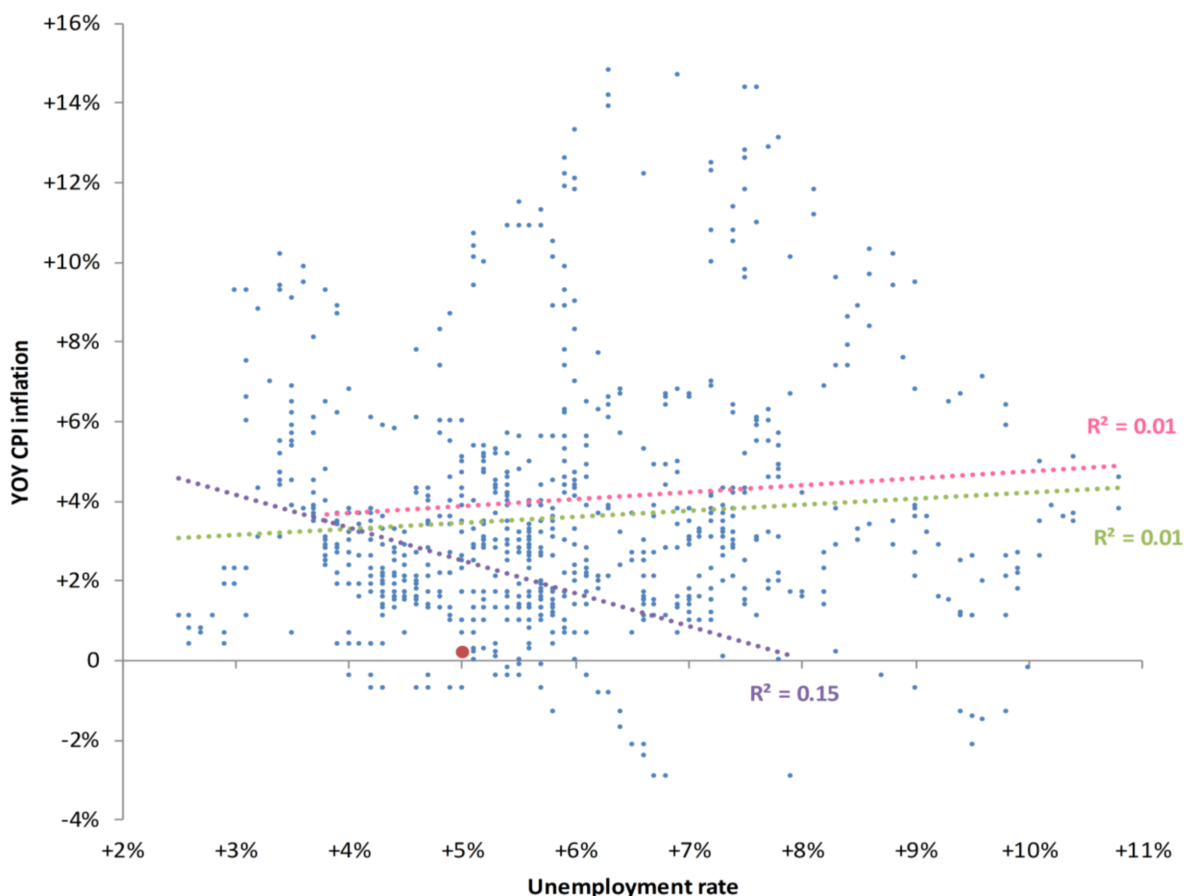
operating tools it must work with now -- and from an abundance of caution, the Fed shouldn't do it.

