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Eyeing an Exit from "No Exit"

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Political stabilization destabilizes the safety net, while higher yields signal QE2 is working.

We expressed a modestly more positive view on the economy last week, and set out what we think is a fairly assumption-free case for higher stock prices over the next year (see "Stock Outlook: Differences Make a Difference" November 10, 2010). The expected correction that has set in since doesn't change that. We think this is only a correction, and we will be looking to buy the dip sooner rather than later. In fact, at the risk of sounding flippant, it actually encourages us that markets haven't corrected more violently given the several potentially systemic threats that have emerged.

That said, we take this correction seriously. It is causing us to reassess one of our most fundamental strategic concepts.

- We have believed -- correctly -- throughout the aftermath of the 2008 banking crisis that authorities the world over would have "no exit" from the policy of averting any systemic risk at any cost. This has led straightforwardly to a winning strategy of boldly buying dips induced by apparently incipient systemic crises, and earning disproportionate risk premia by daring to hold pariah assets.
- We are now seeing evidence, confirmed in markets, that the "no exit" doctrine is beginning to unravel.
- Headlines about Irish debt and Chinese inflation are part of this story. But the point of immediate unraveling is the United States, as a spillover effect of the GOP takeover of the House of Representatives. Ironically, what is on the face of it a salutary political stabilization, which we see as a likely driver of better growth in 2011 (see "The Pendulum Swings Back" November 2, 2010), is also a source of destabilization to the extent that it ends the "no exit" doctrine.
- Ultimately, moving past "no exit" is necessary and good, as it is a policy of limitless moral hazard, fraught with incentive distortions and unintended consequences. But in the post-crisis environment of constant aftershocks, it has been a useful safety net. Giving it up involves both gains and risks.

Let's look at all the factors are work in this correction, one by one.

Update to strategic view

US MACRO: While the GOP takeover of the House stabilizes politics and creates a better growth environment, at the same time it moves the US away from "no exit" from guarantees against systemic financial risk. Long-term that's a positive as it removes significant incentive distortions, but it means we're performing without a net for the first time in a long time.

US BONDS, HIGH YIELD BONDS, FED FUNDS: Higher Treasury yields are telling us that QE2 is working, as counterintuitive as that may seem. We expect a continued moderate rise in bond yields over the coming year, and are becoming open-minded about a possible first hike in the funds rate in the first half of 2012. The non-investment grade sector is the best defense.

GOLD: We stand by our $1500 price target, but our upgraded growth outlook reduces the strongest bull case for gold.

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Ireland in crisis

Europe's exit from "no exit" is out there in the middle distance, in the form German chancellor Angela Merkel's initiative to amend the Treaty on European Union to provide for a resolution regime for insolvent members, entailing private investor "haircuts." No one should have expected a German-subsidized safety net to last forever. But reportedly many in Europe are furious at Merkel over this, saying that her pressing the matter at this time has destabilized the peripheral sovereign debt markets and triggered the present crisis in Ireland.

- Even granting that the prospect of a less robust safety net in the future somehow catalyzed the crisis, it is not *directly* about that. We've long said that the ambiguous terms of the European Financial Stability Facility would lure "Mr. Market" into testing its limits, to find out just what it takes to get German credit behind peripheral junk debt (see "Europe Gropes toward Stress-Tests" July 12, 2010).
- The present crisis is simply the result of the reality of the grievous issues faced by nations like Ireland, in the face of a rescue process that is both ambiguous to begin with and then always highly politicized and subject to negotiation when deployed.
- We expect as a general matter that once the usual hand-wringing has run its course, the EFSF parachute will deploy for Ireland if necessary, and will stay in place for Greece. Irish central bank governor Patrick Honohan is giving the first hints of it this morning.

Tightening in Asia

Rising inflation in Asia is in large part a spillover effect of dollar liquidity coming from the Fed's "no exit" policies. Such policies are, we believe, appropriate for the US at this time. But transmitted to developing economies through currency pegs, they are too loose. The Fed is not going to exit anytime soon, so those nations have to find their own exits, either by tightening financial conditions, imposing price controls, or by revaluing their currencies.

The panicky narrative of the last couple weeks is that, for China, tightening will expose lethal fragilities in its debt-intensive export economy. If that's a legitimate risk, it's one that would probably not be activated with a moderate amount of tightening, which is probably all it would take at this point to curb inflation. And inflation is a risk, too. Dealing with it quickly is the optimal path. In China's case, dealing with it by adjusting the RMB/dollar peg would have significant spillover benefits. First, it would deflect protectionist pressures from the US (see "On RMB Revaluation" June 20, 2010). Second, a more valuable currency makes China a more competitive buyer of global strategic resources priced in dollars, such as oil and copper -- which are absolutely necessary inputs for China's continued headlong dash toward modernity. To a point, it is probably that case for tightening would be a pro-growth policy for China.

