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FED SHADOW

New Year, Same Old Fed

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Donald Luskin

The new wave of economic optimism isn't moving the Fed toward serious tightening.

It's only the first business day of the New Year. But the Fed has already signaled markets not to expect much policy change anytime soon. With the palpably positive tone-change on economic prospects since Thanksgiving, Ben Bernanke's speech Sunday to the American Economic Association would have been the perfect opportunity to kick off 2010 with a hint that the often-repeated promise of "exceptionally low levels of the federal funds rate for an extended period" is finally about to be broken. But no. He didn't mention it -- which is tantamount to re-affirming it. Instead, he offered an elaborate defense of the "considerable period" of low interest rates Alan Greenspan and he engineered from 2002 to 2006, which many critics have cited as the root cause of the housing and credit bubble. In essence, he concludes that regulatory enforcement should have been much stronger, but monetary policy during that period was entirely appropriate given the information available at the time. If he doesn't admit any errors with respect to that episode, then he's likely to repeat the same inflationary errors in the present episode.

Update to strategic view

GOLD, FED FUNDS: Befitting its November run-up, gold has had the sharp correction we expected, reflecting rising Fed tightening expectations. It's time to start buying the dip, as those expectations -- even if fulfilled -- still reflect extraordinarily easy policy. With the Fed showing no signs of having learned from its prior easy-money mishap, the promise of "extended period" of "exceptionally low" rates remains firmly in place.

US STOCKS: Macro expectations have turned the corner definitively post-Thanksgiving. But stocks had already more than discounted for recovery from recession. With stocks back to peak forward multiples, we don't expect much progress -- in fact, we still expect consolidation and correction before any substantial thrust higher.

[see Investment Strategy Dashboard]

Last April we wrote that "we would have to rethink the bull case for gold" -- that is to say, rethink our inflation fears -- if we heard "a single word from a Fed official suggesting that he now understood that the 2002/2003 policy was misguided" (see "Charm Offensive" April 6, 2009). Okay, Tim Geithner *did* say on the Charlie Rose Show just a month later that "monetary policy around the world was too loose too long. And that created this just huge boom in asset prices." But at that point he was no longer a Fed official. And two years earlier, Dallas Fed president Richard Fisher had already said in a speech that policy then had "amplified speculative activity in the housing and other markets." But he blamed it on "poor data" on inflation that was subsequently revised -- a matter that Bernanke himself cited yesterday. The point is that nothing

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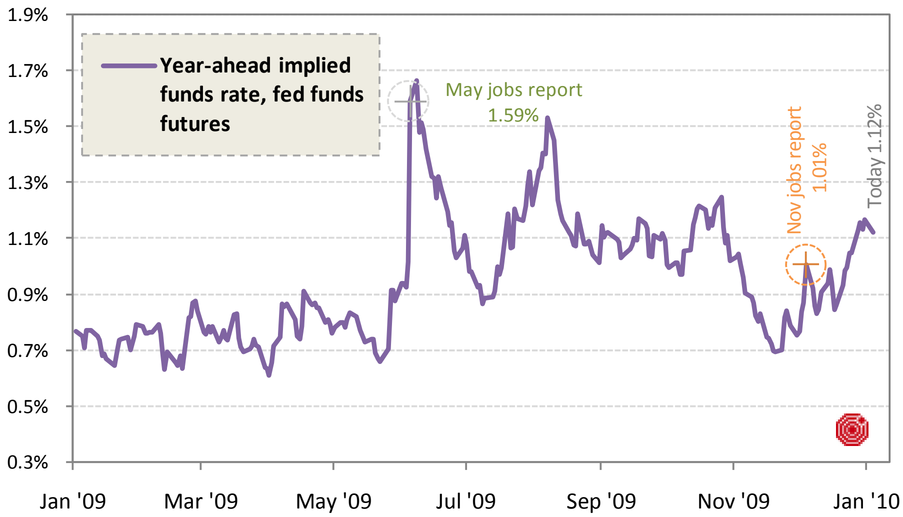
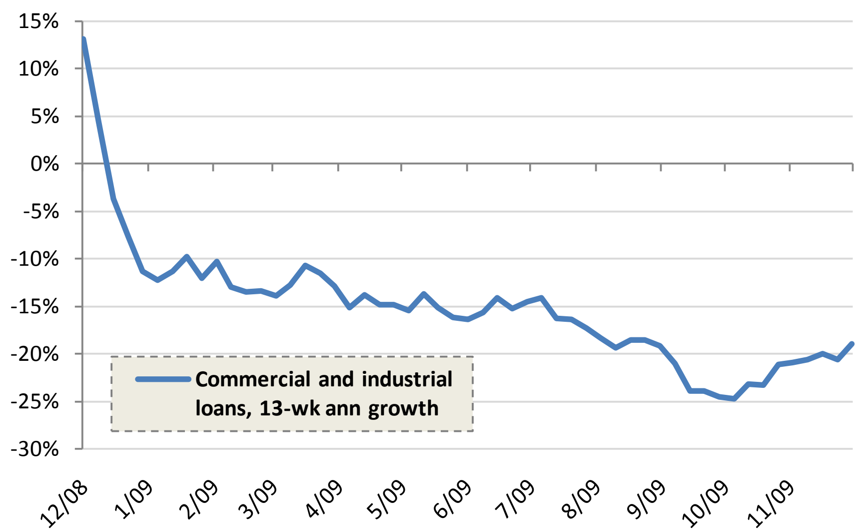
in Bernanke's speech suggests any learning that "slack" in the economy will not prevent a prolonged easy policy stance from translating into inflationary consequences.

