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FED SHADOW

What Should the Fed Do?

Thursday, August 5, 2010
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There's one policy option for next week's FOMC that would be both powerful and gradualist.

Just three FOMC meetings ago, the chatter was all about a purported rebellion by hawkish regional presidents, and what claimed to be leaks about removing the "extended period" language and selling mortgage-backed securities. We didn't buy into that (see "March FOMC Preview" March 15, 2010). As the ongoing "expansionless recovery" has transformed hopes for a "V-shaped recovery" into symmetrically exaggerated fears of a "double-dip recession," we started talking about how the Fed's next move would likely be some form of additional easing (see "How to Ease, Not When to Tighten" June 23, 2010). That's been absorbed now into the conventional wisdom, practically to the point at which all that is being debated is *which means* of easing will be announced at next week's FOMC. There has been widespread speculation about eliminating interest on excess reserves, some talk of letting the Treasury's Special Financing Program roll off, a supposedly authoritative leak that pre-pays on MBS will be reinvested in Treasuries, and a paper from St. Louis Fed president Bullard that has been interpreted as a call for buying more Treasuries outright.

At the same time, despite widespread fears of coming fiscal austerity, Congress passed another extension of emergency unemployment benefits, and the House has just been called back into session to affirm the Senate's vote for a $27 billion state aid bill. With three Democratic senators having forced the issue by advocating extension of the Bush-era tax cuts for everyone, including "the rich" (see "Good Week for Growth" July 26, 2010), majority leader Harry Reid has announced that the matter will be taken up by the Senate before the November elections.

- This all plays into our long-standing strategic theme of "no exit" from the government's monetary and fiscal support for the economy.

As a result, the market environment has changed considerably.

- From the bottom in stocks in early July -- two days after we said "This would be a good place to take the first step toward buying the dip" (see "Betting Against a 'Double Dip'" June 30, 2010) -- stocks have rallied 10.2%, with the both cyclical-sensitive and inflation-

Update to strategic view

FED FUNDS: The Fed should ease next week, and markets expect it in some form. The Fed is unlikely to disappoint, but it will probably be only a baby-step, most likely somehow strengthening the commitment to an "extended period" of extremely low rates.

US STOCKS, US RESOURCE STOCKS, US BONDS, HIGH-YIELD BONDS, GOLD, OIL, COMMODITIES: If the Fed makes at least some step toward easing next week, it should sustain rallies in cyclical-sensitive and inflation-sensitive assets, and drive bond yields and spreads lower. A small disappointment in degree would be an immediately buyable dip. A larger disappointment could set off a serious correction, but it too would be buyable as it would trigger further easing in response.

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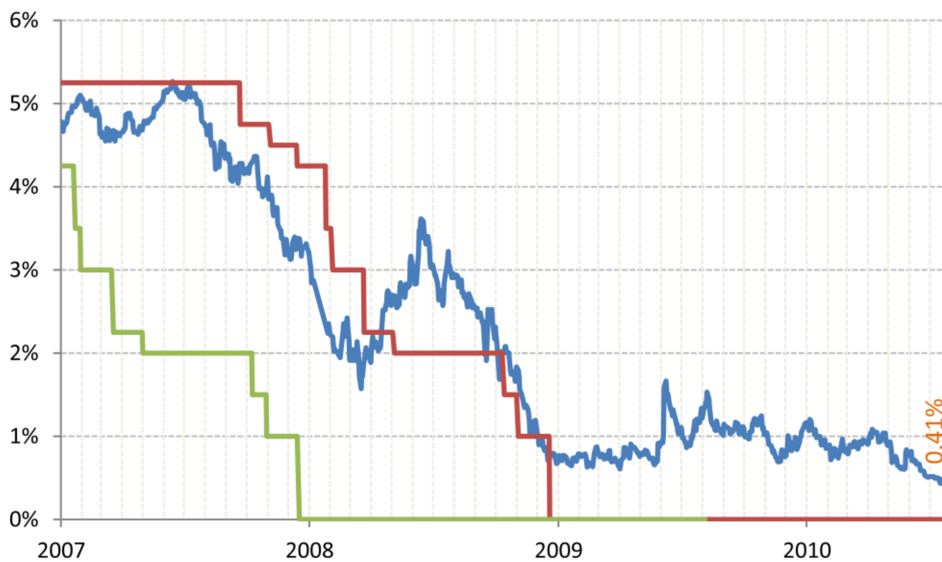
sensitive basic materials, industrial and energy sectors the first, second and third best-performers, respectively.

- Since our last major update on rates in mid-June emphasizing the "no exit" theme (see "Fixed Income Strategy: Take The Low Road" June 16, 2010), expectations for the fed funds rate one year forward, implied in futures prices, have dropped to new all-time lows (please see the chart below). The 10-year yield is below 3%. High-yield spreads have fallen by 71 bp.