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[About us]

The drop in state and municipal bonds

Now we come to an element of the present correction that really gets our attention -- the sharp across-the-board drop in the value of state and municipal bonds. Obviously, this has real systemic salience -- at this point for the US it's the biggest black swan out there. One worries that the recent drop either presages a crisis, or if caused exogenously, could then precipitate a crisis. We think the cause is likely exogenous, and we link it to the idea of a US exit from "no exit."

- Reportedly there is a market-depressing rush of issuance ahead of the expiration of the Build America Bonds subsidy for issuers. This feature of the 2009 ARRA stimulus package subsidizes 35% of the issuer's interest expense. BABs are taxable, but the federal subsidy allows the issuer to offer a high coupon attractive to taxable investors such as pensions -- thus opening up an otherwise inaccessible pool of buyers.
- The year-end termination of the subsidy is no surprise, so why the big move? What is something of a surprise is the political dynamic arising from the mid-term elections.
- The post-election GOP is keying off a Tea Party mandate to cut spending and end bail-outs, and the Democrats are so back on their heels at this point that they haven't found a narrative to compel any GOP compromise in this area. That may change in the horse-trading that ensues in the lame duck session where we expect the present hostage-taking situation around the extension of the Bush-era tax rates to be resolved.
- While the new assumption has to be that BAB is DOA, perhaps the recent drop is "Mr. Market" throwing a tantrum, so to speak, giving the Congress a small taste of the trouble that might ensue if BAB isn't extended.
- Assuming that troubled state and muni issuers can be weaned off the BAB subsidy, there's a larger issue looming on the horizon. We've had little doubt -- and we think the market agrees -- that if there were a large state financial failure the federal government would intervene under a Democrat-controlled Congress. But what now, with congressional control split?
- We know that Republicans in the House and the Senate generally opposed TARP in 2008 when they were in the minority, even though it was proposed by a Republican Treasury secretary, and even though the fragile economy desperately needed swift resolution of the matter. TARP was a deeply flawed bill, but GOP opposition was pure opportunism, because they knew the Democratic majority would have to enact it anyway. Would the GOP House majority act more responsibly next year if a state financing crisis caused a similar situation? That's unknown -- but the GOP's non-stop populist rhetoric ever since TARP isn't encouraging.
- The US weathered the 2008 crisis better than any other developed nation -- we had the shallowest recession and are the closest to getting back to peak output -- in part because it was able to muster a relatively coherent political response. In line with what we noted

above, the ongoing drama of Europe's debt crisis shows the costs of incoherent response. Coherency is the property of political unity, and that's something non-federal Europe simply can't have, but the US *has* had it. Starting in January, the US won't.

- The fact that two of the most financially at-risk states -- California and Illinois -- now have Democratic governors in a year of GOP ascendency doesn't help. Washington contacts close to new speaker John Boehner (R-OH) suggest to us that California in particular, now virtually entirely and extremely blue, will not have an easy time should it have to appeal for help to the new regime.

The backlash against QE2

As we've already noted, GOP populism is vividly on display in the conservative attack on QE2 and the Fed (again, see "Stock Outlook: Differences Make a Difference"). That backlash was the lead story on the front page of the *Wall Street Journal* Monday, reporting that GOP fiscal conservatives such as incoming House Budget Committee Chairman Paul Ryan (R-WI) have sponsored an open letter to Ben Bernanke from conservative economists and hedge fund managers, saying the "planned asset purchases risk currency debasement and inflation" and have "met broad opposition from other central banks."

- We note in passing that this letter was signed by some serious thinkers such as John Taylor and John Cogan. But it was also signed by less serious thinkers such as the famed short-seller James Chanos. We have to wonder whether Chanos opposes QE2 because he sincerely thinks it won't work, or because he's afraid it will and would profit more from its discontinuation.

The GOP initiative against the Fed continued Tuesday, with Representative Mike Pence (R-IN) introducing a bill to eliminate the Fed's dual mandate for stable prices and maximum employment, replacing it with a single mandate for price stability. Bob Corker (R-TN) expressed support for this, saying he had met with Ben Bernanke on Monday. And yesterday speaker-designate Boehner and Senate minority leader Mitch McConnell (R-KY) signed their own open letter to Bernanke protesting QE2.

