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FED SHADOW

Gundlach and Load

Monday, September 12, 2016

Donald Luskin

Friday was a warning shot for the Fed: you're near an invisible tripwire connected to recession.

After a weirdly un-volatile summer for markets coming out of the Brexit panic, Friday's volatility blast was inevitable. But even such necessary equilibrations happen, exactly *when* they happen, for a reason.

- We'll say this first not because it's necessarily the most important factor – though it is a real consideration – but mostly to get it out of the way. We have to note that US stocks peaked in mid-August a day before Donald Trump appointed new campaign leadership, and then improved the tone of his campaign by expressing "regret" for his inflammatory comments. Since then, in the polls he's risen from the grave – in betting markets, he's gone from a 4-to-1 underdog to only 2-to-1. We have said all year that markets have underestimated Trump, and all the uncertainty that would follow a Trump win in November (see, most recently, "Trump's To Lose" August 12, 2016). On Friday, in light of a N. Korean test of a miniaturized nuclear weapon coming only a day after Trump performed relatively well in a televised defense-oriented forum, markets may have awakened to the need to build in a "Trump risk premium," having utterly failed to build in a "Brexit risk premium." If the issue of Hillary Clinton's health continues to intensify, this deserves close watching.
- But Friday's tumult was no ordinary risk-off event like the reaction to Brexit, as we might have expected from the kind of issues we've just raised. *No, investors didn't sell risky stocks and buy riskless government bonds on Friday. They sold 'em all.*
- *That tells us that this is really about the Fed, and the growing risk that it is about to make a stupid policy error – again – less than a year after their last stupid policy error.*

The catalyst for the market's sudden focus on what is, in fact, a longstanding risk seems to have been a webcast by Jeffrey Gundlach, the celebrated fixed income manager. Gundlach predicted that the FOMC would "blow itself up" by capriciously hiking rates at the upcoming September meeting, ushering in a "big, big moment" when "interest rates have bottomed," and a "secular shift to inflation." Incidentally, in the webcast he also predicted that Trump would be elected president.

Update to strategic view

US BONDS, US STOCKS, US MACRO, US FED: Friday's volatility blast was no ordinary risk-off move – both risky and riskless assets fell. The US election becoming more competitive may be a contributing and ongoing factor. But the catalyst seems to be have been Gundlach's widely reported claim that the Fed will "blow itself up" with a September rate hike, and that we face a "big, big moment" in which "interest rates have bottomed" and inflation will come back. Such a hike would be a shock, but it would tend to lower already low inflation, lowering long-term yields and supporting asset values. But Gundlach's claims resonate with reckless remarks like Rosengren's that the economy risks "overheating," when so much recent data has been alarmingly weak – and with the ECB's failure to increase stimulus suggesting that central banks have given up. Friday sent a warning to Yellen – so if a September hike wasn't off the table before, it is now.

[Strategy dashboard]

- We agree with some of Gundlach's views, and disagree with others. He's one of those people who seem to emerge in every market cycle – a clever, articulate and provocative figure who earns a great deal of credibility from having correctly foreseen some particularly important trend, and gets elevated to the status of celebrity oracle. Despite recent poor performance, when he talks, he moves markets – especially when, as in this instance, he's really tapped into the *zeitgeist*.
- It's not like Gundlach hasn't been bearish on bonds before. Over the summer he notoriously said "sell everything," saying his firm had gone "maximum negative" on Treasuries when the 10-year yield hit 1.32% in the Brexit panic. We took the same view at the same time, and it has proven very correct (see "Brexit: Who Won, Who Lost, What's Next?" July 11, 2016). But for us, that unsustainable low in yields was the result of a risk-off panic in the wake of the Brexit false-alarm. It had nothing uniquely to do with central bank policy.
- The issue *now* is that, as Gundlach puts it, the Fed does seem bound and determined to "blow itself up" – and the rest of us along with it – if not by some mistaken decision at some upcoming FOMC meeting, then by an increasingly cacophonous public display of incoherency.
- *But the issue is not about blowing up the bond market. The kind of policy error that Gundlach – and we – are worried about would be deflationary, and that would only drive bond yields lower. In that sense, Friday's market action seems perverse.*

It's like last year. US data is weakening by many key measures (see "On the August Jobs Report" September 2, 2016 and "Data Insights: Global PMI" September 6, 2016). Yet the Fed keeps yapping about imminent rate hikes (see "On Yellen at Jackson Hole" August 26, 2016).

