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

FED SHADOW

Ben Can, But Ben Probably Won't

Wednesday, February 10, 2010

Donald Luskin

The Fed has the tools to "exit," but using them correctly remains a challenge.

Unable to testify before the House Financial Services committee in person in snowbound Washington, Ben Bernanke nevertheless released his prepared testimony on the Fed's "exit strategy" from its present state of extreme monetary ease. Out of all 3,500 words of it, all you really need to know are two: "extended period." For all the talk about this, that and the other tool at the Fed's disposal to tighten policy, what's important is that Bernanke repeated today that "economic conditions, including low rates of resource utilization, subdued inflation trends, and stable inflation expectations, are likely to warrant exceptionally low levels of the federal funds rate for an extended period." In a nutshell, the Fed has the tools -- did anyone ever really doubt that they did? -- and it won't use them for a long time.

Update to strategic view

FED FUNDS: Bernanke's testimony today about the Fed's "exit strategy" from extreme ease repeated the promise of low rates for an "extended period." We continue to believe that a weak jobs market and the political pressures of a critical election year will keep the Fed on hold for the rest of 2010.

US STOCKS: The idea that the Fed and the rest of the world's central banks are set on imminent tightening has been one of several intertwined narratives driving the present correction. Bernanke's highly anticipated testimony this morning gave no new support to that narrative -- and the growing likelihood that Europe will do whatever it takes to contain its PIIGS problem -- indicate that the global safety net of easy money will remain in place. We expect stocks to continue to consolidate and correct, but the alleviation of this thematic element should take some of the pressure off.

[see Investment Strategy Dashboard]

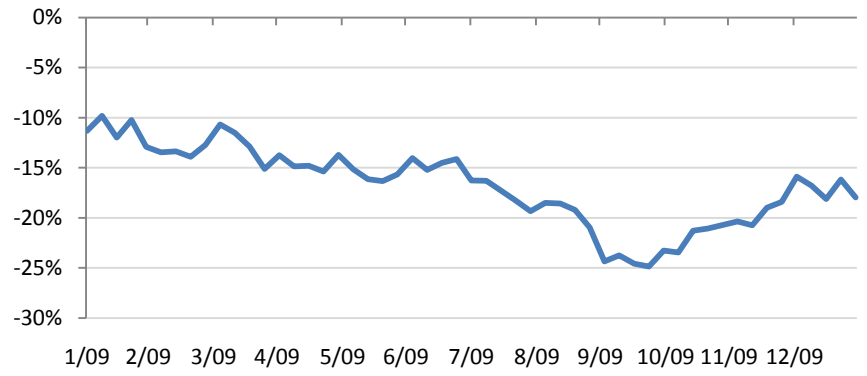
That's because the Fed's extreme ease still hasn't done its intended work. Despite its creation over the last year of more than a trillion dollars of excess reserves, banks still aren't lending. Commercial and industrial loans outstanding are continuing to fall at the recessionary rate of about 18% on a 13-week annual basis. The only glimmer of light there is that this is an improvement from several months ago, when they were falling at the depressionary rate of 25% (please see the chart on the following page). Despite last week's joint announcement by the Fed and other bank regulators intended to encourage small business lending -- by, among other things, promising banks that they "will not be subject to supervisory criticism" -- the National Federation of Independent Business reported yesterday that availability of loans is near a 28-year low. According to the Fed's senior loan officer survey, while lending standards for both large and small businesses are no longer getting tighter (for large/medium businesses they are actually getting looser), demand for those loans is still falling.

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

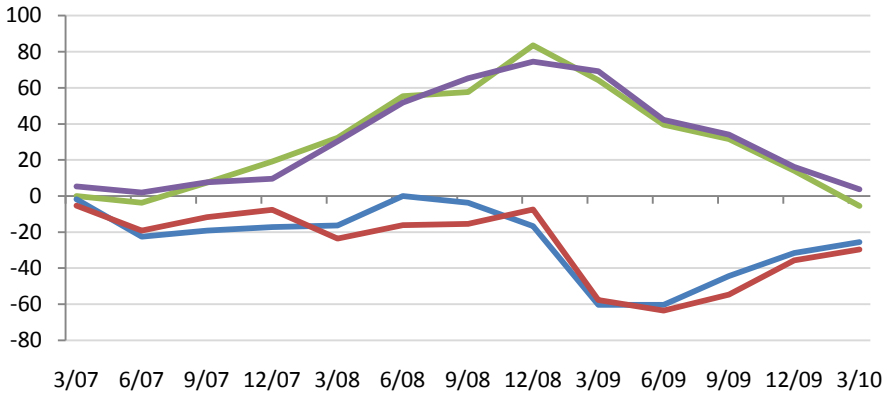
Offices:
Menlo Park CA
Charlotte NC

Phone:
650 429 2112
704 552 3625

Commercial and industrial loans
13-week annual growth



Commercial and industrial loans
Tightening standards for — large/medium and — small businesses
Increasing demand for — large/medium and — small businesses



Source: Federal Reserve

At the same time, the labor market -- the sector to which the Fed is most closely attuned both analytically and politically -- remains deeply mired. We thought January's jobs report was actually surprisingly encouraging, despite the headline continuing job losses from the payroll survey (see "PIIGS, Panic and Jobs" February 5, 2010). But by our estimate, it will still take 240,000 new jobs each and every month to keep the unemployment rate from not rising above its present 9.7%. In this sluggish economy, that's a big hurdle. Considering that the Fed regards slack in the labor market as a bulwark against inflation -- and considering that this is an election year in which Ben Bernanke barely got re-elected himself -- we think it nearly inconceivable that the Fed will begin to tighten soon -- because it is inconceivable that the labor market will significantly improve anytime soon.

BOTTOM LINE: Bernanke's testimony today about the Fed's "exit strategy" from extreme ease repeated the promise of low rates for an "extended period." We continue to believe that a weak jobs market and the political pressures of a critical election year will keep the Fed on hold for the rest of 2010. The idea that the Fed and the rest of the world's central banks are set on imminent tightening has been one of several intertwined narratives driving the present correction. Bernanke's highly anticipated testimony this morning gave no new support to that narrative -- and the growing likelihood that Europe will do whatever it takes to contain its PIIGS problem -- indicate that the global safety net of easy money will remain in place. We expect stocks to continue to consolidate and correct, but the alleviation of this thematic element should take some of the pressure off.