- *But we aren't especially scared that "liftoff" will trigger a flight to the dollar out of emerging market economies.* It's old news -- some degree of it has been ongoing ever since former Chair Ben Bernanke first hinted about "tapering" all the way back in May 2013. To be sure, as "liftoff" has neared, many emerging markets currencies have weakened. We aren't a fan of devaluing your way to prosperity (if *that* worked, Greece would rule the world). But in this case we are talking about natural market-driven weakening, which should have some chance of improving the terms of trade -- not credibility-destroying devaluations by fiat.
- *We aren't especially scared that Treasury yields will back up in lockstep with the funds rate, eroding the equity risk premium and imperiling equity valuations.* History -- such as Alan Greenspan's famous "conundrum" -- shows that such a relationship doesn't really exist.
- We think Treasury yields are driven more by global demand for liquidity, and by inflation. There's no sign yet that the world's demand for liquidity is any less insatiable that it has been for the past decade of weirdly low yields. And as to inflation, we don't see much of a chance that it will rise back to normal levels any time soon.
- The Fed seems to see that differently -- indeed, we think the Fed's compulsion to "liftoff" is driven mostly by a mistaken belief in the Phillips Curve -- the idea that low unemployment leads to inflation. For example, the October FOMC statement said, "Inflation is anticipated to…rise gradually toward 2 percent over the medium term as the labor market improves further…"
- We discussed at length our strong skepticism about the Phillips Curve, and the Fed's enduring admiration for it, two weeks ago (again, see "On the October Jobs Report"). We won't repeat all that here. But following up on a number of client questions about it that we've fielded in the meantime, we will present what we consider to be drop-dead evidence that ought to consign the Phillips Curve to the over-crowded graveyard for discredited economic myths.
- For the Phillips Curve to deserve to be a touchstone for Fed policy, it ought to show up clearly in the data. You shouldn't have to torture the data with a lot of advanced techniques (Phillips certainly didn't in his 1958 paper). It should jump off the spreadsheet. *Au contraire*, the data clearly shows that the Phillips Curve stopped working in the early 1970s.
- Please see the chart on the following page, which we have presented each month for years in "Data Insights: Jobs" (see, for example "Data Insights: Jobs" November 6, 2015).
- *The Phillips Curve appears to have been correct through 1973. But then from 1974 -- and for the life of the data overall, from 1948 to present, unemployment and CPI inflation line up the opposite way the Phillips Curve would predict: that is, when unemployment is higher, inflation is higher too.*

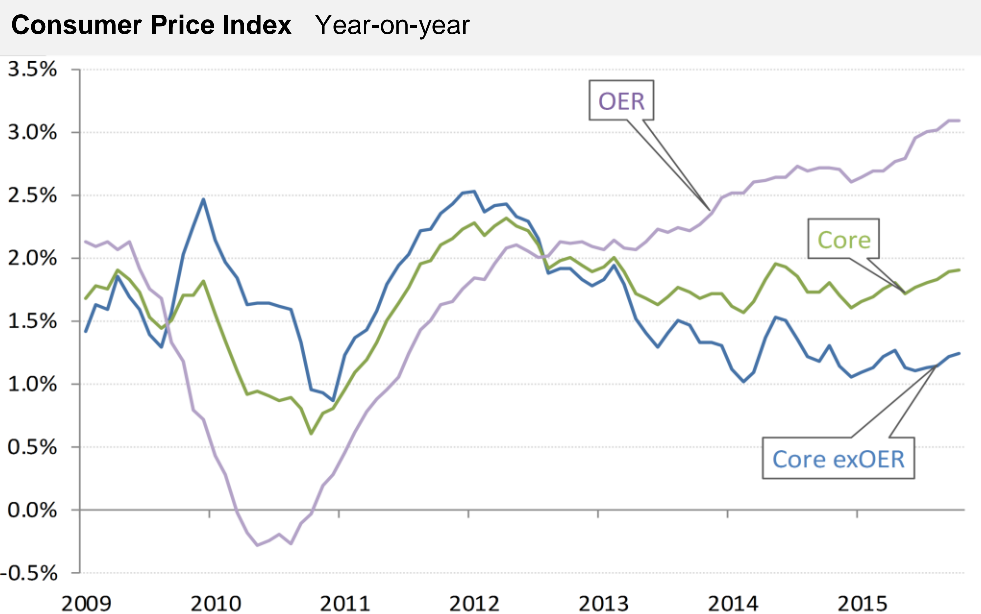


Source: BLS, TrendMacro calculations

- If you lag inflation -- as though to assume that it takes time for low unemployment to lead to high inflation -- it makes it even worse for the Phillips Curve.
- If you look only at the most extreme cases -- as though to assume that at normal levels of employment or unemployment it is irrelevant, but then kicks in when employment or unemployment are especially high -- it doesn't change the *overall* picture. However, in the extreme, it has worked well *since* 1974 but poorly *before* 1974.
- But that exercise begs the question *what is extreme?* -- especially today, when the unemployment rate is as low as it is only because so many people have dropped out of the labor force.
- *With the Phillips Curve ruled out, we see no other reason to be bullish on inflation, especially if economic conditions deteriorate.*
- If oil prices bounce back somewhat -- as we do believe they will (see "Oil's Hard Road Forward" October 5, 2015) -- that won't do much help to *core* inflation which is, properly, the inflation gauge the Fed watches.
- Moreover, the only thing that has been keeping core inflation as strong as it has been is owner's equivalent rent (OER) -- the

statistical proxy for residential housing prices. It is the largest component in consumer prices -- about a quarter of CPI, and about a third of core CPI. Currently the OER component is running at 3.1% year-on-year. Without it, core CPI -- currently running at 1.9%, would only be 1.25% (please see the chart below).