- The particularly outrageous yapping that acted as an accelerant to Friday's fire was a speech by Boston Fed President Eric Rosengren, usually a moderately dovish fellow, who said:

  "…the current degree of monetary policy accommodation… increases the chances of driving the core inflation rate closer to the Federal Reserve's 2 percent target, but it also increases the chances of overheating the economy."

- Seriously? "Overheating"? *This economy*? Hillary perhaps (sorry, we couldn't resist). But not *this economy*.
- Such a characterization is objectively wrong. But what's so dangerous about it is the way Rosengren frames it as justifying a policy trade-off requiring the sacrifice of the Fed's mandate-driven inflation target of 2%.
- Set that against the paper published last month by San Francisco Fed President John C. Williams -- Chair Janet Yellen's hand-picked successor – calling for an *increase* in the Fed's inflation target:

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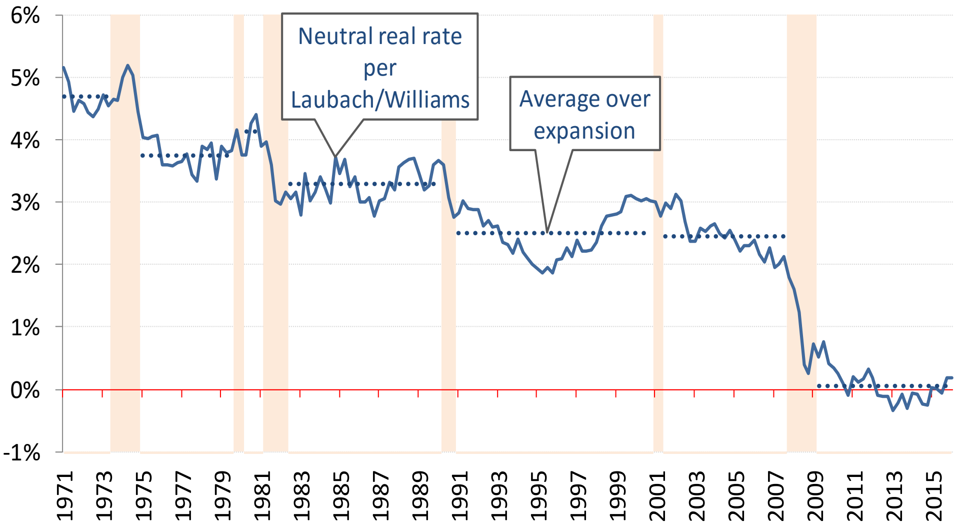
[About us]

The neutral real interest rate **Recession** Quarterly



Source: [Laubach and Williams (2015)](), TrendMacro calculations

> *"This would imply a higher average level of interest rates and thereby give monetary policy more room to maneuver."*

