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

FED SHADOW

No QE2 Yet -- Just QE 1.1

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Donald Luskin

Bernanke disappointed the "double dip" crowd, but it was still a step toward more easing.

After Ben Bernanke's testimony before the Senate Banking Committee yesterday, Senator Bob Corker (R-TN) asked him under what conditions the Fed would "begin tightening." Bernanke replied by explaining the exact opposite: that is, when the Fed might take new unconventional actions to *begin further easing*:

> …certainly one important criteria would be whether the recovery is sustainable, whether it's fading and not being self-propelling. If the recovery is continuing at a moderate pace, then the incentive to take extraordinary actions would be somewhat less.

Update to strategic view

FED FUNDS: No "QE2" indications in Bernanke's testimony Wednesday. But he implicitly extended the "extended period," effectively making a small down-payment on additional easing.

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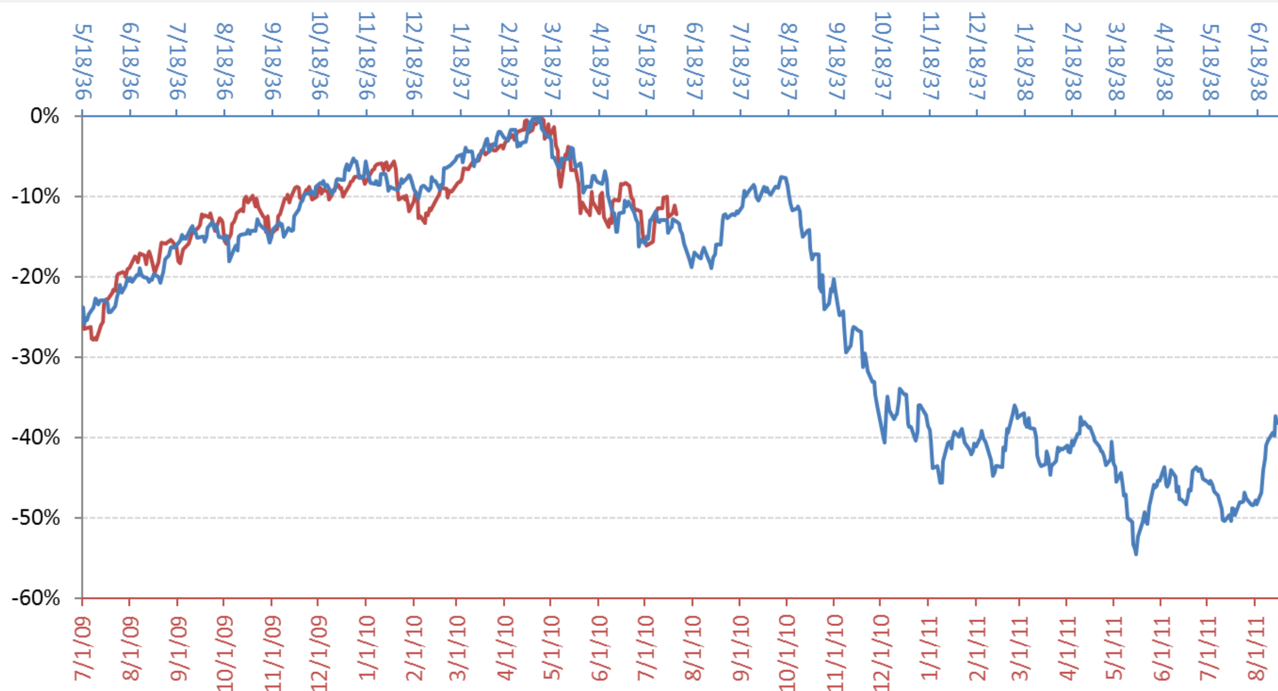
S&P 500 in post-1936 "recession in the Depression" — S&P 500 today
Percentage change from respective recovery peaks



Source: Standard & Poor's, TrendMacro calculations

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We take this as a Freudian slip. Though the bulk of the policy discussion in Bernanke's prepared testimony involved future *tightening* options, apparently *easing* was on his mind (see it for yourself at 1:14:20 in this CSPAN video). But stocks certainly didn't pick up on it, after they dropped the moment Bernanke's prepared testimony was released. It was immediately clear that he wouldn't be announcing the upcoming easing measures that have been the subject of so much market chatter over the last week -- what the rumor mill has come to call "QE2" -- and after that, nothing else mattered.

