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FED SHADOW

Warsh's Warning

Monday, September 28, 2009

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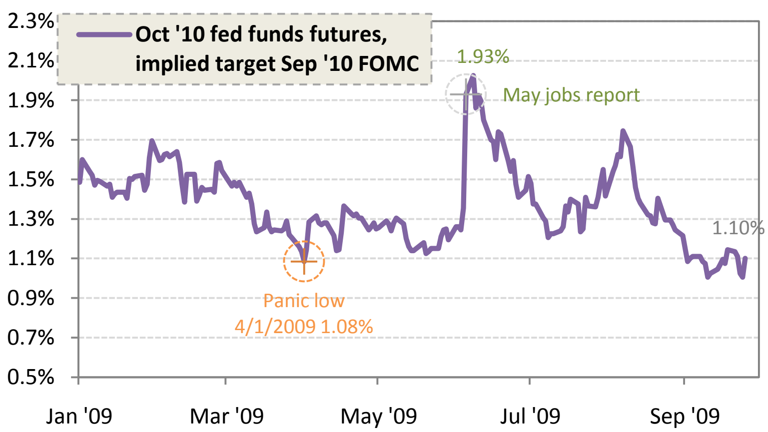
Okay, so the Fed won't be easy forever. Just almost forever.

Update to strategic view
US STOCKS: It's complicated. Intuitively stocks still feel like they don't want to go down, yet we still call for a sharp short-term correction as expectations for earnings and economic data adjust for the realities of a slow and jobless recovery. In the intermediate term, with the Fed taking the inflationary course of continued accommodation to assure against a recurrence of last winter's monetary deflation, we expect any correction in stocks will only be a correction. **GOLD:** We expect some reduction in the size of the Fed's balance sheet, but it will come from programs sterilized by exogenously funding. It should not be interpreted as reversal of the Fed's accommodative posture, so we continue to expect gold to work higher after correcting and consolidating its move to $1000.
[see Investment Strategy Dashboard]

On Wednesday the FOMC gave the dovish assurances we expected, promising "exceptionally low levels of the federal funds rate for an extended period" (see "Carrying On" September 23, 2009). Then on Friday Fed Governor Kevin Warsh gave a hawkish warning in a *Wall Street Journal* op-ed (and repeated it nearly verbatim in a speech) -- *"prudent risk management indicates that policy likely will need to begin normalization before it is obvious that it is necessary, possibly with greater force than is customary, possibly with greater force than is customary…"* What does Warsh's warning mean for markets and an economy still very much dependent on accommodative Fed policy to claw their way back from near-Depression, -- especially when among our clients, who are preponderantly now extremely bullish on stocks, Fed policy is by far the most often-cited bull case?



As a protégé and confidante of Ben Bernanke, Warsh's words must always be taken very seriously. Most markets didn't react much to his warning Friday -- with the notable exception of the year-ahead fed funds futures, which bounced off Thursday's all-time lows for tightening expectations for the biggest one-day gain since the day after the