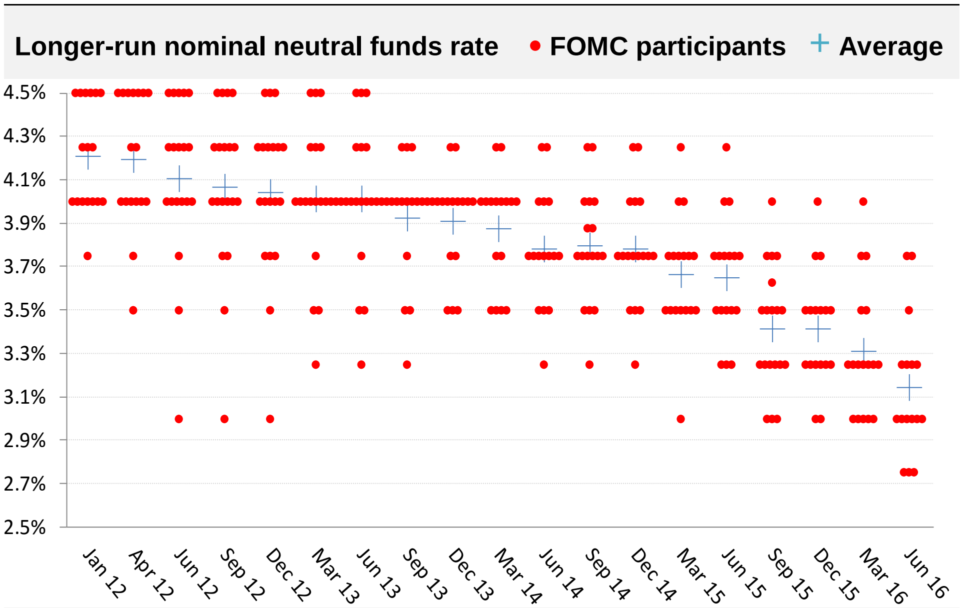
- Williams's idea is a recognition that the real "natural interest rate" or "neutral interest rate" has been stuck at a little above or below zero for about six years (please see the chart above). When inflation is low, this constrains the *nominal* policy rate and gives the Fed little or no room to cut rates in response to a recession or crisis.
- Radical? *Novel*, perhaps, but it rates a "surely" in Larry Summers's post-Jackson Hole commentary: "surely a higher target is appropriate when the neutral real rate is zero."
- A natural rate or neutral rate near zero makes many radical things merely novel. Over the last couple years as the financial crisis of 2008-2009 has receded into the past, many clients have argued that the Fed and other central banks are holding back robust recovery by persisting too long in zero interest rate and asset purchase policies which, so the argument goes, distort incentives and lead to dangerous imbalances. But we have always argued to the contrary, proposing that if central banks didn't exist, the natural interest rate would probably be zero anyway. *To raise policy rates, then, would be an unnatural act, and a form of tightening.*
- This year's Jackson Hole conference was, in an important sense, devoted to these issues – especially the risk that at a zero neutral real rate central banks have no "room to maneuver."
- *Jackson Hole set markets up to focus on what is a critical prudential matter for those who believe that central banks can actually perform "maneuvers" to stimulate a contracting economy*. Investors *would* seem to believe that. A good part of the media narrative explaining Friday's volatility was disappointment that the European Central Bank didn't announce any new stimulus at the Governing Council meeting on Thursday (see "Data Insights: Euro

Area Recovery Monitor" September 8, 2016). Central banks certainly believe it – hence Bank of England Governor Mark Carney's self-congratulatory proclamation that the UK economy is doing just fine post-Brexit, despite his own prior dire warnings, "because the bank took timely, comprehensive and concrete action" by cutting rates.

- For all that, we have Rosengren throwing it all out the window in the name of "overheating." For that matter we have SF Fed President Williams himself – the advocate of raising the inflation target, which would require *easier* policy to achieve – telling the press on Tuesday that "The economy has climbed back to full strength…it makes sense to get back to a pace of gradual rate increases, preferably sooner rather than later."
- *So as Gundlach says, the Fed really is in some sense "blowing itself up."* Out of the side of its mouth controlled by its neomammalian complex, it recognizes that like it or not, until further notice, we live in a very un-normal world with a near-zero real neutral interest rate – and we'd better think of novel policy approaches that will help us survive in that world. But out of the other side of its mouth controlled by its reptilian complex, it acts as though everything is normal now, so policy can be normal too, and pronounces wishful and utterly false-to-fact fetish-words like "overheating" and "full strength."

