Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist
Thomas Demas, Managing Director

FED SHADOW

Promise Keepers

Tuesday, October 27, 2009

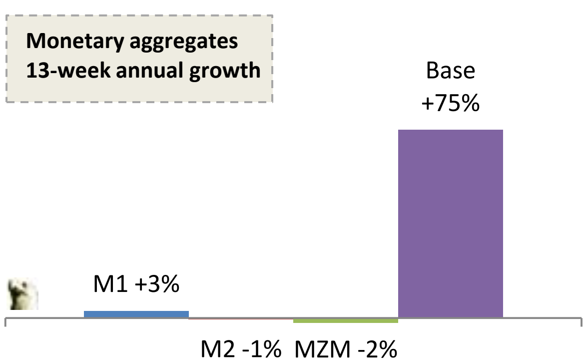
Donald Luskin

Next week the FOMC will repeat its assurance to keep rates low for "an extended period."

Update to strategic view
FED FUNDS: Next week's FOMC meeting is highly unlikely to substantively revise its promise to keep rates extremely low for "an extended period."
[see Investment Strategy Dashboard]

Media Fed-watchers are abuzz with speculation that next week's FOMC meeting will see a debate on retracting the promise to keep rates low for "an extended period" (see *Wall Street Journal* and *Financial Times*). Debate, yes, with a couple of regional presidents agitating for signaling impending exit from extreme monetary ease. But they don't represent the FOMC's center of gravity, and we would be amazed if, other than the usual tweaks and hedges, the promise did not stay substantially in place.

Late last week an influential Fed governor, who has generally hewed to the FOMC's decision consensus, told us that even though the recession has likely formally ended, basic economic conditions are not seen as having begun to substantively improve. He noted one major positive -- the wealth effect arising from improving prices in capital asset markets. Yet most critically, the labor markets, which the Fed sees as the central symbol of economic well-being, are still worsening. By some indicators they are worsening more slowly -- for example, the decline in new jobless claims and the deceleration in net payroll job losses. But by other measures there is really no progress at all. The percentage of the workforce working part-time involuntarily is still at cycle highs (possibly at all-time highs), and the monthly job-finding probability for the unemployed is only one small tick better than last month's all-time lows.



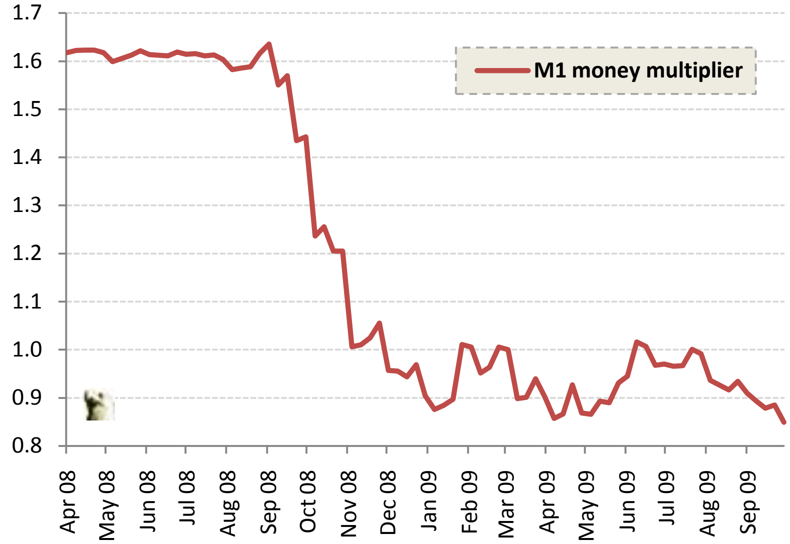
And by some measures, the demand for money remains quite high in relation to the quantity the Fed is supplying -- which is to say that this would be a bad time for the Fed to supply less, without risking a relapse into last year's monetary deflation. The various "M" money aggregates are not growing at all -- yet the monetary base is currently growing at a 75% 13-week annual rate (see the chart at left). So the "money multiplier," the rate at

http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com
tdemas@trendmacro.com

