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FED SHADOW

They Laughed When I Sat Down to Monetize

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Donald Luskin

The Fed is less worried about deflation -- but it's not worried enough about inflation.

Update to strategic view
GOLD, COMMODITIES, OIL, US RESOURCE STOCKS: Inflation plays, our "best idea" theme, have been the top-performing risky assets coming out of last year's crisis. The Fed is becoming more confident about the recovery from deflation, and this is cause for caution on the theme. But we think it won't dare to not keep today's inflationary policies in place, sustaining another leg higher for the theme.
[see Investment Strategy Dashboard]

Inflation-sensitive gold fell $20 yesterday while Fed chair Ben Bernanke was testifying before the House Budget Committee. It's useful to discern exactly which of his remarks moved the market, and which didn't. There was no reaction at all when he told Representative Jeb Hensarling (R-TX) that the Fed "will not monetize the debt." Why should markets react to a statement so self-evidently meaningless? It is an obvious fact that the Fed is *already* monetizing government debt, directly by buying $300 billion of Treasury bonds, and indirectly by buying $1.25 trillion of agency mortgage-backed securities. For that

matter, ordinary open market operations in which a central bank buys government securities to enforce an overnight interest rate target are necessarily a form of monetizing debt. So the question isn't really *whether* the Fed will monetize the debt -- the question is: *how*

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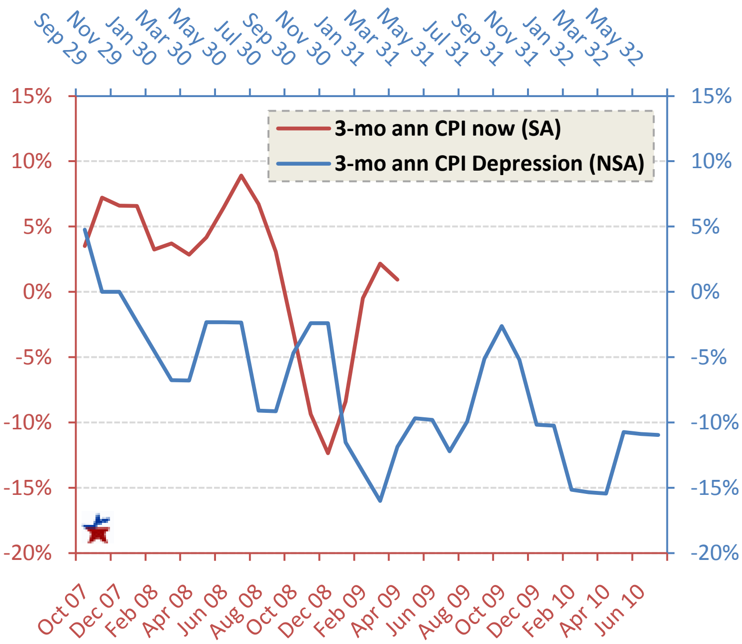
much more debt will the Fed monetize?

Gold *did* react yesterday -- with a sharp drop (please see the chart on the previous page) -- the moment Bernanke [explained to](#) Representative Rick Larson (D-WA) that the Fed's "concern for a time was that the recession would be so severe we'd see deflation. I think the fear of deflation has receded somewhat, and that's a positive development." Several minutes later, gold fell even more sharply the moment Bernanke [told](#) Representative Gwen Moore (D-WI), "I put a lower probability on deflation than I would have a couple months ago."



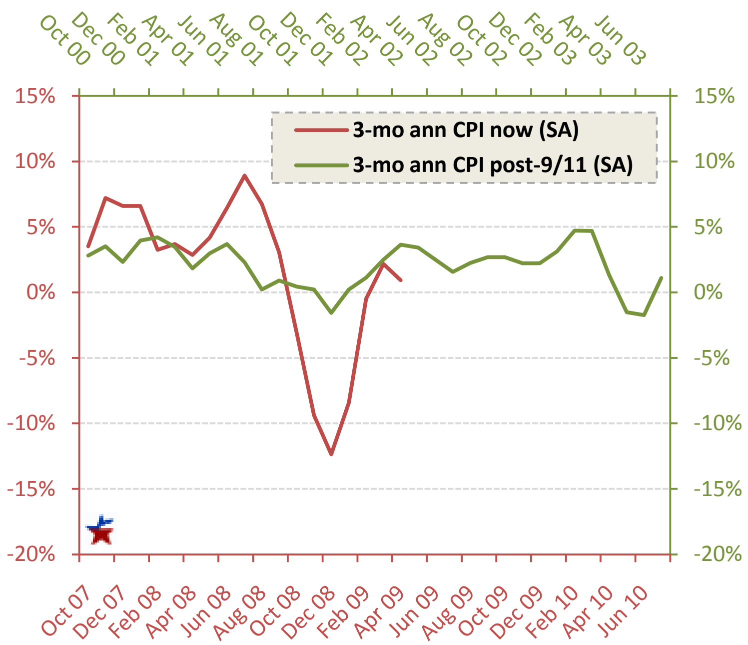
Bernanke is right that deflation has receded. At its worst late last year, deflation as measured by the CPI was nearly as bad as in the darkest days of the Great Depression (see ["Deflation Takes Center Stage"](#) November 19, 2008) -- and all the worse for being a violent whipsaw from an alarming rate of *in*flation just months earlier. Set on not repeating the errors of the passive Fed of the early 1930s, Bernanke took rates to zero and began a massive expansion of the Fed's balance sheet -- that is, he monetized debt (see ["'Some Time' A Great Notion"](#) December 17, 2008) -- and has so far succeeded in reversing last year's deflation. Why would gold drop sharply when Bernanke states the obvious about deflation, after it has done nothing but rally -- coming within a few percentage points of all-time highs -- following Bernanke's [saying](#) exactly the same thing a month ago?