Consumer Price Index Year-on-year

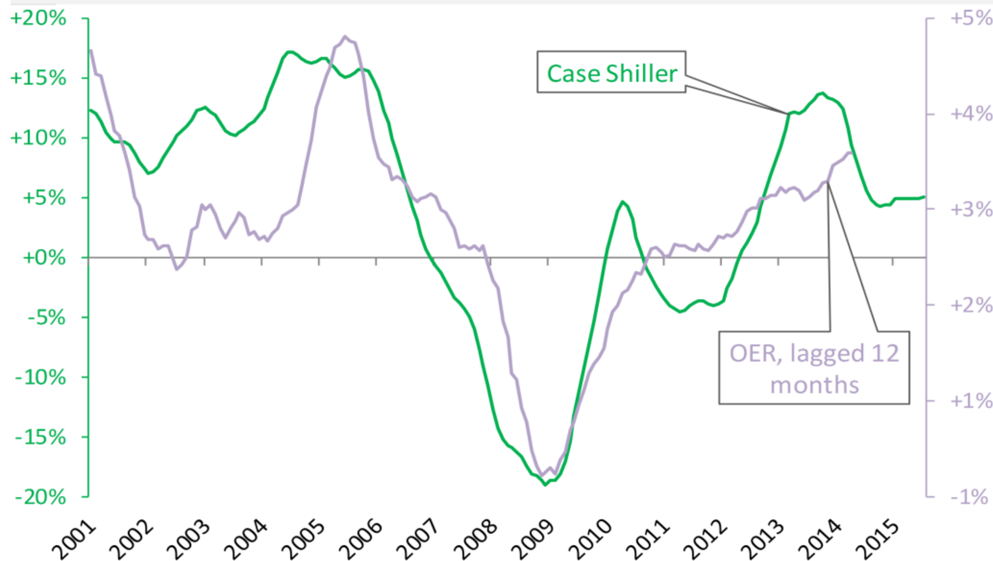


Source: BLS, TrendMacro calculations

- *Important note: We are making this point with CPI, rather than the Fed's preferred Personal Consumption Expenditures price index, because we have more granular data on it. As a general rule, you can subtract 50 to 75 basis points from CPI to approximate PCE.*
- While the Fed is quick to point to oil and the dollar as "transitory" disinflationary forces, they never mention OER -- they treat it, by omission, as a permanent feature pushing inflation higher. But is there any particular reason to think that OER will not mean-revert, just as the Fed expects oil and the dollar to? Again, a bounce-back in oil won't impact core inflation anyway. But that aside, if anything we expect the inflationary effects of OER to wane.
- While the housing market does show, by some measures, some degree of tepid ongoing improvement, it looks to us like its surging momentum off the bottom after the "Great Recession" is spent. Given that, we would not expect OER to continue to inflate in the future as it has over the last four years. OER is highly correlated to changes in home prices, with a 12-month lag -- and the rate of increase in home prices has notably cooled (please see the chart on the following page).

And that leaves us with what we think is the biggest risk of December "liftoff" -- that the Fed will lose credibility for making a momentous policy move for a transparently silly reason. At the same time, as we have pointed out, the Fed seems to be willfully ignoring and even making material misstatements about improving economic conditions which are, in fact, deteriorating (again, see "On the October FOMC").

Case Shiller Home Price Index versus lagged OER Year-on-year



Source: BLS, Bloomberg, TrendMacro calculations

- *<u>If we are right that the economy is entering a recession-like event, then further deterioration in the data will embarrass the Fed by swiftly proving it wrong.</u>*
- *<u>Considering the prideful bullheadedness with which the Fed has become committed to December "liftoff," it's not clear that the Fed will be able to swiftly reverse course. Even in the face of dire consequences, Trichet's equally prideful rate-hike in 2011 was only belatedly and grudgingly reversed, and not fully for over a year until Trichet had been replaced by Draghi.</u>*
- We don't mean this to be understood as a forecast that the Fed's December "liftoff" -- if it indeed happens -- will be as catastrophic as the ECB's 2011 mistake. The world is a far less fragile place now than it was then.
- But we'd be surprised if, after this, Janet Yellen gets a second term -- or even finishes out her first.

Bottom line

Bad data (or another large terror attack) could derail December "liftoff," but it seems to be a *fait accomplis*. Gold and the dollar are indicating a large deflationary error. But other markets, including inflation compensation markets, don't seem to care much. The Fed has been diligent in promising a "shallow" hiking regime -- indeed Yellen's "38 words" have been promising it ever since she arrived. We don't expect a lot of fallout in emerging markets, for whom this is old news, and who can be the beneficiary of passive devaluations. The Fed's beloved Phillips Curve is a myth, and with housing cooling off, there's no reason to expect core inflation to rise. So bond yields needn't back up with even a "shallow" hiking regime, which leaves the equity risk premium safe from a yield shock.