The reality – as best we can determine it in these murky matters – is that we do indeed, as we have been telling clients for years, live in an un-normal world with a near-zero real natural interest rate. Central bank policy must take account of this, just as it must take account of any reality.

- By Williams's calculations, with his colleague Thomas Laubach, we've actually been approaching that un-normal world gradually for 45 years, with the real neutral rate declining in each successive business cycle expansion (with the exception of the brief expansion of 1982; again, please see the chart on the previous page).
- Former Chair Ben Bernanke puts this at the center of the challenges that central banks are dealing with, and points out that it can be seen reflected in the "longer run" "dot plots" for the funds rate prepared by FOMC members as part of the Summary of Economic Projections. Gradually worn down by years of erring on the high-side in the belief that the real neutral rate would mean-revert up from zero, the dots have been persistently adjusted downward (please see the chart on the following page).
- In our recollection, New York Fed President William Dudley was the first to seriously discuss the low neutral interest rate, last November – about a month before he ignored it by acquiescing in liftoff.
- Yellen referred to it at the time of liftoff, in the December FOMC press conference (see "On the December FOMC" December 16, 2015).
- She went so far as to blame it for the relative ineffectiveness of three programs of Fed quantitative easing:

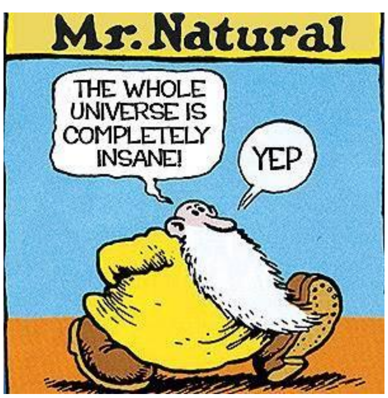


Source: FRB, TrendMacro calculations

> *"Had the neutral rate been running closer to its longer-run level, these policy actions would have been expected to foster a much more rapid economic expansion."*

- But she went ahead and lifted off anyway – justifying herself, in part, by asserting that "the neutral federal funds rate should gradually move higher over time." The rest of the ugly quarter that followed that policy error is history (see, among many, "Is This 2016, or 2008?" January 15, 2016).

We'll get to what all this portends for markets momentarily. But if you've gotten this far, having pinned so much on the concept of the natural rate – or the neutral rate – we owe it to you to stop and give our account of what those words mean.



The natural interest rate is the interest rate that would exist in a state of nature – without interference by non-economic institutions like central banks. As such, it is not observable or calculable, but it is nevertheless an important benchmark for understanding whether and how central banks are influencing the economy.

- The concept of the natural rate was articulated almost 120 years ago by economist Knut Wicksell. He worked before the era of rate-targeting central banks, so he framed his definition of the natural rate in a state of nature without money itself. His definition:

"…the rate of interest which would be determined by supply and demand if no use were made of money…"

- Anticipating the Taylor Rule by 95 years, Wicksell claimed that *money interest rates below the natural rate lead to inflation.*

"…no matter how small the gap, prices will rise and will go on rising…"

- Symmetrically, *money interest rates above the natural rate lead to deflation*:

"…no matter how little above *the current level of the natural rate, prices will fall continuously and without limit."*

- Why would this be so? The mechanism for it is the quantity theory of money. The idea is that too-low (or too-high) interest rates, by encouraging (or discouraging) credit, lead to an excess (or shortage) in the quantity of money relative to goods, requiring an equilibration through the inflation (or deflation) of the price of goods when measured in money-units.
- Like natural selection as the mechanism for the theory of evolution, this seems self-evidently true, and strongly so – even obvious. Yet it is devilishly difficult to rigorously prove by means of the scientific method. But in that sense it is no worse than most propositions in economics, and probably a lot better.
- Is the natural rate idea *too* obvious? In our view, obviousness in economic theorizing is a plus. And it's not so obvious that no one disagrees with it. Saint Louis Fed President James Bullard has theorized just the opposite – that low interest rates cause deflation, citing the example of Japan. Some better-credentialed economists agree with him, too.
- But there remains the inescapable issue that the natural rate is unobservable – because it doesn't exist except as a concept, a Platonic form. But in an important sense *the whole point of the natural rate is that it doesn't exist.* It *can't* exist, because central bank policies destroy it, in the manner of the "uncertainty principle" of quantum mechanics. If there were no central banks, then the natural rate *would* exist – but it would be of no interest to us as a benchmark for central banks (because then *they* don't exist).

