TrendMacro

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

FED SHADOW

When PhD's Attack

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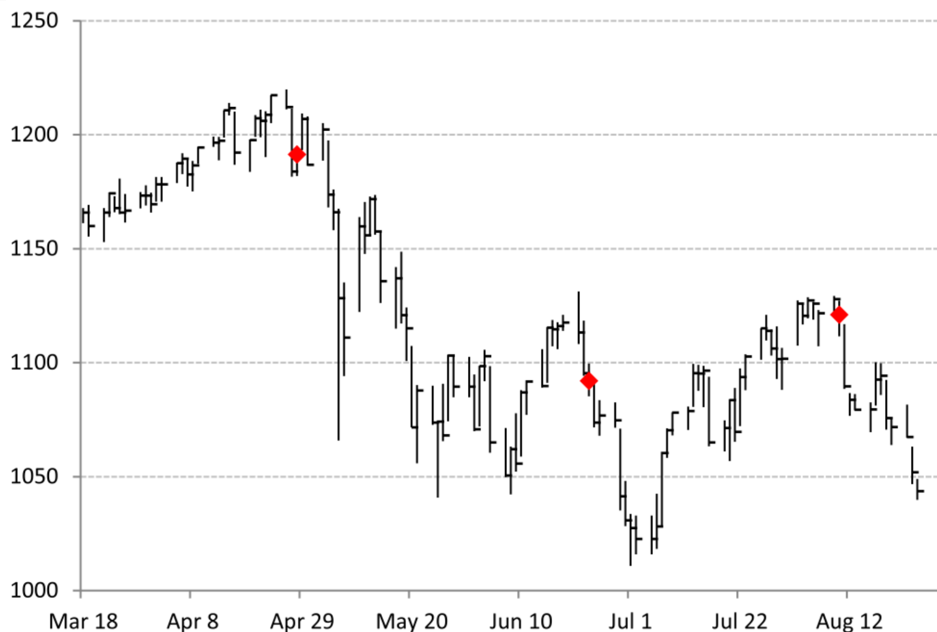
Donald Luskin

Markets will flail until the academics who run the Fed stop theorizing and get real.

A new seasonal pattern in stocks has emerged over the last three months. Every time there's an FOMC meeting, stocks go into a big correction (please see the chart below).

We don't think that's because the Fed has some kind of magic bullet to save the economy and the market is disappointed that they don't fire it. It's more that the Fed is shooting the economy in the foot by creating uncertainty about its policy stance with pointless academic debates at a time when there is already more than enough to worry about. We think Ben Bernanke may seize the opportunity to energize markets Friday by signaling a commitment to clarity when he gives the closely watched keynote speech at this weekend's annual Jackson Hole conference. Surely he knows it is incumbent upon him to do so, after yesterday's widely

S&P 500 ♦ FOMC meetings



Source: Reuters, TrendMacro calculations

Update to strategic view

US STOCKS, FED FUNDS, US BONDS, HI YIELD BONDS, US MACRO: We still don't expect a "double dip" recession, but with the Fed adding to the climate of uncertainty instead of alleviating it, we're definitely mired in an "expansionless recovery." The Fed will hold rates low effectively forever, but their failure to commit to that more fully ironically lengthens the time that it will be necessary. That's supportive of ongoing low bond yields, and stocks stuck in the trading range already established for the year. A signal of dovish clarity from the Fed would change everything -- pushing stocks back up the trading range, jolting yields higher and narrowing credit spreads as growth expectations improve.

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[discussed *Wall Street Journal* article](#) describing the dysfunctional dynamics of the August FOMC meeting.

It's more than just that the FOMC itself wasn't clear about its decision to reinvest pre-payments from its MBS portfolio in Treasuries -- or as the article quotes Philadelphia Fed president Charles Plosser, "We sent some garbled message about a weaker economy where we wanted to be more accommodative." The issue is that clarity and confidence are at a premium in this economy, in which Bernanke [admits](#) the prospects are "unusually uncertain." Firms, investors and households have no idea what their tax rates or their regulatory burdens will be. The Fed has the opportunity to be an oasis of certainty, yet it is adding to the climate of fear.

Most of our clients tell us they are having a hard time embracing our forecast of low rates virtually forever (see ["Fixed Income Strategy: Take The Low Road"](#) June 16, 2010), fearing that the Fed may suddenly pull the rug out from under markets by ending the "extended period" of the zero funds rate. That's more than a market call for these clients -- it's the cognizance that the Fed hasn't said anything to guarantee it won't stumble into the mistake it made in 1936 and 1937, tightening too early in a fragile recovery and triggering "the depression inside the Depression" and history's longest bear market for stocks. Our chart tracking the day-to-day parallel relationship between stocks today and stocks back then is not comforting -- after a hopeful month above the 1937 track, we're now a little below it (please see the chart below).

