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

FED SHADOW

The Scariest Chart in Economics

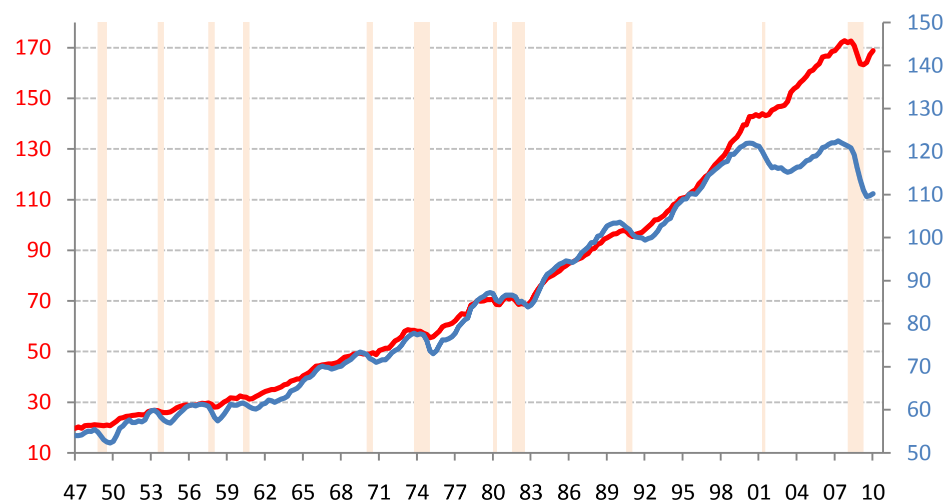
Tuesday, April 27, 2010
Donald Luskin

The FOMC meets, facing a secular breakdown in the labor market.

Look at the chart at the bottom of this page. You can be sure the FOMC is looking at it today, because it perfectly portrays the Fed's decision space.

- On the one hand, looking at output -- the red line -- the recession is manifestly over, and the economy is recovering. But looking at hours worked -- the blue line -- there is almost no recovery at all, indeed a decade-long depression.
- It's worse than that: this is a secular trend breakdown in the labor market. It was masked during the last expansion by the unemployment rate falling to as low as 4.4% -- but that only happened because of the secular shift over the decade to part-time work, voluntary and involuntary, in which a worker is counted as "employed" but actually works fewer hours.
- There will be those on the FOMC who will want to nudge expectations toward tightening, given the recovery in output. But with the unemployment rate at 9.7% -- and especially with this historic gulf

Non-farm business hours worked — Output Recessions
Seasonally adjusted indices, 2010Q1 estimated



Source: Bureau of Labor Statistics, TrendMacro calculations

Update to strategic view

FED FUNDS: In tomorrow's FOMC statement the "extended period" promise will remain, and there will be no announcement of asset sales. The funds rate will remain near zero for the rest of the year.

US BONDS, HIGH YIELD BONDS: The "extended period" promise pins the 10-year Treasury in a trading range between 3.5% and 4%. The ongoing commitment by the Fed and all the world's monetary and fiscal authorities to massive liquidity support will continue to flatter lesser credits, so buy dips in distressed situations, and don't pay up for quality -- in bonds or any other asset class.

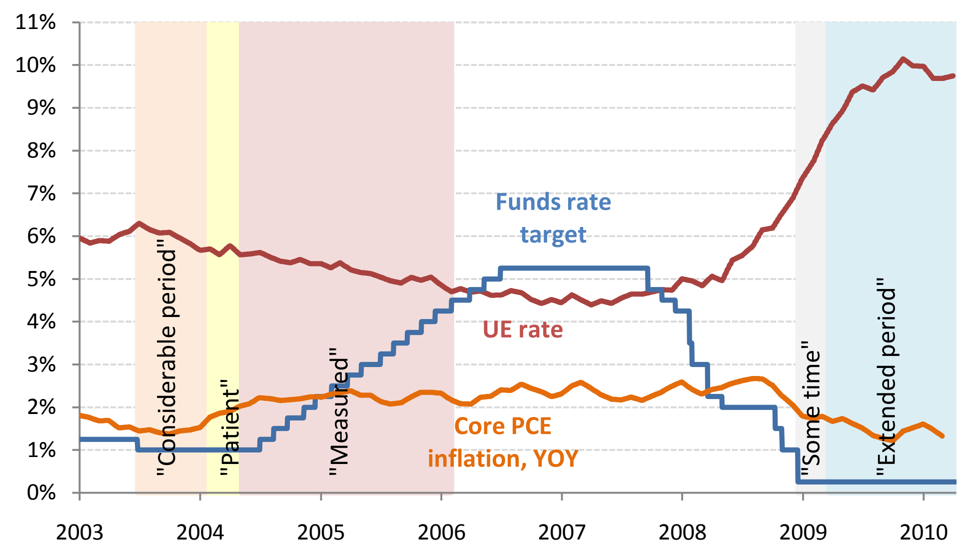
[Strategy Dashboard home]

between recovering output and stagnating hours worked, the Fed knows it is light years behind the curve in fulfilling its mandate for maximum employment. No tightening is possible, and any attempts to move expectations in that direction will be minimal.