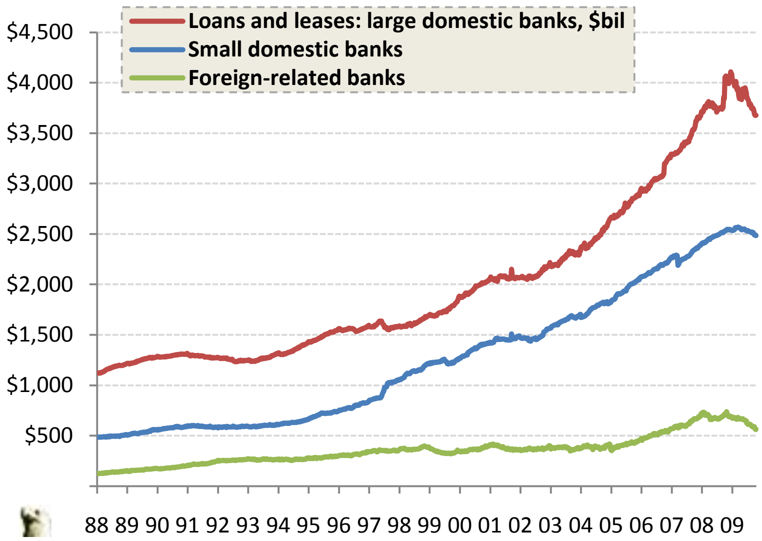
Offices:
Menlo Park CA
Parsippany NJ
Charlotte NC

Phone:
650 429 2112
973 335 5079
704 552 3625

which base or "high powered" money from the Fed gets into the economy, has fallen to a new all-time low (see the chart at right). This is because the usual transmission mechanism for transforming the monetary base into money -- the credit channel -- is broken. Banks are simply not lending, on net -- loans and leases have fallen to near a two-year low, and are falling further each week (see the chart below).



Cutting against this on the hawkish side, our source was clear that the Fed is not indifferent to the post-panic decline in the US dollar. Specifically, the FOMC might see dollar weakness as contributing to increased inflation expecations, thus activating a transmission mechanism that could drive inflation even if the credit channel remains broken. So while we have noted that the Fed doesn't wish to take any responsibility for its hyper-accomodative posture's causal role in dollar weakness (see "Whose Dollar Is It, Anyway?" October 23, 2009), it may nevertheless eventually have to tighten policy in response to further weakness. But we have no reason to think the time is now.



Another factor likely to keep the Fed's monetary stance easy is the need to balance against its tightening regulatory stance. Last week the Fed published proposed guidance for its supervision of bank pay policies, which we see as the opening shot in a long campaign of bank re-regulation. The Fed's iniative is being driven by Daniel Tarullo, an Obama-appointee to the Board of Governors with a strong pro-regulatory reputation. Framed in the context of "safety and soundness" -- rather than seeking to cap "excessive" pay -- it should be seen as the first in a series of moves by government to rein in risk-taking of all kinds. In the aftermath of a global financial crisis caused, in part, by irresponsible risk-taking, it does not seem totally inappropriate to take steps to assure "never again." But don't forget that economic growth is the product of risk-taking, so as a first approximation, government regulation of risk -- however motivated by safety -- is necessarily anti-growth.

In the near term, our conversations with the Fed and the Treasury indicate that they are intently focused on artfully timing financial re-regulation. They don't want to introduce so much of it so quickly as to derail the nascent rebirth of risk tolerance coming out of the financial panic. But it is surely coming. Next will be the imposition of much more stringent capital adequacy standards, and then Fannie Mae and Freddie Mac will have to be unwound. The Fed can ease the way for all this by keeping monetary policy as loose as possible for as long as possible, limited only by its belief that inflation expectations are still anchored.

BOTTOM LINE: Next week's FOMC meeting is highly unlikely to substantively revise its promise to keep rates extremely low for "an extended period."

Recommended reading
Has the Rise in American Inequality Been Exaggerated? Robert J. Gordon August 28, 2009
[Recommended Reading home]