Contact TrendMacro

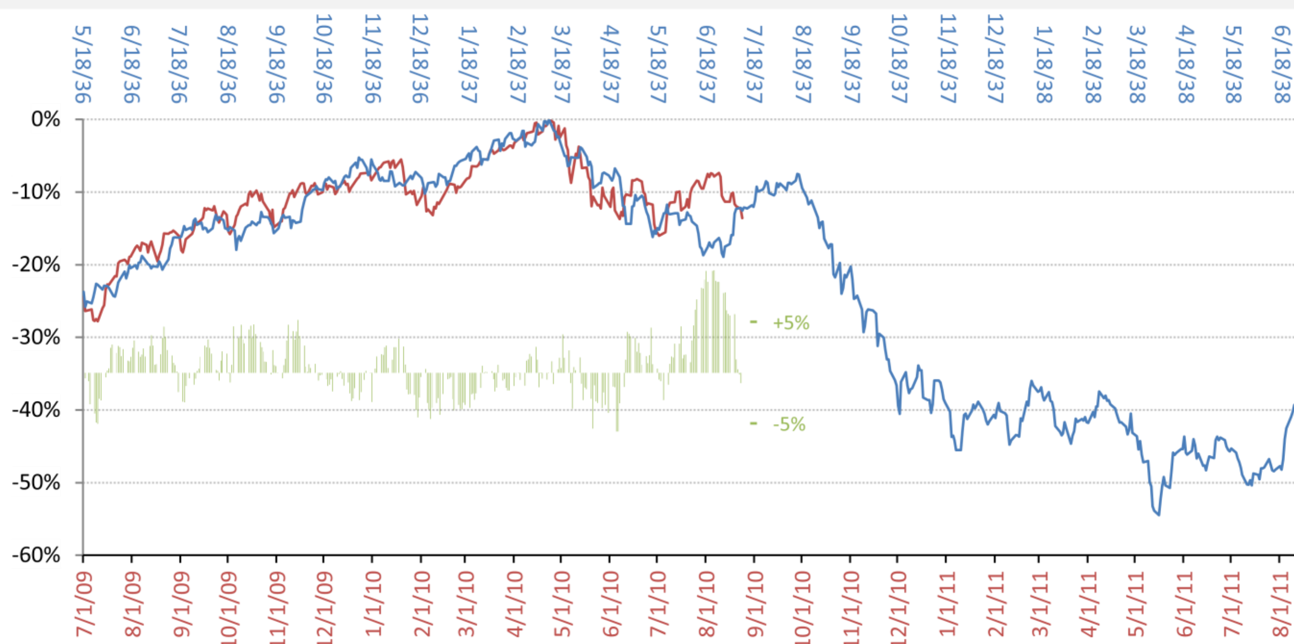
On the web at
[www.trendmacro.com](#)

Donald Luskin
Menlo Park CA
650 429 2112
[don@trendmacro.com](#)

Thomas Demas
Charlotte NC
704 552 3625
[tdemas@trendmacro.com](#)

[About us]

S&P 500 in 1937-38 "depression in the Depression" — S&P 500 today — Difference
Percentage change from respective recovery peaks



Source: Standard & Poor's, TrendMacro calculations

The risk of Fed policy error is always present, even in the best of times. But all the more now, as the economy is in *terra incognita*. It's been a year now since the US economy bottomed. In every other post-war recovery, real GDP has rebounded to a new all-time high by this point, with the strongest rebounds following the deepest recessions. Not this time -- we've had the deepest recession and the weakest recovery, and nobody quite knows why.

The Fed itself is in *terra incognita*, too. It's more than short-term interest rates stuck at zero. The Fed now operates a nearly $2.4 trillion balance sheet, holding AIG's and Bear Stearns' toxic assets and about 20% of the agency mortgage pass-through market, essentially all of it funded with borrowed or newly printed money. Here, too, we hear worries from clients. One of them despairs that the Fed is now the biggest leveraged hedge fund in history, and it's being run by a committee of economics professors -- like Long Term Capital Management with political appointees.

Of the five Fed governors and 12 regional presidents, 11 have PhD's in economics, and nine have taught economics at the college level. The key dysfunction at the Fed now -- what's generating so much uncertainty in markets -- is how starkly these economists disagree with each other about the most fundamental tenets of their supposed science.

Consider the core strategy that the Fed has employed ever since it lowered the Fed funds rate to near-zero in December, 2008 -- the promise to maintain that rate "for an extended period." *This language has been deliberately employed to reduce uncertainty.* Bernanke, who got his doctorate at MIT and once chaired the economics department at Princeton, explained it in his well-known November, 2002 "helicopter" speech. By assuring the bond market that the funds rate would not unexpectedly be hiked, yields further out on the yield curve would come down -- because long-term yields are, in large part, the sum of expected short-term yields.

