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Risk-On Hearts QE2

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Gold, sure. But do rising stocks really mean more Fed asset purchases will boost growth?

Five months ago we were alone saying that the Fed would make additional asset purchases this year (see "So Much For The 'V'" May 21, 2010). Now market expectations have completely come to our view -- to the point where if the Fed does *not* announce some form of "QE2" at the November FOMC meeting, it feels like there would be some kind of market crash. But this raises an intriguing question. While there is little doubt that the stellar rally in stocks, gold and other "risk-on" assets over the last month is attributable to mounting certainty of QE2 -- *why would markets move so positively in expectation of something of such dubious value?* It's obvious why inflation-sensitive gold would celebrate the prospects of a vast new monetization of debt by the Fed (see "Pushing On a Golden String" October 1, 2010). But we can see why stocks should celebrate as well. In fact, our expectation for QE2 played a role in our call to start buying stocks in late June (see "Betting Against a 'Double Dip'" June 30, 2010).

The reason is in the chart below, proving that the Fed is too tight, even after all it has already done -- from this starting point, QE2 is a move in the direction of goodness. The chart shows a "Taylor Rule" fitted to the funds rate since 1988, based on inflation and unemployment. It demonstrates

Update to strategic view

GOLD, US STOCKS, US MACRO: Stocks and gold surging at the same time is telling us that QE2 is on the way, and that its inflationary implications are a positive for growth. The Fed is objectively too tight, and raising inflation expectations through QE2 can lower rates in real terms even when they are stuck at the zero-bound in nominal terms. QE2 is now thoroughly anticipated, so unless its size is an upside surprise, the actual …

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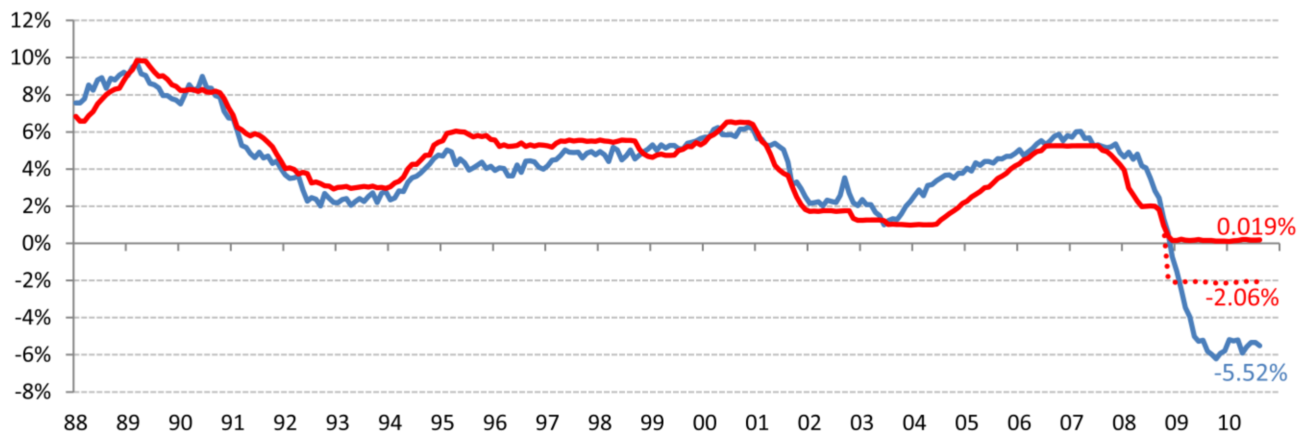

Source: Federal Reserve Bank of San Francisco (Rudebusch 2009), TrendMacro calculations

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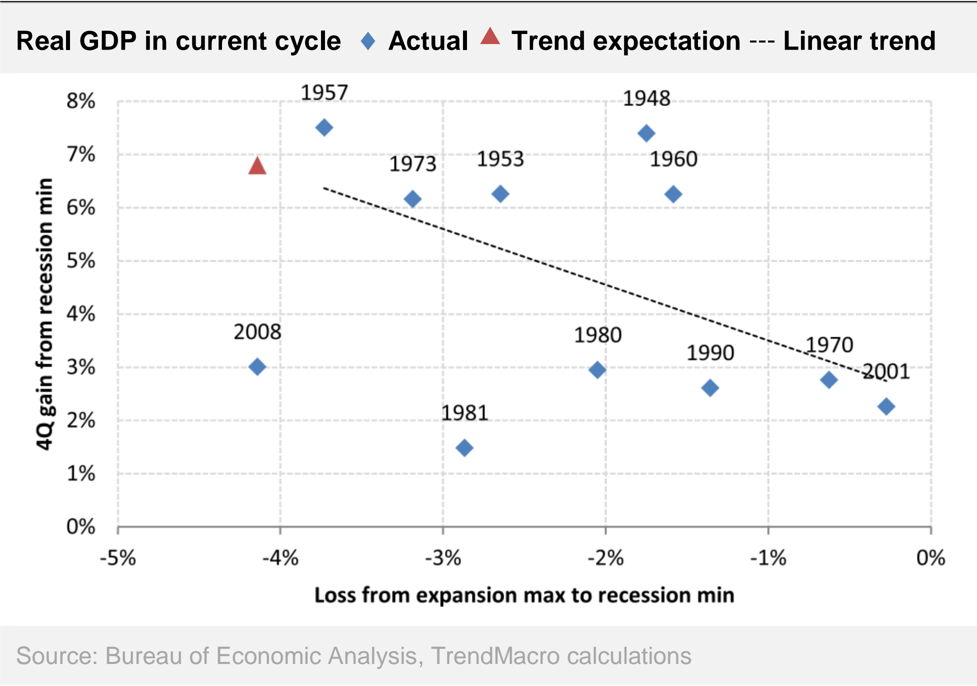
that by the Fed's own norms, the funds rate should be *negative* 5.52% now. At the zero-bound, the Fed is too tight. Even assuming the QE done so far has effectively reduced the funds rate to about negative 2%, it's *still* too tight.