We've been expecting some kind of new easing step by year-end for about a month now (see "How to Ease, Not When to Tighten" June 23, 2010). But we're not disappointed that nothing came yesterday -- the semi-annual policy report to Congress wouldn't have been the place, and this would have been too soon for Bernanke. He's a champion of "gradualism," except when extraordinary events demand action, and there is no particular urgency now. All that is extraordinary now is that the outlook is "unusually uncertain," to use the two words from Bernanke's testimony that have gotten the most press.

Yes, the dominant narrative now is that a failed "V-shaped recovery" must, as though by a law of nature, turn into a "double-dip." But we don't think that's so, and either does Bernanke. By all indications he agrees with us that we're in an "expansionless recovery" (see "Betting Against a "Double Dip" June 30, 2010). So for a gradualist like Bernanke, further deployment of nonconventional policy tools, with all their attendant uncertainties, doesn't pass a cost/benefit test at this exact moment. But as the "expansionless recovery" drags on, and the economy falls further and further behind trend even as it modestly grows, we think the cost/benefit calculus will change, and some further easing steps will be taken. Bernanke laid out several possible stops in yesterday's testimony.

That said, while "QE2" wasn't explicitly teed up yesterday, "QE 1.1" was. After the release of Bernanke's testimony and during the Q-and-A, fed funds futures ticked higher, setting the implied funds rate for the August 2011 FOMC meeting at their lowest level ever -- just 47 bp. As indeed they should be, considering Bernanke's expectations for our "expansionless recovery," and with that uninspiring view itself held to be "unusually uncertain." This adjustment to funds rate expectations affects rates across the whole curve, and is therefore very much a form of easing. In fact, first among the tools Bernanke listed yesterday for Richard Shelby (R-AL), when asked how the Fed might further ease, was "modifications of our language or our framework describing how we intend to change interest rates over time" -- in other words, to convince the market that today's extremely low rates will be more long-lived.

The political context of yesterday's testimony -- it was delayed to accommodate Obama's signing of the Dodd-Frank financial re-regulation bill -- makes us all the more certain that the Fed will stay easy for a very long time, and probably get easier before all is said and done. The Fed will need to try to offset the implicit tightening effects of Dodd-Frank, and to fail to do so would be to court a repeat of the Fed's fatal Depression-era error

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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of raising reserve requirements before recovery was complete. Dodd-Frank does many things, many of which won't be understood with certainty until regulators newly empowered under the law complete rules-making processes. But we know that, for banks, its thrust is to rein in risk-taking. Regardless of how this is accomplished, it is the logical equivalent of raising bank reserve requirements. Between August 1936 and May 1937, the Fed doubled reserve requirements in three steps. What followed was the "recession within the Depression," so steep that it would qualify as a depression on its own in any other context -- and the longest-lasting and second-deepest bear market in US history (see "A Funny Thing Happened on the Way to the Depression" July 6, 2010).

We don't want to overplay the significance of one of those "ominous parallels" charts, but it can't be denied that stocks are acting ominously parallel to the way they acted in 1936 and 1937 (please see the chart on the first page, and our *Wall Street Journal* op-ed "Why This Isn't Like 1938 -- At Least Not Yet" July 9, 2010). Aligning the April 23, 2010 top with the March 10, 1937 top, the patterns of the prior run-ups and the subsequent declines then and now are amazingly similar.

Whether or not Ben Bernanke is focused on this chart, we know he is focused on the historical parallels. He is a student of the Depression, and he understands the mix of monetary tightening, tax hikes, protectionism and anti-business policy that snatched defeat from the jaws of victory in 1937. Of those four horsemen of the economic apocalypse, he can only control the first one. We have no doubt that he will do so.

Bottom line

No "QE2" indications in Bernanke's testimony Wednesday. But he implicitly extended the "extended period," effectively making a small down-payment on additional easing.