This strategy allows the Fed to combat deflation even when the funds rate can't be lowered any further. Now, with the economy weakening, Bernanke wants to strengthen the "extended period" language. He wants to reduce uncertainty further by guaranteeing the "extended period" would last for at least, say, one year, rather than having to renew it *ad hoc* at each FOMC meeting. In Senate testimony several weeks ago, that was first among equals on Bernanke's list of remedies for a faltering economy. We believe it is exactly what the Fed should do (see "What Should the Fed Do?" August 5, 2010), as it both effectively eases policy and creates certainty.

Now that strategy for creating certainty is itself being subjected to uncertainty, and that effectively tightens policy just when it should be eased. Enter James Bullard, president of the St. Louis Fed, who got his doctorate at Indiana University and taught at Washington University. In a paper released days before the last FOMC meeting, Bullard called maintaining the funds rate at zero a "peril." He blames the Bank of Japan's similar policy for that country's lost decade of monetary deflation. Minneapolis Fed president Narayana Kocherlakota -- who got his doctorate at University of Chicago and taught at University of Minnesota and

Stanford -- agreed with Bullard in a speech last week, saying "It's simple arithmetic."

- First one economics PhD says an "extended period" of low rates is the cure for deflation. Now two other PhD's say the same thing causes deflation.

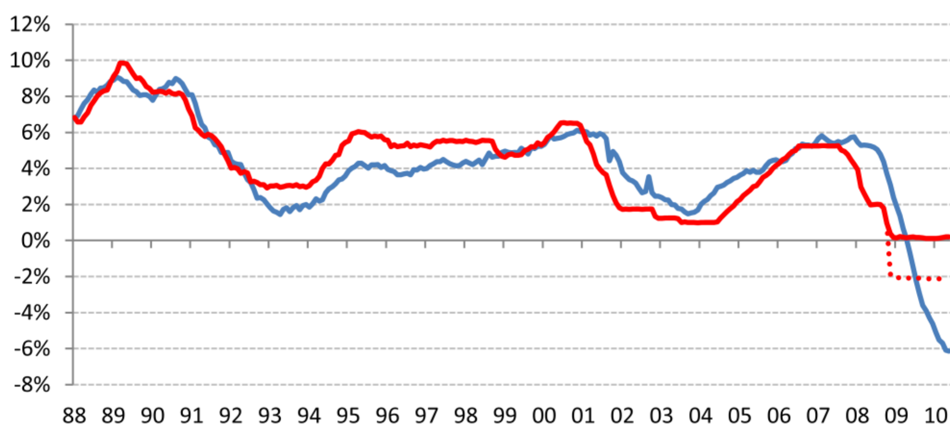
Bullard's and Kocherlakota's case is only "simple arithmetic" in the *ceteris paribus* world of economic abstractions, but in the real world in which the Fed must operate, it's virtually irrelevant. Some hard empirical proof is that when the funds rate was first lowered to zero in December 2008, annual CPI inflation had fallen to exactly zero, and would then go negative -- that is, into deflation -- for several months. Now, after 18 months of a zero funds rate, inflation has risen to 1.3%. If a zero funds rate causes deflation, it's not in the data. Just the opposite.

Nevertheless, Bullard's and Kocherlakota's theorizing adds critical mass to the long-standing opposition of Kansas City Fed president Thomas Hoenig, who has dissented at every FOMC meeting this year, objecting to the "extended period" language (see "Advice and Dissent" January 28, 2010). Hoenig, who got his PhD at Iowa State and taught at the University of Missouri, argues that the promise of a near-zero funds rate will lead to credit distortions like those that caused the housing bubble.

- One PhD says assuring the markets of a continued low funds rate will reduce uncertainty and lower long-term rates, and the other PhD says it will cause a credit bubble.

We have to admit we admire Hoenig's spunk, and his apparent commitment to minimizing central bank interventionism -- he's the Ron Paul of the Fed. But we sense he's gotten caught up in ideology for ideology's sake at this point, and has become confused about the facts. In

— Taylor Rule-based funds rate — Actual .... Adjusted for balance sheet
Rule = 2.07 + 1.28 x 12-mo core PCE inflation - 1.95 x (UE - CBO natural rate)