Source: CME Group, Federal Reserve, TrendMacro calculations

- Commodities have performed well, with oil up 15.5% and copper up 23.2% from recent lows. Gold, normally the commodity most sensitive to monetary conditions, has been odd man out. We said in early July it would have to undergo a correction as panic over Europe's debt problems subsided (see "On Today's Drop in Gold" July 1, 2010). We predicted then that it would be a buying opportunity. We haven't flagged any particular entry point, but at the moment a rally of as much as 4.1% from last week's intra-day low is looking encouraging, especially considering that it has happened at the same time as the euro has continued to rally.

Surely much of this has happened thanks to expectations for new Fed easing. That should both embolden the Fed to believe that further easing might be effective, and at the same time obligate the Fed not to disappoint. So we think *something* will be done at next week's FOMC. But we continue to maintain that any new easing will come in baby-steps. Absent an emergency, the Bernanke Fed will always opt for "gradualism." So if markets are expecting anything dramatic next week, then they will likely be

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[About us]

Key documents

Seven Faces of The Peril
James Bullard
Preprint, Federal Reserve Bank of St. Louis *Review*
September-October

The High Cost of Exceptionally Low Rates
Thomas M. Hoenig
June 3, 2010

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at least somewhat disappointed, for at least a short time, producing a buyable dip. But in some sense, with a little patience this is a no-lose proposition. If the Fed totally shoots a blank, the ensuing panic reaction in markets will virtually guarantee a big easing move at the following FOMC -- so it would be a buyable correction (remember, that's how "no exit" works).

What is the Fed most likely to do next week? We don't rule out reinvesting MBS pre-pays. That meets the need for gradualism, perhaps to a fault. It's not really easing at all in the absolute sense -- it would just keep the Fed's balance sheet from automatically shrinking by about $10 billion per month. But would it really be effective? We've heard it argued that it would be a symbolic gesture of the Fed's preparedness, but we think that would backfire -- it would be more a signal of both the recognition of a need and the timidity to do anything substantive about it.

Other steps would be more impactful, but they don't feel to us like they are sufficiently gradualist at this moment. Outright acquisition of Treasuries or MBS would be more signal than the Fed wants to send now, evoking the panic of late 2008 and 2009. Lowering or eliminating interest on reserves is unlikely -- it would be a $1 trillion experiment, and Ben Bernanke is on record worrying that it could cause the fed funds market to shut down. We think there's little chance of letting the SFP run off, because it is freighted with political significance for the Fed and the Treasury. It represents an institutional commitment by the Treasury to fund the Fed's holding of various assets acquired in rescues undertaken in 2008 on behalf of the Treasury.

The most likely step -- the one that would be both powerful and gradualist at the same time -- would be for the Fed to make specific and explicit its commitment to an "extended period" of extremely low interest rates. In other words, it could commit to a near-zero funds rate for a stated minimum period, say six months, or one year. When asked in Senate testimony last month how the Fed could intervene if the economy weakened, this was first on his long list of options, expressed as follows: "modifications of our language or our framework describing how we intend to change interest rates over time -- giving more information about that."

- *This would be powerful because what the markets and economy need now more than anything is certainty*. The economy's ability to take risk -- for employers to hire, for banks to lend, and so on -- would be strongly enhanced by the elimination of fear that monetary policy could be as volatile in the coming years as it has been in the recent past. It would take off the table the risk that that Fed might err as it did in 1936 and 1937, throwing a struggling economy back into contraction (see our *Wall Street Journal* op-ed, "Why This Isn't Like 1938 -- At Least Not Yet" July 9, 2010).

- This could be done with any desired degree of gradualism. The "extended period" language already, any time it is employed, commits the Fed to at least three months of extremely low rates (we say that because even with no time commitment, a target rate is generally presumed to be left in effect for six and a half weeks,

the period until the next FOMC meeting -- so even the most minimal commitment would have to mean at least three months, the period spanning the next *two* FOMC meetings). It wouldn't be a big deal to extend it to six months -- *four* FOMC meetings -- or a year -- *eight* meetings. Futures markets already expect that, anyway.

- Sadly, this cuts against the continuing dissents of Kansas City Fed president Hoenig, who argues that the "extended period" language ties the Fed's hands and potentially creates distortions in asset markets (see "Advice and Dissent" January 28, 2010). This must be galling to Ben Bernanke, because tying the Fed's hands (to eliminate uncertainty in markets) and distorting asset markets (to lower long-term interest rates) is exactly the purpose of the language in the first place.