- *So how do we use a non-existent benchmark for monetary policy?*
- Wicksell got around this sticking point by advocating that one not bother to observe the unobservable, only its consequences (as one might not bother to try to see the Invisible Man, instead observing his footprints in the snow).

"So long as prices remain unaltered, the banks' rate of interest is to remain unaltered. If prices rise, the rate of

interest is to be raised. ... and likewise mutatis mutandis *if the price level falls."*

- In other words, if inflation is too high then policy rates must have been too low, and if inflation is too low then policy rates must have been too high. _*So policy-makers need no indicators other than inflation itself.*_ For what it's worth, the best years of Alan Greenspan's Fed chairmancy were when he followed a policy something like this – back then it was called a "price rule."
- One can smirk at this approach as too reductivist. In 1931 trade-theorist John H. Williams pejoratively compared it to "faith," saying:

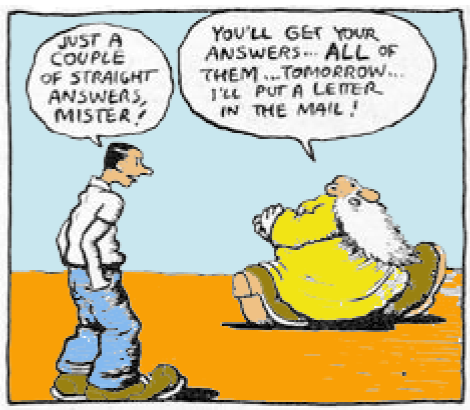
"One can only say that if the bank policy succeeds in stabilizing prices, the bank rate must have been brought in line with the natural rate, but if it does not, it must not have been."

- _*But if a central bank is going to target inflation, we can think of worse ideas than observing inflation to see if policy is working or not. One of the conspicuous absurdities of the Fed's present drive toward "normalization" is that it is talking about tightening policy even though it has failed to achieve its inflation target for the better part of a half-decade.*_
- Instead of this simple results-driven empiricism, the Fed with its thousands of professional economists on-staff and serving as consultants, has warped the idea of the *natural* rate into the "*neutral* rate" or "r-star."
- As Yellen defined it in her Jackson Hole speech last month, the neutral rate is "the inflation-adjusted short-term interest rate consistent with keeping output at its potential on average over time."
- With this definition, economists can use a traditional macro model to back out the real rate that is consistent with NAIRU. This technique is afflicted by all the embedded assumptions – and fallacies, such as the Phillips Curve and Okun's Law – that underlie all such models. The Laubach/Williams time series in the chart on page 3 uses this kind of approach. It is considered the gold standard among those who respect such things.

*Now let's turn to what all this means for the economy and the markets.*

- With the Wicksellian conception of the natural rate, observing the fact that actual inflation and expected inflation are below the Fed's targets, then the policy rate is too tight now, not too easy. _*So a rate hike would be an error that makes a suboptimal situation worse.*_

- With the modelled conception of the neutral rate, policy is arguably slightly accommodative. At mid-year the real neutral rate stood at positive 0.18% – the real funds rate is only 0.71% below that at negative 0.53% (based on the headline Personal Consumption Expenditures deflator). *So a rate hike would seem to be a move in the right direction.*
- *Nevertheless, even in this decision framework, we strongly believe a hike would be an error.* We think that the logic of the Wicksellian natural rate, and of using inflation as an indicator of where we stand relative to it, strongly dominates the use of models that depend on erroneous conceptions of labor market dynamics.
- *But even if you accept the modelled neutral rate as the appropriate policy guide, it remains a close call. Considering all we've had to go through to trudge up from the Great Recession into the Not So Great Expansion, shouldn't a decision to tighten policy be better than a close call?*
- Given all the agitation that the Fed has created by all its talk about lacking "room to maneuver" in a world that Yellen admits is beset by "uncertainty" (see "Yellen Adds 'Uncertainty'" March 30, 2016), a hike would both produce cognitive dissonance and err on the side of recklessness.