The "glass half full" way of looking at this situation would be to call it *productivity*. Good for corporate profits? To be sure. But to be good for profits *growth*, the gap needs to keep getting wider and wider. And the Fed doesn't care about that anyway, or at least not directly. By legislative mandate, it has no choice but to take a "glass half empty" view, and use every tool at its disposal to move the economy back toward maximum employment. It needs to get that blue line to turn back up and make new highs. If the way to do that is to get the red line to move higher, too, even if the gap between the lines widens, then so be it. For the Fed, it's all about jobs. Period.

The Fed is undistracted from a mono-focus on employment because inflation is not operating as a side-constraint. Core personal consumption expenditures inflation, now at 1.3% year-on-year, is lower than it was at the lows in 2002 and 2003 when Ben Bernanke gave [his infamous "helicopter drop" speech] warning about *deflation* (please see the chart below). If anything, deflation is the Fed's worry now, too.

Fed "code words" versus policy rate and key macro variables



Source: Federal Reserve, Bureau of Labor Statistics, Bureau of Economic Analysis

In this context, we judge it virtually unthinkable that the Fed will drop its promise of an "extended period" of an "exceptionally low" funds rate. We understand that the minutes of the March FOMC meeting made it clear that this promise was conditional, subject to evolving economic circumstances. Policy is *always* conditional. And we know *exactly* what the

Contact TrendMacro

On the web at
www.trendmacro.com

Donald Luskin
Menlo Park CA
650 429 2112
don@trendmacro.com

Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

[About us]

Key documents

Deflation: Making Sure "It" Doesn't Happen Here
Ben S. Bernanke
November 21, 2002

Back to a Better Normal: Unemployment and Growth in the Wake of the Great Recession
Christina D. Romer
April 17, 2010

[Client Resources home]

conditions are: there's no inflation, and the labor market is in something like a depression. The promise stands.

Kansas City Fed president Thomas Hoenig's two FOMC dissents about the "extended period" promise (see, first, "Advice and Dissent" January 28, 2010) seem to us to be a fundamental misunderstanding of how the promise functions as an instrument of policy. It's how the Fed controls long-term interest rates when the overnight policy rate is stuck at the zero-bound, and it's why we've been saying that the 10-year Treasury will be controlled in a trading range between 3.5% and 4.0% (see, most recently, "Obamacare: Do Markets Care?" March 18, 2010). Hoenig argues that dropping the promise "would provide the Committee flexibility," but the whole point of the promise is *to deliberately signal an inflexible commitment*. Bernanke laid it out explicitly in the "helicopter drop" speech:

> One approach, similar to an action taken in the past couple of years by the Bank of Japan, would be for the Fed to commit to holding the overnight rate at zero for some specified period. Because long-term interest rates represent averages of current and expected future short-term rates…a commitment to keep short-term rates at zero for some time -- if it were credible -- would induce a decline in longer-term rates.

Even the White House is chanting the "extended period" mantra. In a speech last week calling for additional fiscal stimulus to prop up lagging aggregate demand, Council of Economic Advisers chair Christina Romer used the expression no less than three times. Is the Fed ready to let long-term interest rates rise? Unthinkable. So it's unthinkable that the "extended period" promise won't be repeated in tomorrow's FOMC statement.

We judge it to be just as unthinkable, and for the same reason, that the FOMC will indicate any intention to reduce the size of its balance sheet by selling assets. A rather confused analysis in the *Wall Street Journal* last week made it sound as though asset sales will be up for grabs at the meeting, while at the same time, warning that the Fed will soon announce implementation of a term deposit facility, through which banks can park excess reserves at the Fed for fixed periods. Yet such a facility is specifically designed so that the Fed will *not* have to sell assets, being assured of long-term funding for them with the term deposits. The Fed's MBS portfolio has already been reduced a bit -- having acquired exactly the target face amount of $1.25 trillion, $81 billion has run off through pre-payments. But the Fed won't actively sell these assets anytime soon, because buying them was another way -- beyond the "extended period" promise" to lower long-term interest rates with the overnight policy rate at the zero-bound. Again, Bernanke laid it all out in the "helicopter drop" speech:

> Lower rates over the maturity spectrum of public and private securities should strengthen aggregate demand in the usual ways… Yet another option would be for the Fed to use its existing authority to operate in the markets for agency debt (for example,

mortgage-backed securities issued by Ginnie Mae, the Government National Mortgage Association).

Surely the Fed has no desire to make long-term rates *rise* by *selling* these assets. With the zero funds rate and the Fed's large asset portfolio both such historic anomalies, with each FOMC meeting it is tempting to think that the default expectation ought to be a move back toward normality. Someday, hopefully, we can make such moves. Not now. Look again at the hours worked chart on the first page. Is there any way the Fed is going to do anything that will make long-term rates go *up*?

Bottom line

In tomorrow's FOMC statement the "extended period" promise will remain, and there will be no announcement of asset sales. The funds rate will remain near zero for the rest of the year. The "extended period" promise pins the 10-year Treasury in a trading range between 3.5% and 4%. The ongoing commitment by the Fed and all the world's monetary and fiscal authorities to massive liquidity support will continue to flatter lesser credits, so buy dips in distressed situations, and don't pay up for quality -- in bonds or any other asset class.