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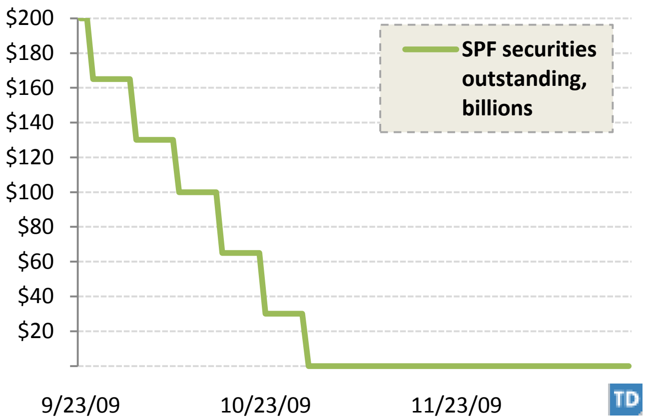
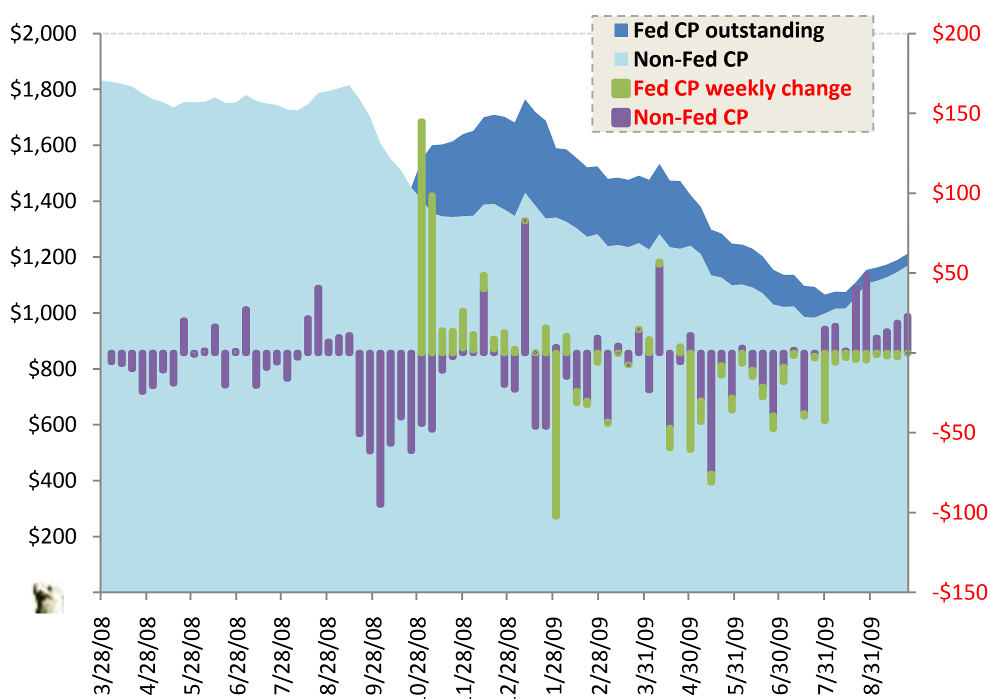
surprisingly positive May jobs report (see "On the May Jobs Report" June 5, 2009). For all that, expectations a year out only put the funds rate at 1.10%. But at minimum, Warsh's warning is a reality check on unreasonable hopes about what the FOMC means by "exceptionally low levels," or blind faith that the Fed is utterly oblivious to the need to eventually raise rates to normal, and reduce the scope of its balance sheet.

At the same time, we think it would be a mistake to read too much into Warsh's warning. We know from very senior Fed sources that this is not a new view for Warsh, but rather one he has held going all the way back to when the Fed was still at its most active in providing liquidity to panic-gripped markets (see "Ben Boldly Goes" March 19, 2009). At that time, as a member of the Fed's "four musketeers" who masterminded its crisis response, he had watched Ben Bernanke transform from a doctrinaire academic to a highly innovative and decisive battlefield commander. So for Warsh, there is no reason *not* to believe that Bernanke could be just as decisive again in the future -- in reverse. This was reflected in his speech Friday when he said, *"policy might need to be unwound with the resolve equal to that in the accommodation phase. That is, the speed and force of the action ahead may bear some corresponding symmetry to the path that preceded it."*



These words will have special salience in the coming weeks, when some reduction in the Fed's balance sheet is likely to occur -- even though, at last week's report, its assets reached an all-time high value of $2.364 trillion. As we reported two weeks ago, the Treasury has announced that it will shrink its Supplemental Financing Program for the Fed from its current level of $200 billion to only $15 billion (see "Gold Above $1000: What Took So Long?" September 16, 2009). This will deprive the Fed of a key source of funding for its assets. As the chart above shows, based on the current maturity schedule of the Cash Management Bills that underlie the SPF, it will happen rather suddenly, within the coming month.



Two ways the Fed can deal with this sudden loss of financing are by the announced slowing of the rate of purchases in its agency MBS and agency debt buy programs, and by the announced reduction in the capacity on offer in its Term Auction Facility (TAF). And other Fed emergency initiatives are shrinking out of sheer lack of interest. For example, the Term Securities Lending Facility (TSLF) and the Primary Dealer Credit Facility (PDCF) have fallen to zero (from highs of $235 billion and $146 billion, respectively, a year ago) as the bank solvency/liquidity crisis has passed. The Commercial Paper Funding Facility (CPFF) has fallen to $42 billion from a high of $342 billion -- with the strong 14% growth in paper outstanding over the last ten weeks due entirely to non-CPFF transactions (see the chart on the previous page).

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The Treasury may help buffer the need for the Fed to make too sudden a response on the asset side of the balance sheet by depositing discretionary funds with the Fed outside the SFP, which it has done from time to time over the last year, and sometimes in extremely large size. But as a general proposition, we do expect the balance sheet to be smaller by year-end than it is today -- unless the Fed funds its assets with excess reserves beyond today's near-record of $837 billion, or with currency in circulation beyond today's near-record of $913 billion. But that shrinkage shouldn't be taken as an indication that monetary policy has become any tighter. It just means we are seeing the roll-off of programs the monetary impact of which, all along, had been fully sterilized by exogenous funding from the Treasury. So we shouldn't leap to the conclusion, when this happens, that it presages Warsh's vision of policy tightening implemented with "speed and force."