Bad things happen when the Fed breaks the Taylor Rule. Note, on the chart, that the Fed was too loose for too long from 2003 to 2006. This distortion laid the foundation for the credit market distortions that led to the mortgage bubble and the subsequent banking bust. Today the Fed is deviating even further from the Taylor Rule, but in the other direction. If it does not act, bad things will again happen.

They already are happening. Having come through the harshest of all post-war recessions, the US economy has bounced back less than half what should be expected based on past experience (please see the chart below). There are multiple good explanations for this. But if all you knew about today's economy was the Taylor Rule chart on the previous page, you'd think you'd hit upon a pretty convincing one.



Source: Bureau of Economic Analysis, TrendMacro calculations

At first blush, it's difficult to construct a vivid mental picture of how the Fed's buying another trillion dollars of Treasury bonds would tangibly help the economy. Would it create a single new job? But permit yourself to imagine that the Fed had some way of quite literally observing the Taylor Rule, and could set the overnight rate at negative 5.52%. In other words, *the Fed would pay you* to borrow from it. It's not hard to imagine various investments that would look quite attractive with not only *no* cost of financing, but *positive cash flow from financing*. Such a policy, if it were possible, would surely increase economic activity.

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…announcement may be an occasion to sell on the news. But if it is indeed the right next move in the Fed's ongoing reflation mission, then buy the dip -- gold and stocks will end up higher still.

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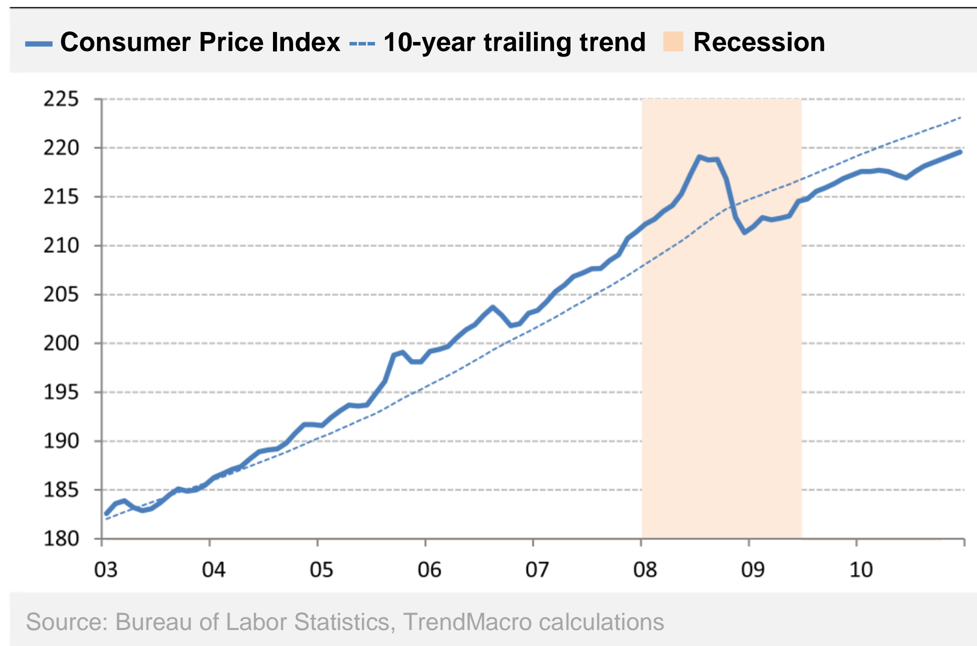
But the Fed can't do that -- not directly. So it uses QE2, to do it indirectly, through two channels. The first is to reduce interest rates further out on the curve -- not to negative levels, but to levels so low that, in combination with the certainty of locking in such low rates for long fixed periods, will make various investments attractive at the margin.

The second channel is the power of QE2 to upwardly influence expectations for -- and the reality of -- inflation. This is key because, first, higher expectations for inflation would take the fear of a recurrence of 2008's savage deflation off the table. But most important, higher inflation reduces the *real* interest rate -- and unlike nominal rates, real interest rates have no zero-bound. With sufficient inflation, a central bank can make *real* interest rates as negative as it likes.

