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TRENDMACRO LIVE!

On the November FOMC

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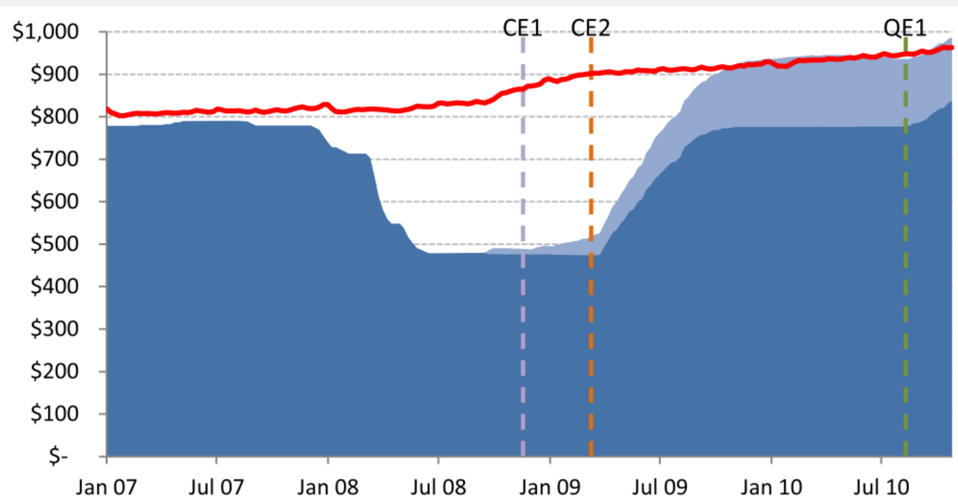
Donald Luskin

If it's sell on the news for QE2, buy the dip: the Fed won't quit till it works.

The quantitative easing program announced at today's FOMC was not much of a surprise in magnitude or structure. But as we think it through over the coming days and weeks, let's acknowledge what a new enterprise this is for the Fed, and for those who make investment decisions based on the Fed's actions.

- The MBS and GSE direct obligations purchases begun November 25, 2008 should be understood as "credit easing," according to Ben Bernanke, under the Fed's lender of last resort function.
- Same for the enlargement of those purchases announced on March 18, 2009 -- and also for the $300 Treasury buy program announced that same day, as all it did was not quite replenish the inventory of Treasuries the Fed had prior to the onset of the banking crisis.
- Also, none of this was "debt monetization" in the classic sense, as the government debt portion never exceeded the amount of currency outstanding (please see the chart below).

Currency outstanding **Treasuries** **GSE direct obligations**
USD billions



Source: Federal Reserve, TrendMacro calculations

Update to strategic view

US STOCKS, GOLD, FED FUNDS: "QE2" arrived on schedule, without a lot of surprises in size or structure. As we've expected over the last several weeks, it could be a "sell on the news" opportunity for stocks and gold, especially in conjunction with the at-expectations good news from yesterday's election. Our quick take is that the reflationary goals of QE2 will be achieved one way or the other, even if takes QE3, QE4… QE*n*, so this will be an opportunity to "buy the dip" for "risk-on" assets.

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- If these two announcements were credit easing -- "CE1" and "CE2" -- the first true quantitative easing -- "QE1" was August 10, 2010 when the Fed announced the reinvestment in Treasuries of the proceeds from its MBS portfolio.
- With these Treasury purchases, for the first time, the value of government debt owned by the Fed -- Treasuries plus the direct obligations of GSEs which, at this point, are entirely owned by the government in conservatorship -- exceeded currency outstanding. That Rubicon was crossed on September 24.
- Unless currency outstanding rises commensurately, then the "QE2" announced today will monetize debt, all else equal to the tune of the full $600 billion to which the Fed committed today.
- So we are using a new technique -- quantitative easing, as opposed to credit easing -- and simultaneously monetizing debt for the first time.
- *This is a new world of unknown unknowns, where the Fed doesn't even know what it doesn't know.*

The object of this adventure is to increase the price level by temporarily -- *hopefully temporarily* -- raising the rate of inflation. This will take the Fed from its long-standing posture of being too tight, stuck at the nominal zero-bound when the Taylor Rule calls for a negative 5.5% funds rate, and move it in the direction of neutrality. We've explained this over the last couple months (see for example "Risk-On Hearts QE2" October 14, 2010), and it has subsequently been strongly validated by Bernanke's speech on "mandate-consistent" inflation-targeting, and even more strongly by Chicago Fed president Charles Evan's speech on "state-contingent price-level targeting."

- Make no mistake about it: the object here is to increase the inflation rate, in order to lower the *real* funds rate when the *nominal* funds rate can't be made any lower.

If indeed the Fed is too tight, then while this is no silver bullet, it is a positive in the sense that it alleviates a negative. Crunch time will come later, if the Fed succeeds in generating a "state-contingent" burst of inflation to get us back to a "mandate-consistent" trend. They're using utterly new tools to accomplish this. Will these tools have the precision to pull back in time to prevent high rates of inflation from becoming permanently embedded?

And how will other major central banks respond? They're all meeting this week. At the G20 they forswore competitive devaluations. That doesn't mean they won't get into a war of competitive QE. As we said, this is a world of unknown unknowns.

Bottom line

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[About us]

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