The reason is that the sudden rise in long-term Treasury yields over the last month has now put the Fed on the spot -- and its perception of deflation has a lot to do with how it will react. On the one hand, the Fed doesn't want to let yields hold back the economy and the credit sector just when they are finally beginning to stabilize (see ["Green Overshoots"](#) May 29, 2009). Surely the Fed is focused on the fact that at today's 3.63%, the 10-year yield is *only illusorily low* compared to the post-war historical average of 6.38%. Given still-lingering CPI deflation, running now at 0.62% year-over-year, the *real yield* of the 10-year is 4.25% -- and that's *above* the historical average of 2.55%. In the short run the Fed's solution is quite clear: buy more Treasuries and MBS -- that is to say, monetize debt. Doing so will lower *nominal* yields through the force of open market operations, and be even more effective at reducing *real* yields by also raising the inflation rate. In the long run it can only end in a vicious cycle, in which ultimately the inflation induced by debt monetization becomes fully reflected in nominal yields (see ["No, Mr. Bond, I Expect You to Die"](#) May 22, 2009). We're seeing early hints that this is already beginning (see ["Thrown A Curve"](#) June 1, 2009). But the more concerned the Fed is about lingering deflation, the more it will tend to interpret the rise in nominal Treasury yields as being the result of an improving growth outlook, rather than the result of mounting inflation expectations. Indeed, that's precisely how Bernanke framed it in his [prepared testimony](#) yesterday, raising the odds that he was likely to blunder into that vicious cycle. But he apparently belied that view moments later in response to questions, when he took a step toward recognizing rising *inflation* expectations by recognizing receding *deflation* expectations.

We belabor these subtleties because they are key to making the right call on gold and other inflation plays, such as commodities and materials stocks -- which have been our "best idea" investment theme coming out of last year's panic (see "Why Isn't Gold at $1500?" December 10, 2008), and have turned out to be among the world's best-performing risky assets. We are mindful that the continued performance of this theme is dependent on the Fed making an inflationary mistake in the name of fighting deflation -- the same mistake it made in its deflation panic of 2002 and 2003, kicked off when Ben Bernanke gave that infamous speech advocating, among other things, the Fed's buying long-term Treasuries, buying MBS, and making "helicopter drops of money." We wrote two months ago,

> If we were to hear a single word from a Fed official suggesting that he now understood that the 2002/2003 policy was misguided -- that to avoid deflation, a bubble was set in motion that practically wrecked the world economy (and truth be told, ended up creating a deflation far more "dire" than the one feared at the time) -- we would have to rethink the bull case for gold. (See "Charm Offensive" April 6, 2009.)

Should we count what Treasury Secretary Tim Geithner confessed in a Charlie Rose interview a month ago? Geithner said, "monetary policy around the world was too loose too long. And that created this just huge boom in asset prices, money chasing risk." Perhaps we should, especially in light of Bernanke's apparent willingness to concede that the risk of deflation has lessened. But we are not inclined to think that Bernanke will permit the Fed to take any risk at all of repeating the *deflationary* error of 1930 just to avoid repeating the *inflationary* error of 2002. Indeed, if we were in Bernanke's shoes, having to make world-historical decisions under extreme uncertainty, we would probably do the same thing -- we would choose to deliberately err on the side of *inflation* to forestall any risk at all of *deflation*. That is precisely the risk-control framework that Alan Greenspan articulated in a 2005 speech discussing the Fed's 2002 decision. And as the chart at left shows, the current experience of deflation presents a far more alarming prospect than did the one in 2002. If the risk of deflation was worth controlling then, it is doubly so now.



But while central bankers must think in a risk-control framework, we do not. We are willing to make the call that the risk of deflation has passed -- given what we see as a successful resolution of the global banking crisis (see "The Stress Tests' Hidden Mickey" May 4, 2009). So attempts to reduce *deflation* will do nothing but create *inflation*. We are also willing to make the call that Bernanke is wrong to rely on "slack" in the economy to keep the Fed's extreme monetary ease from showing up as consumer inflation. Yesterday he told Representative Paul Ryan (R-WI), who asked him whether he was putting dangerous reliance on the notion of the output gap, "We can't debate that the output gap exists… We don't see any inflation risk in the near term." And we are willing to make the call that the Fed has made a long-term strategic commitment to a very large balance sheet, as a necessary institutional framework to assist the private sector's deleveraging. As Bernanke told Representative Larson, even when it ultimately decides to tighten policy, selling assets would only be "if worse came to worse… but that's not part of our plan."

So for now, put us in the camp with the students at Peking University who reportedly laughed out loud when Tim Geithner told them that dollar-based "assets are very safe." The bet on inflation stays on the table.

BOTTOM LINE: Inflation plays, our "best idea" theme, have been the top-performing risky assets coming out of last year's crisis. The Fed is becoming more confident about the recovery from deflation, and this is cause for caution on the theme. But we think it won't dare to not keep today's inflationary policies in place, sustaining another leg higher for the theme.