This is the main reason why the Fed took what would otherwise seem to be an absurd policy position in the September FOMC statement -- that there is insufficient inflation (see "On the September FOMC" September 21, 2010). At the present annual rate of 1.2%, the rate of CPI inflation *is* insufficient to get the zero *nominal* funds rate sufficiently negative in real terms to meet the Taylor Rule's negative 5.52% nominal mandate.

This is uppermost in the Fed's mind as it approaches the decision about QE2. At the next FOMC, we are certain that the chart below -- showing the level of consumer prices -- will be the centerpiece of discussion.



Source: Bureau of Labor Statistics, TrendMacro calculations

What will this chart tell the Fed?

- The level of the consumer price index is lower today than at the peak in July 2008, by 0.43%. In other words, over the last two years the US economy has experienced deflation, on net.
- While only 0.43% below peak, today the CPI is 1.62% below trend.

- For the Fed, this gap below trend represents a barrier to upwardly shifting inflation expectations, and the sooner it can be eliminated the better.
- The CPI would have to rise 1.65% in a single immediate jump to catch the trend.
- But the trend itself is rising at the rate of 1.93% per annum. At today's annual inflation growth rate of 1.2%, we fall further and further behind trend every month.
- If we wait long enough at a 1.2% growth rate, the trend itself will slow to that rate. At that point, we'll stop falling further behind, but we'll never catch up.
- Besides, regardless of the trend, 1.2% is well below what the Fed believes is a more optimal inflation rate even in ordinary times, say 2%.
- Even if the Fed were able to shift up to a 2% inflation growth rate right now, we would not catch up to the trend for more than four years.
- It is likely the Fed's judgment that a short-term burst of inflation greater than 2% is an acceptable price to pay to get back to trend sooner -- indeed, it's not a price at all, it's a benefit.

Ben Bernanke has lectured the Japanese on this very matter for years, suggesting that an explicit price-level target would be the way to positively alter those expectations. We expect that Bernanke will revisit that advice on Friday in a speech on "Monetary Policy Objectives and Tools in a Low-Inflation Environment." That will be powerful confirmation of the Fed's intention to move ahead with QE2 at the November FOMC meeting. But it is not without irony. While such an approach is a well-known arrow in Bernanke's quiver, in his August Jackson Hole speech in which he listed several policy responses to ongoing economic weakness, he cited this one but disclaimed that "I see no support for this option on the FOMC."

But then again, the Fed's price level target won't be explicit. When QE2 is announced, it will be a particular dollar amount of securities to be bought on a particular schedule, for some amorphous purpose such as "to help improve conditions in private credit markets." But even this is not without irony. Renewed Treasury purchases will be, for the Fed, the revisiting of a strategy already tried once before, which we believe was generally regarded by most if not all members of the FOMC (at least in private) as a failure (see "Fed Still On The T-Bond Sidelines" August 24, 2009).

The purchases of mortgage-backed securities and direct GSE obligations, first announced in November 2008 and then enlarged in March 2009, are believed to have been successful programs, in that they substantially lowered mortgage interest rates. Not so the Treasury purchase program announced in March 2009. After a one-day blip. Treasury yields *rose* following the program's inception. And from the get-go, the program created serious credibility issues for the Fed, and indeed the entire US government, by raising the specter of debt monetization (see "They Laughed When I Sat Down to Monetize" June 4, 2009).

This time may be different. To be sure, yields may rise again this time upon QE2's announcement, unless the program's magnitude is unexpectedly enormous -- that is, larger than the approximately $500 billion expected in economist polls -- simply because this time QE2 is so thoroughly anticipated. But the reputational issues shouldn't be so intense. The March 2009 program came just weeks after hasty enactment of the $787 billion "stimulus" bill, giving the impression that it was connected to the bill's financing -- and an implicit promise of further financing for what seemed like a wide-open spending spigot. This time, the market is more likely to interpret QE2 for what it is -- monetary policy, not fiscal policy.

Our purpose here is not to rationalize QE2 as a silver bullet, or to rationalize inflation as a boon rather than a curse. But if the Fed is as excessively tight as the Taylor Rule implies, then QE is the right thing for the Fed to do. Not doing it would be the wrong thing to do. We think this is the message markets are sending us, if we will just listen. On the one hand, an all-time high gold price is telling us that inflation is about to move higher. At the same time, rapidly recovering stock prices are telling us that that inflation is indeed a good thing just now.

Bottom line

Stocks and gold surging at the same time is telling us that QE2 is on the way, and that its inflationary implications are a positive for growth. The Fed is objectively too tight, and raising inflation expectations through QE2 can lower rates in *real* terms even when they are stuck at the zero-bound in nominal terms. QE2 is now thoroughly anticipated, so unless its size is an upside surprise, the actual announcement may be an occasion to sell on the news. But if it is indeed the right next move in the Fed's ongoing reflation mission, then buy the dip -- gold and stocks will end up higher still.