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FED SHADOW

Sell on the Leak?

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The new conventional wisdom is QE will be small -- but committees do unexpected things.

Last week we thought it was a little too early to sell for the likely corrections in stocks and gold that will set in after next week's back-to-back mid-term elections and FOMC meeting (see "Sell On *Good* News" October 20, 2010). We were right for stocks -- the S&P 500 advanced to higher highs, and the Dow Jones Industrial Average even peeked above its April highs, thus achieving for that index at least our price target for the year (see "Betting Against a 'Double Dip'" June 30, 2010). But gold, on the other hand, rallied a bit from last week's lows but didn't make new highs, and as of this writing it's pretty much back to those lows.

In some sense gold hardly needs a reason for a correction after its stellar run to all-time historic highs two weeks ago. Be that as it may, we don't see the talk that has emerged since gold's high of a new "strong dollar policy" at the US Treasury as being much of a reason, because it's not a credible narrative. Even if were to grant that a stronger dollar fit in with Tim Geithner's vision for "global rebalancing," he doesn't control the dollar. When it comes to the Treasury's diplomatic position on the critical dollar/RMB exchange rate, it's Congress that's in the driver's seat (see "On RMB Revaluation" June 20, 2010). And when it comes to the larger issue of dollar's purchasing power, which ultimately controls all dollar exchange rates, that's the Fed's responsibility (see "Geithner and the Dollar: That's Not My Job" October 15, 2009).

That makes it all about QE2, obviously enough. Over the last two weeks expectations for the size of the Fed's program to be announced next week have moderated, with Goldman Sachs' Jan Hatzius now being pretty much a voice in the wilderness upping the ante with a call for as much as $4 trillion. The *Wall Street Journal's* John Hilsenrath, supposedly the Fed's favored leak vector, made it official in a story this morning guiding down expectations to "several hundred billion," and emphasizing the Fed's likely preference for flexibility going forward.

We were among the first to expect QE2 (see "So Much For The 'V'" May 21, 2010). But we don't have a strong view about *exactly* what will happen at next week's FOMC. Whatever may be leaked to Hilsenrath by whomever, the fact is that there is going to be a two-day FOMC meeting where voting and non-voting members (both have a voice in the decision)

Update to strategic view

US STOCKS, GOLD, FED FUNDS, US MACRO: We still expect a "sell on the news" correction in stocks and gold next week, but with the correction we've already seen and so much legitimate uncertainty about the nature of QE2, we will wait for the details to make the call. Longer term, the reality remains that we are in an "expansionless recovery" in which the Fed will have to fight a persistently high unemployment rate, and resist many real-economy impulses toward deflation or low inflation. Its only weapon is QE, and it will keep firing that weapon until inflation rises back to trend. This will necessitate a burst of above-normal inflation, and when it occurs, the Fed will be deeply challenged to contain it to a mere burst, and will likely fail to do so. While this plays out, it will be good for stocks and great for gold.

[Strategy Dashboard home]

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are going to want to hash out a very wide variety of passionately held views. Chicago Fed president Charles Evans anchors the dovish side, basing his views very much on the rationale we offered several weeks ago about the Fed's need to lower *real* interest rates at the *nominal* zero-bound by raising inflation back to trend (see "Risk-On Hearts QE2" October 14, 2010). Kansas City Fed president Thomas Hoenig, predictably, anchors the hawkish side, with his statement this week that QE2 would be a "bargain with the devil" demonstrating his near-religious conviction on the matter. So something's going to happen on Wednesday -- but no one knows exactly what, because committee decisions are very strange things.

- The natural tendency of committees made up of differing views is to compromise them at some perceived average point. Evans wants *lots* of QE, Hoenig wants *none* -- so they compromise on *some*. That's the most likely outcome, and it's probably what the market expects at this point, especially given this morning's Hilsenrath story.
- But while this particular committee is made up of a majority who favor QE to some degree, large or small -- the small minority who opposes it does so passionately. Since it's impossible to satisfy passionate opposition with compromise -- Hoenig, for example, openly dissents at every FOMC meeting simply because he opposes the "extended period" language -- then there is little social incentive for compromise. So perhaps the result could be a larger than expected QE, with the narrative in the meeting room being something like, "You're going to hate this decision anyway, so let's do it big and give it the best chance of success -- the last thing we need is for this to fail."

Unless there's a giant upside surprise -- well more than $500 billion in QE2 -- then we're going to stick with the idea that the FOMC will be a "sell on the news" event for gold and stocks, recognizing that some of the selling has probably already taken place, especially for gold. We note that the mid-term election is a factor here, too. Anything less than a surprisingly large GOP sweep would probably be another reason to "sell on the news." It troubles us that this is a somewhat obvious view, and that we hear it frequently as we talk to investors. We're going to be very open to shifting our call when the details become known next week.

Bottom line

We still expect a "sell on the news" correction in stocks and gold next week, but with the correction we've already seen and so much legitimate uncertainty about the nature of QE2, we will wait for the details to make the call. Longer term, the reality remains that we are in an "expansionless recovery" in which the Fed will have to fight a persistently high unemployment rate, and resist many real-economy impulses toward deflation or low inflation. Its only weapon is QE, and it will keep firing that weapon until inflation rises back to trend. This will necessitate a burst of above-normal inflation, and when it occurs, the Fed will be deeply challenged to contain it to a mere burst, and will likely fail to do so. While this plays out, it will be good for stocks and great for gold.

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