TrendMacro

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FED SHADOW

Dialing Down the Drama at the Fed

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Gold's new highs means the Fed's reflation campaign is already starting to work.

We've been ahead of the consensus all year, early on expecting no Fed tightening even as the economy seemed to be gathering steam, and then expecting new easing as it seemed to lose that steam (see, for example, "Advice and Dissent" January 28, 2010 and "How to Ease, Not When to Tighten" June 23, 2010). Now, based on sources, we are dialing down our expectations. Absent a substantial deterioration in the growth outlook, which we see as unlikely, we think the Fed will stand pat the rest of the year, doing nothing more than continuing to slightly downgrade its growth forecasts and move forward in time the pledge of an "extended period" of a very low funds rate. We see little chance of a massive "QE2" of the type expected now by some well-known Wall Street economists. In fact, we think the Fed sees such speculations as contributing substantially and gratuitously to the background level of anxiety in markets (see "When PhD's Attack" August 25, 2010).

Ben Bernanke's important speech last month at Jackson Hole was dovish, in that it transparently was intended to muzzle the hawks among the regional presidents, and it laid out trigger conditions for further easing (see "On Bernanke at Jackson Hole" August 27, 2010). But Bernanke repeated several times in the speech that any future easing would have to pass a cost-benefit test. This symbolizes thinking at the Board of Governors that the many unconventional easing actions taken so far leave the Fed at a point of diminishing returns, at which future actions would have both little positive effect and high risks. If the economy were to worsen sharply, that calculus would change. If it only lingers in "expansionless recovery," there would be difficult decisions, but that's for 2011.

In some sense this can be understood bleakly, as the Fed's confession that it is out of bullets. In other words, the Fed is sensibly asking itself how a trillion dollars in "QE2" would create a single new job. But there's a brighter way of looking at it, too, because at the same time the Fed sees that its reflationary easing actions taken so far are gradually, almost stealthily, beginning to bear fruit. That's all the Fed can do to support growth now -- no magic bullet, but it's an utterly critical prerequisite.

- Gold's move to new highs this week headlines a complex of market evidence that suggests to the Fed that the risk of deflation from

Update to strategic view

FED FUNDS: Next week's FOMC will condition markets to expect an even longer "extended period" of a very low funds rate, but will give little comfort to those who expect massive quantitative easing.

GOLD: Gold at new all-time highs symbolizes a complex of market evidence telling the Fed that the threat of deflation has become quite minimal. Its reflation efforts are working, and will continue to do so. We expect gold to continue to work higher.

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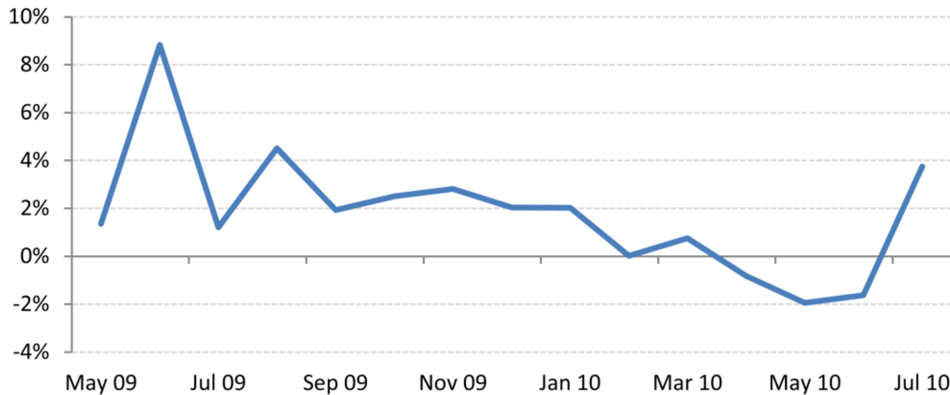
here is quite low. The Fed sees firm commodity and energy prices working in a cost-push model to put a floor under possible deflation.

- So the Fed remains cognizant of the *risk* of deflation -- indeed, it was highlighted strongly in the Jackson Hole speech -- but at this point it is judged to be a risk that is highly unlikely to actually eventuate. Given Bernanke's predisposition to be an anti-deflationist first and foremost, this moves to the sidelines the single element most likely to trigger further easing.
- Even as the economy has slowed and raised risks of a "double-dip" recession, the latest month's inflation statistics show a sharp uptick from their downtrend of the last year (please see the chart below).

— Consumer Price Index
1-month annualized change, seasonally adjusted



Source: Bureau of Labor Statistics, TrendMacro calculations

- Currency in circulation has made a new all-time high, and all standard measures of money-supply are rising over the last 13 weeks. This is happening at the same time as the monetary base has contracted due to pre-pays in the Fed's MBS portfolio (prior to the initiative to reinvest the proceeds in Treasuries). So the money-multiplier, a proxy for monetary velocity, has risen to the best level of the year (please see the chart below).

— M1 money multiplier
M1 as a multiple of the monetary base

Source: Federal Reserve, TrendMacro calculations

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[About us]

- The reflation-sensitive basic materials sector -- our long-standing favorite sector in the S&P 500 (see recently "What Should the Fed Do?" August 5, 2010) -- has been the best performing since the July 2 bottom. Its total return has been 18.3%, versus 10.5% for the S&P 500.
- Yesterday's unsterilized Japanese yen intervention symbolizes the growing success of the Fed's attempt to weaken the dollar. Just as happened in 2003, the last time the Fed weakened the dollar as part of a reflationary initiative, Japan has been forced to protect itself from the collateral damage of a too-strong yen.
- With a little help from protectionist rumblings in the House of Representatives, even the Chinese RMB has begun to strengthen, making the first significant move since yuan flexibility was resumed in June (see "On RMB Revaluation" June 20, 2010).
- There's a nexus here. Japan has let it be known that it is alarmed by heavy Chinese buying of JGBs, as part of China's diversification away from dollar holdings. With capital controls making it impossible for Japan to symmetrically buy Chinese bonds, it has no choice but to buy dollars to combat yen appreciation -- indeed, Japan ends up being an intermediary for the dollar-buying China would probably like to do in the first place.

We don't think markets are strongly expecting a big move the Fed next week, so we wouldn't expect our do-nothing forecast to have a lot of impact one way or the other. Besides, what we call "do-nothing" isn't really nothing -- implicitly lengthening the "extended period" is an act of significant easting, even if it lacks drama. Absent such drama, the biggest potential market-moving impact could come from some concrete sign of the abatement of this year's chaotic and unproductive public brainstorming by several of the regional Fed presidents (again, see "When PhD's Attack"). So it's an outside chance -- but if somehow Bernanke manages to persuade Kansas City president Tom Hoenig to give up his long-standing dissent, it would be a significant boost to confidence in the Fed's policy coherency, and it would have a very positive effect on risk markets.

Bottom line

Next week's FOMC will condition markets to expect an even longer "extended period" of a very low funds rate, but will give little comfort to those who expect massive quantitative easing. Gold at new all-time highs symbolizes a complex of market evidence telling the Fed that the threat of deflation has become quite minimal. Its reflation efforts are working, and will continue to do so. We expect gold to continue to work higher.