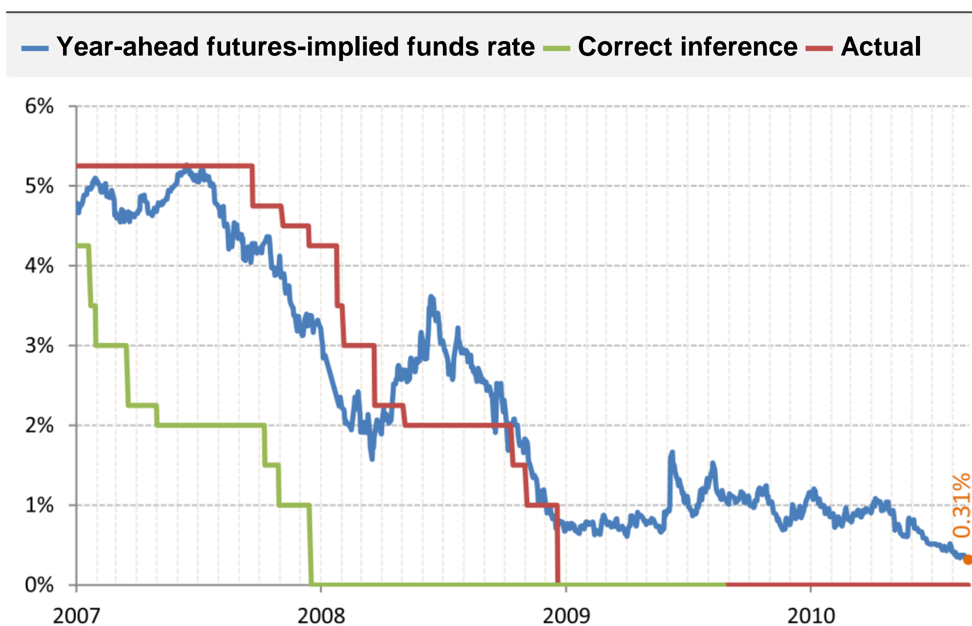


Source: Federal Reserve, BEA, TrendMacro calculations per Rudebusch (2009)

a speech last week he justified his hawkish stance by saying "the economy is improving and is growing at a rate faster than the last two recoveries." But this week he said in another speech that we're in an "abnormally slow recovery."

Either way, he's fighting the last war. From 2002 to 2005, the funds rate was demonstrably too low versus simple "Taylor Rules" that benchmark the funds rate to inflation and growth. So serious market distortions followed -- Hoenig is right about that. But today, such rules unambiguously say interest rates should be well below zero (please see the chart on the previous page). Hoenig is brave to frankly question the Fed's past errors, but today it's higher rates, not low ones, that would cause the distortions he fears.

Earlier this year Hoenig was a useful foil for Bernanke, providing a hawkish counterpoint that would keep inflation expectations in check while the "extended period" marched on. But now the economy is weakening, and this is where Hoenig ought to stop dissenting, and support Bernanke in alleviating uncertainty by strengthening of the "extended period' language. The upcoming Jackson Hole conference, where Hoenig is the host, would have been the perfect opportunity to signal reconciliation. But as fate would have it, Hoenig has picked up two intellectual allies in Bullard and



Source: Federal Reserve, CBOT, TrendMacro calculations

Kocherlakota -- even though, as far as we know, Hoenig doesn't subscribe to their belief that low rates cause deflation. The three of them seem to be enjoying the publicity their dissenting views have gotten for them over the last several weeks -- that's done much to create the uncertainty we're worried about, and at the same time makes it difficult for them to back down. Bernanke can muster the votes to have his way -- all the more when reliably dovish Janet Yellen becomes vice chair later this year (she's a tiger, and the vice chair's office controls the budgets of the regional Feds).

But this is about credibility and commitment, not just votes. For maximum effect, any easing ought to appear to have broad support and sustainability.

As all this has played out, long-term Treasury yields have fallen as year-ahead funds rate expectations have fallen to new all-time lows (please see the chart on the previous page). Ironically, the uncertainty has created its own certainty: the political inability of Bernanke to make an explicit time commitment for the "extended period," as we think he wishes to do, diminished growth prospects, and thus has the property of extending the period over which the "extended period" will have to be renewed *ad hoc*. In other words, now the best way to *shorten* the "extended period" would be to promise to *lengthen* it. In the absence of such a promise, it will be longer still.

So at this point, if Bernanke were to come out with a surprise at Jackson Hole to the effect that the "extended period" would be made explicit to a particular time period, or alternately that some large "QE2" effort was in the offing, the consequence may well be a jolt *upward* in yields. Don't rule that out. If the Fed were about to make a deflationary mistake, gold wouldn't be creeping back up to the vicinity of all-time highs. But until something like that happens one way or the other, at Jackson Hole or at the next FOMC meeting, yields and the stock market are likely stuck in their recent trading ranges.

Bottom line

We still don't expect a "double dip" recession, but with the Fed adding to the climate of uncertainty instead of alleviating it, we're definitely mired in an "expansionless recovery." The Fed will hold rates low effectively forever, but their failure to commit to that more fully ironically lengthens the time that it will be necessary. That's supportive of ongoing low bond yields, and stocks stuck in the trading range already established for the year. A signal of dovish clarity from the Fed would change everything -- pushing stocks back up the trading range, jolting yields higher and narrowing credit spreads as growth expectations improve.