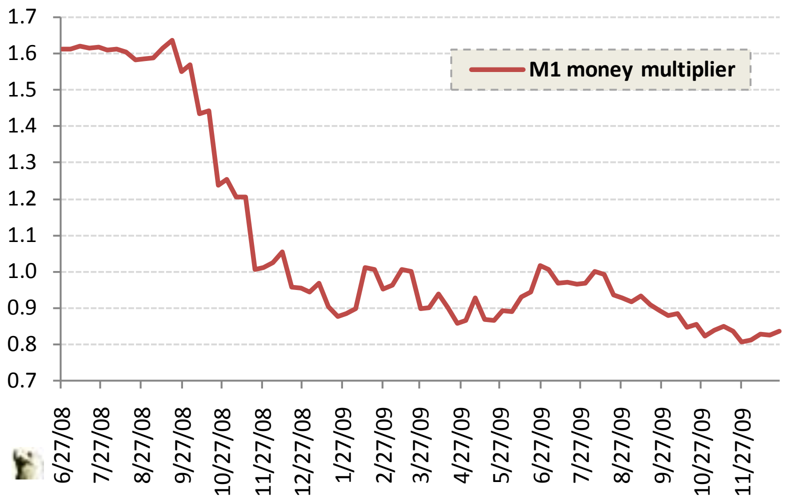
In [another speech](#) at the same forum yesterday, Fed vice-chair Don Kohn's dealt with the issue of the "extended period" promise head-on. There was a certain amount of tough talk, saying that there is "no shortage of tools" to effect tightening, and that policy will "depend on forecasts" and so the Fed will "begin withdrawing extraordinary monetary stimulus well before the economy returns to high levels of resource utilization." It was somewhat reminiscent of Fed governor Kevin Warsh's bold prediction in [a speech](#) last September that the Fed will "likely need to begin normalization before it is obvious that it is necessary, possibly with greater force than is customary" (see ["Warsh's Warning"](#) September 28, 2009). But for Kohn all that is hypothetical. He sees "considerable persisting slack in labor and product markets," and thinks "cost and price inflation should remain quite subdued." And he is concerned that "we are still in uncharted waters" in the economy and the policy realm, which is presumably an argument for Bernanke's preferred path of ["gradualism."](#) By the end, Kohn ended up reiterating the "extended period" promise.