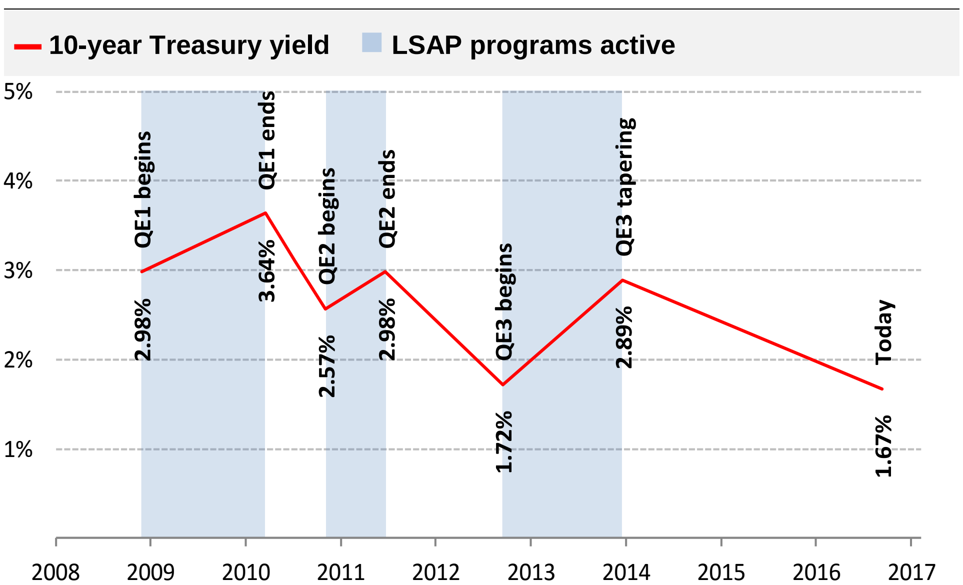
- We think Friday's market action will activate Yellen's sensitivity to "uncertainty," raising the stakes – and lengthening the already long odds – on a September hike.
- *For these reasons – although, yes, we can hear loud and clear all the stuff the Fed is saying to prepare the markets for hikes – we don't think a hike is going to happen anytime soon, certainly not in September.*
- What if it does? While we have already mentioned some alarming similarities between the present moment and one year ago, when the Fed contributed to a near-recession by lifting off at the December FOMC, there are key differences as well.
- Last year we took the risk of recession very seriously as S&P 500 forward earnings rolled over, credit spreads widened and inventories built up in response to the free-fall in oil prices (see "Is This the Oil Shock Tipping Point?" August 20, 2015).
- Now oil has double-bottomed and the global crude market is in something like equilibrium for the first time in two years, credit spreads have narrowed, and forward earnings have broken their downtrend – indeed, excluding the energy sector, they have broken out to new all-time highs (see "Have We Suffered Enough?" February 26, 2016).
- There's still a big inventory overhang to work off, *but we don't think we're facing a recession.*
- *So in this sense we're at less risk to a rate hike now than we were last year. On the other hand, long-term inflation expectations are*

lower now than they were last year – so we should worry that an error now might be more deflationary.

- But make no mistake about it. The natural rate is out there somewhere, invisible to us. It's like a hidden tripwire set in the jungle by the Vietcong, and we're soldiers trudging through the bush wondering exactly where it is. In the jungle, the invisible tripwire is connected to a mine – so soldiers walk very, very carefully. The invisible natural rate is connected to a recession. The Fed should walk very carefully.

