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

FED SHADOW

How to Ease, Not When to Tighten

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Donald Luskin

Today the FOMC will take the first tiny steps down the path to further easing.

How shall we interpret the strange silence that has fallen over the Fed? Since the April FOMC meeting, no senior Fed official has given a speech *about economic conditions*, with the exception of Ben Bernanke's June 9 testimony before the House Budget Committee -- and that was in the context of talking about fiscal sustainability. Coming just days after the disastrous May jobs report (see "On the May Jobs Report" June 4, 2010), Bernanke tried to be as upbeat as he could about what we call an "expansionless recession", citing the FOMC's upgraded growth forecasts -- but he was at pains to point out that those forecasts had been made over a month ago.

- We sense the Fed sees the economy as having taken an alarming -- or at least disappointing -- turn for the worse. We expect an indication of that to appear in today's FOMC statement. And we think that may prove to be the opening move in a campaign to condition markets to expect further easing this year unless the economy rights itself.
- With the funds rate already at zero, that would take the form of additional asset purchases for the Fed's balance sheet.
- Alternately, the Fed could start talking about deliberately creating higher inflation.

To be sure, cutting starkly against this view is the fact that in the absence of any economic speeches by top fed officials the "extended period" language has not been reaffirmed. It had been reaffirmed frequently prior to other recent FOMC meetings. In his one opportunity to reaffirm it in the June 9 testimony, Bernanke did not do so. The only Fed official who has mentioned it at all, to our knowledge, is Kansas City Fed president Thomas Hoenig, who denounced it in a June 3 speech, in the same spirit in which he has dissented against it at every FOMC meeting this year (see "Advice and Dissent" January 28, 2010).

Yet we're not convinced that the failure to condition markets to expect a reiteration of the now-familiar language indicates that it will be dropped -- which itself would indicate that a new tightening cycle is at hand. We think that, if anything, not mentioning it is a token of the extent to which senior officials now consider it a given, and assume markets see it the same way.

Update to strategic view

FED FUNDS: The economy has gotten worse since the last FOMC, when the Fed upgraded its growth forecasts. At this point the Fed has to be thinking about how to get looser, not when to get tighter. We expect the FOMC to take a darker tone on the economy, and start subtly laying the expectational framework for more easing later this year.

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And indeed they do. Yesterday year-ahead futures-implied expectations for the funds rate fell to all-time lows at 58 bp. If we were to let our speculative impulses run, we could even imagine that Fed spokesmen aren't mentioning the "extended period" language because they intend to replace it with something even more dovish.

In the minutes of the March FOMC meeting, the "extended period" language was said to be "explicitly contingent on the evolution of the economy." The plain reality is that the economy has been devolving, not evolving. The unemployment rate is stuck near 10%, and inflation is falling to the point where the Consumer Price Index has printed negative for the last two months. A fitted Taylor Rule puts the funds rate at *negative* 6% now, which means the Fed is too tight, not too loose (see "Fixed Income Strategy: Take The Low Road" June 16, 2010). At the zero bound, the only ways to loosen further are by more asset purchases, or by making explicit policy statements aimed at convincing markets that the Fed actively wants inflation instead of deflation.

Impossible? If we've learned nothing else these last two tumultuous years, we should have at least learned to banish *that* word from our vocabulary. Yes, long Treasury yields are already ridiculously low, it would seem -- but they were even lower last year when the Fed announced it would buy $300 billion in Treasuries, and an additional $750 billion in MBS -- the 10-year yield then was 2.6% (see "Ben Boldly Goes" March 19, 2009). And the Fed has plenty of room on the balance sheet, with so-called "excess reserves" down $200 billion since February (that said, with its printing press, the Fed *always* has enough room).

And is it so impossible for a central bank to announce it actively wants inflation? It would have been crazy for Paul Volcker to do that in 1980. But that is precisely what Bernanke has publicly recommended to the Bank of Japan in a similar situation to ours, after its attempts at quantitative easing proved inadequate to reverse a long-standing deflation. It may well be what he does here and now in the US to prevent our incipient deflation from becoming long-standing. With gold hovering near all-time highs, the bet seems to be that Bernanke will follow his own advice.

Bottom line

The economy has gotten worse since the last FOMC, when the Fed upgraded its growth forecasts. At this point the Fed has to be thinking about how to get looser, not when to get tighter. We expect the FOMC to take a darker tone on the economy, and start subtly laying the expectational framework for more easing later this year.

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

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