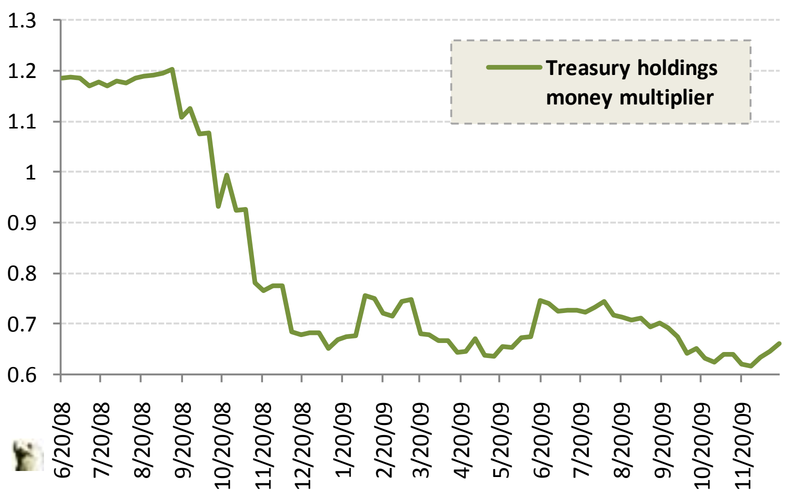


All that said, with the positive tone-change since November -- there's near unanimous agreement among clients now with our long-held view that the recession bottomed last May (see ["Stress Test for T-Bonds"](#) May 8, 2009) -- Fed tightening expectations have been steadily rising. In fact, viewed through the microscope necessary to contemplate the fed funds rate at the zero-bound, tightening expectations appear to have been exploding. But in a more macroscopic context, only the most trivial of tightening is actually expected. At their lows just before Thanksgiving, year-ahead expectations in futures markets were for a funds rate of 69 bp. Since then, following the brief false alarm of the Dubai debt crisis and then the better than expected November jobs report (see ["On the Dubai Debt Crisis"](#) November 27, 2009, and ["On the November Jobs Report"](#) December 4), futures markets are now reflecting a 112 bp funds rate at year-end 2010 (see the chart above left). They're still 47 bp lower than just after the brief euphoria of the May jobs report, the first one to come in better than expected



and thus signal the end of recession (see "On the May Jobs Report" June 5, 2009). Never mind that the futures markets have habitually over-estimated the year-ahead funds rate (at no point did they ever anticipate anything close to the present zero rate). Even granting perfect accuracy to today's year-ahead expectation of 112 bp or so, the Fed could quite rightly claim then that we are still within the "extended period" of "exceptionally low" rates. In other words, no one ever said that "exceptionally low" had to equal zero.





From the inflation standpoint, for the moment the Fed can correctly say "so far, so good." But that's because the safe-haven *demand* for money continues to counterbalance the enormous *supply* of base money the Fed created since the worst of the credit crisis in 2008 (see "2010's Great Debate: Inflation or Deflation?" December 22, 2009). The Fed will have completely succeeded in thwarting the crisis when that demand substantially subsides, and financial intermediaries stop hoarding and start lending and investing. The Fed's dilemma is that it is just that circumstance that will create an inflationary threat, because at that point the vast supply of new base money now trapped on the Fed's balance sheet will have started to get out into circulation where it can cause inflation. There are only the most timid signs that this is beginning to happen now. Commercial and industrial lending has stopped falling as rapidly as it had been several months ago, but is still declining at a 19% three-month annual rate (see the chart at the bottom of the previous page). And the almost $1 trillion in excess reserves on the Fed's balance sheet has only now begun to turn into either money, or bank investment in Treasury securities (see the charts at left, above). We don't doubt that the Fed has the tools to staunch this flow into money if it wishes to -- that's what its plans to do reverse repurchase agreements, and to accept term deposits, are all about. What we doubt is that the Fed will have the skill, the wisdom, or even the correct information to enable it to do so before serious inflation gets underway. Given the size of the Fed's balance sheet, and the volatility of the sentiment that drives the economy's willingness to turn base money into money, the stakes are so enormous that even the smallest and best-intentioned mistake will have measurable inflation consequences.

BOTTOM LINE: Befitting its November run-up, gold has had the sharp correction we expected, reflecting rising Fed tightening expectations. It's time to start buying the dip, as those expectations -- even if fulfilled -- still reflect extraordinarily easy policy. With the Fed showing no signs of having learned from its prior easy-money mishap, the promise of "extended period" of "exceptionally low" rates remains firmly in place. Macro expectations have turned the corner definitively post-Thanksgiving. But stocks had already more than discounted for recovery from recession. With stocks back to peak forward multiples, we don't expect much progress -- in fact, we still expect consolidation and correction before any substantial thrust higher.