- Bullard hasn't helped, with his paper last week advocating quantitative easing as the optimal solution to Japan-style deflation. While it's useful that Bullard has expanded the solution space for considering *some* form of further easing at next week's FOMC, his logic explicitly argues against a long-term zero interest rate policy, claiming it can lead to an "unintended equilibrium" that is a "liquidity trap." We don't want to go into an in-depth critique of Bullard's theory here (clients who are interested in discussing it should let us know) -- suffice it to say that Bullard has given Hoenig intellectual ammunition, which will make it more difficult for Bernanke to achieve what we think he wants.

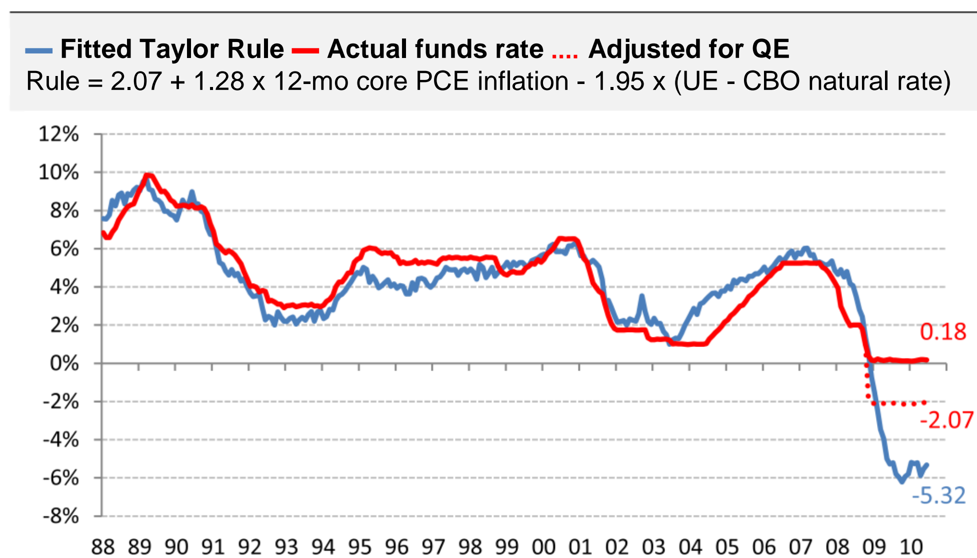
- The bottom line is that Bernanke could execute a move that is both powerful and gradualist -- but it would take overcoming internal opposition from both Hoenig and Bullard. It's not that they couldn't just be outvoted. The problem is that the whole point is for the Fed to make a commitment to markets, and that's hard to do if the Fed is visibly divided.

- Bernanke has a fall-back position that would get him half-way there. Without making an explicit time commitment for the "extended period," which would be ideal, he can nevertheless signal to markets that it's going to be for longer than they expected. We believe he has already done this twice with good effect -- first at the June FOMC meeting, and again in his congressional testimony two weeks ago (please see "On the June FOMC" June 23, 2010 and "No QE2 Yet -- Just QE 1.1" July 22, 2010).

- Remember, just a few months ago there was serious talk about the "extended period" language being "in play" for removal from the FOMC statement! Now the only talk is about whether the language will be strengthened. *That change in expectations means it already has been strengthened, for all practical purposes -- so what we're really debating now is by what means and to what degree it will be even further strengthened.*

Methodological and timing issues aside, none of this should be controversial. There's really no doubt that the Fed should do something in the direction of ease. You don't have to think the economy is headed for a "double-dip" to believe that. Even if you do think that, at the moment it is not falling apart before our eyes, commanding some kind of emergency response from the Fed. But none of that matters. Growth is too anemic (see "On Q2 GDP" July 26, 2010) to make a dent in unemployment -- and with inflation so low there's no immediate risk to price stability that would inhibit further Fed easing actions.

The chart below updates with the latest data a fitted Taylor Rule that reveals how very much more the Fed could ease, given current unemployment and inflation. By historical norms, the funds rate should



Source: Federal Reserve, BEA, TrendMacro calculations per Rudebusch (2009)

now be at negative 5.3%. Even granting that quantitative easing effectively lowers the zero funds rate to about negative 2%, policy is still not easy enough. In this framework, unemployment would have to fall to 7.8% from 9.5%, or core PCE inflation would have to rise to 3.9% from 1.4% -- or some linear combination of the two -- *just to justify today's policy as not being too tight.*

Bottom line

The Fed should ease next week, and markets expect it in some form. The Fed is unlikely to disappoint, but it will probably be only a baby-step, most likely somehow strengthening the commitment to an "extended period" of extremely low rates. If the Fed makes at least some step toward easing next week, it should sustain rallies in cyclical-sensitive and inflation-sensitive assets, and drive bond yields and spreads lower. A small disappointment in degree would be an immediately buyable dip. A larger disappointment could set off a serious correction, but it too would be buyable as it would trigger further easing in response.