So then what could trigger it, especially, as Warsh put it, "before it is obvious that it is necessary"? Warsh suggests (correctly, in our view) that the Fed not rely on *"arithmetic readings of stimulus-induced gross domestic product or lagged composite readings of inflation."* Instead, he says,

> *"Financial market developments bear especially careful watching. They may impart more forward-looking signs of growth and inflation prospects… For example, the level of asset prices and associated risk premiums, and gauging their trend and durability, will demand careful assessment."*

The small reduction in the Fed's balance sheet that we expect over the rest of the year will be a function of just these factors. That is, no such reduction would be possible without recovery in financial markets enabling the Fed to stop providing emergency support. Yet beyond that, we have to wonder whether financial markets now can necessarily send signals that are any more reliable than those embedded in macroeconomic statistics. Those statistics may indeed be "stimulus-induced" as Warsh says, but are markets now not stimulus-induced as well? Indeed, perhaps they are doubly so -- first by the fact that they impound *expectations* for stimulus-induced economic growth (as surely stocks do now), and second by the fact that they are being *directly subsidized* by the Fed itself (as surely the entire yield curve, and all credit spreads, are now -- again, see "Carrying On").

Warsh himself is very aware of this difficulty, referring to it in a 2006 speech as the "mirror problem." He said, *"The more that 'market information' reflects our own actions, the less it is useful as a source of independent information to inform our policy judgments."* And we've learned over the last several months that the "mirror problem" generates both false negatives and false positives. As an example of the former, we've seen that the Fed's long-term Treasury buy program had the perverse consequence of *raising* bond yields (see "The Fed's Bond Boo-Boo" July 24, 2009), which at their peak in June Ben Bernanke interpreted as reflecting "greater optimism about the economic outlook" -- yet now with the 10-year yield 60 bp lower, we doubt

Bernanke feels any less persuaded of the market's optimism. As an example of the latter, we've seen that the Fed's subsidy of the commercial MBS market through its Term Asset Back Lending Facility (TALF) had the perverse consequence of keeping CMBS credit default swap costs anomalously high, feeding the widespread false apprehension that this sector would be "the next shoe to drop" (see "Signs of Life in the CMBS Rubble" August 20, 2009).

If somehow the economy and the markets manage to give clear signals, if as Warsh puts it, *"the economy were to turn up smartly and durably,"* then indeed *"policy might need to be unwound with the resolve equal to that in the accommodation phase."* But the "mirror problem" makes such clarity unlikely. And even without that problem, a smart and durable upturn just wouldn't be a crisis, and only a crisis can so clarify the mind of an institution such as the Fed as to produce a response of the "speed and force" we saw as the global banking meltdown unfolded. We respect Warsh's warning, but we think the course of least resistance is that the Fed will follow Ben Bernanke's prescription from a 2004 speech called "Gradualism." He said then that *"uncertainty about the economy should lead to more gradual adjustment,"* noting also that *"gradualism reduces risks to financial stability."*

Besides, we don't expect that the economic recovery will be seen as especially smart and durable, once the present euphoria about having turned away from a potential global depression wears off (see "Muted Celebration" September 3, 2009). Last week, for the first time since the recession's end, we began to see economic statistics coming in below too-high expectations -- leading indicators, existing home sales, new home sales, and durable goods orders. In the case of durables, it was more than just a disappointment of expectations -- it was a downright negative, and the second in a row. We've seen declines now for two months running in new orders for non-defense capital goods ex-aircraft, the most sensitive forward-looking indicator of capital spending. It's especially disappointing if you regard it as stimulus-induced, and not exactly the kind of thing that would persuade the Fed to act anything but gradually.

For stocks, which have experienced a near-historic rally off the March bottom (see "Monster Rally" August 31, 2009), the disappointing data is a familiar paradox. On the one hand, it is short-term bearish as it reveals the fragility of the recovery that stocks seem to be counting on. But on the other hand it is long-term bullish, as it keeps at a distance the day when the Fed begins the potentially recovery-killing policy normalization process. For the inflation outlook, there's nothing paradoxical about it at all. Until demonstrated otherwise, the Fed seems committed to erring on the side of inflating our way to recovery.

BOTTOM LINE: It's complicated. Intuitively stocks still feel like they don't want to go down, yet we still call for a sharp short-term correction as expectations for earnings and economic data adjust for the realities of a slow and jobless recovery. In the intermediate term, with the Fed taking the inflationary course of continued accommodation to assure against a recurrence of last winter's monetary deflation, we expect any correction in stocks will only be a correction. We expect some reduction in the size of the Fed's balance sheet, but it will come from programs sterilized by exogenously funding. It should not be interpreted as reversal of the Fed's accommodative posture, so we continue to expect gold to work higher after correcting and consolidating its move to $1000.