For asset values, this implies an interesting dynamic – which in some ways cuts against the way markets behaved on Friday.

- Stocks and bonds falling sharply at the same time implies fear of a Gundlach-type scenario that Fed rate hikes will move long-term yields higher. This would spill over into stocks through the channel of the equity risk premium, which has supported equity valuations that have otherwise been on the high side by historical standards.
- As a demonstration of this dynamic, on Friday, the S&P 500 equity risk premium barely changed at all, as equity values fell in near perfect equilibrium with the rise in long-term Treasury yields.
- *But rate hikes, whatever else they do, would likely suppress inflation, which would drive long-term yields lower, not higher.* Even Rosengren seems to know *that*.
- *Proof: throughout the aftermath of the financial crisis, whenever the Fed has eased with large-scale asset purchase programs (LSAPs), bond yields have gone up – when the Fed has ended such programs, bond yields have fallen* (please see the chart below).



Source: FRB, TrendMacro calculations

- This result is the exact opposite of Fed rhetoric claiming that LSAPs are intended to lower long-term yields when the Fed is powerless to lower short-term rates below the zero bound. *But the* *fact that the Fed's gun seems to shoot backwards is a feature, not a bug. Higher long-term yields are a sign of success for LSAPs*, because they imply that the policy has reinvigorated inflation and growth expectations. The same would be true for any easing strategy.

- *So the Gundlach-inspired back-up in long-term yields on Friday would seem inconsistent with his own vision that the Fed is going to tighten.* In his defense, he does claim that inflation is going higher – but we don't think that's reconcilable with his views of a tighter Fed.
- By the way, a Fed-induced recession wouldn't do equity markets any favors, but it would drive long-term yields lower.

But another way of thinking about Friday's market dynamics is that they imply central bank tightening in a deeper sense, entailing the cutback or reversal of LSAPs that are believed to have supported asset prices.

- For one thing, Fed QE has been dormant for almost two years, during which time both stock and bond prices managed to make it to all-time highs.
- And for all the supposed disappointment that the ECB or the Bank of Japan haven't *increased* their LSAPs (that is, increased them *again*), there is no evidence at all they intend to discontinue them. And no central bank is showing any signs of liquidating its asset portfolio.
- To be sure, the Fed's stated "normalization" policy calls for the eventual return to a smaller asset portfolio. Yellen repeated that long-term goal in her Jackson Hole speech. But in context, it was more by way of assuring markets that it was a long way off.
- But it's just a religious incantation for Yellen anyway, meant to connect her institution to nostalgia for the good ol' pre-crisis days. It will never happen.
- Elite thinkers in the Fed's orbit know this full well. Bernanke recently wrote that a straightforward finding in the existential re-examination of central banking that went on at Jackson Hole is that the large balance sheet should be maintained permanently. *We've said the same thing for years, arguing that there is no reason why today's Fed balance sheet associated with a period of financial stability ought to be returned to the level associated with global financial collapse.*

So we do see Friday as a warning shot to scare the Fed off making a policy error at the September FOMC. That's a good thing – it will probably keep the Fed on hold. We don't think it's a predictive foreshock – a "big, big moment" – that the world's central banks are about to do – or undo – anything that would deeply undermine asset values.

Bottom line

Friday's volatility blast was no ordinary risk-off move – both risky and riskless assets fell. The US election becoming more competitive may be a contributing and ongoing factor. But the catalyst seems to be have been

Gundlach's widely reported claim that the Fed will "blow itself up" with a September rate hike, and that we face a "big, big moment" in which "interest rates have bottomed" and inflation will come back. Such a hike would be a shock, but it would tend to lower already low inflation, lowering long-term yields and supporting asset values. But Gundlach's claims resonate with reckless remarks like Rosengren's that the economy risks "overheating," when so much recent data has been alarmingly weak – and with the ECB's failure to increase stimulus suggesting that central banks have given up. Friday sent a warning to Yellen – so if a September hike wasn't off the table before, it is now.