- We agree that a single price stability mandate would be economically sound. It's not an especially revolutionary idea -- it's currently employed by the European Central Bank and the Bank of England, among others. Ben Bernanke would probably welcome it too, have favored explicit inflation-targeting for many years, and theming his first speech as Fed chairman around the idea that the best way a central bank can support jobs is to provide stable prices (see "Is Ben Bernanke a Phillips Head?" March 1, 2006).
- But regardless of the underlying merit of the idea, or the merits of the conservative objections against QE2 -- with which we disagree, but nevertheless respect -- the reality is that this is all just populist posturing, and it is a very dangerous game.

- The open letter from economists notes, correctly, that "improvements in tax, spending and regulatory policies must take precedence in a national growth program." But until the GOP can deliver such improvements, it makes little sense to *not* do other things in the monetary policy domain that are the only available palliatives.
- We think it is very unlikely the Fed will succumb to this pressure and abort QE2. Already it has sent a phalanx of spokespersons out far and wide to evangelize for it. In an interview with the online *Wall Street Journal* Monday, combative Fed vice chair Janet Yellen wouldn't even mention the possibility of curtailing QE2, saying instead, "I am not happy to see us caught up in a political debate. …we are open to further action if it turns out the economy remains sufficiently weak." Similarly, New York Fed president William Dudley said on CNBC yesterday, "exit could be years away."
- But the market has no choice but to take on board at least some possibility that the Fed might cave. Because monetary policy depends so much on expectations, and because expectations are so critically dependent on the perception of the central bank's commitment to stated policy, the attack on QE2 actually makes QE2 less effective -- even if it does nothing to address its putative dangers. Thus it is an utterly negative-sum game.
- Even if the Fed doesn't cave, there's little doubt that this pressure will, at least at the margin, inhibit future quantitative easing.
- Does this bring the Fed closer to exit? No, but it does begin to pull the Fed slightly away from "no exit," and that could prove to be an important change at the margin.

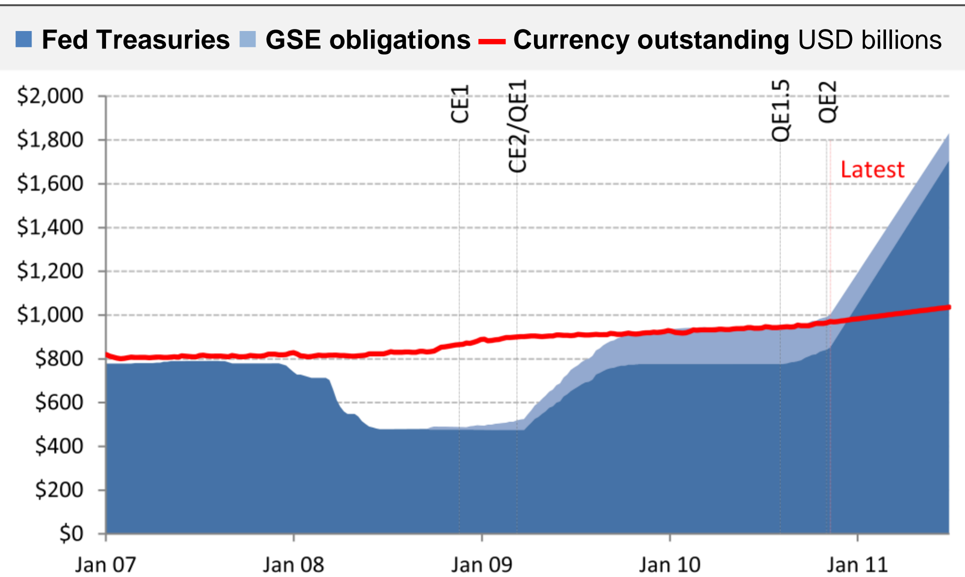
The back-up in Treasury yields

Let's set the backlash against QE2 in the context of the steep back-up in Treasury yields we've seen over the last week, a back-up that might have been even steeper if troubles in Europe were not driving a flight to the dollar.

We expected a backup in the aftermath of the Fed's announcement of the $600 billion QE2 buy program. We said in August that the announcement would have the effect of "jolting yields higher…as growth expectations improve" (see "When PhD's Attack" August 25, 2010). So maybe the backlash against QE2 -- and the idea that it will be aborted or curtailed as a result -- have little to do with it. Instead, maybe it means that QE2 is working. Yes, it's strange that a program seemingly designed to spur the economy by making yields *lower* can be judged by the extent to which it makes yields *higher*, but monetary policy is a strange thing, and general equilibrium is even stranger. And it's happened just this way before.

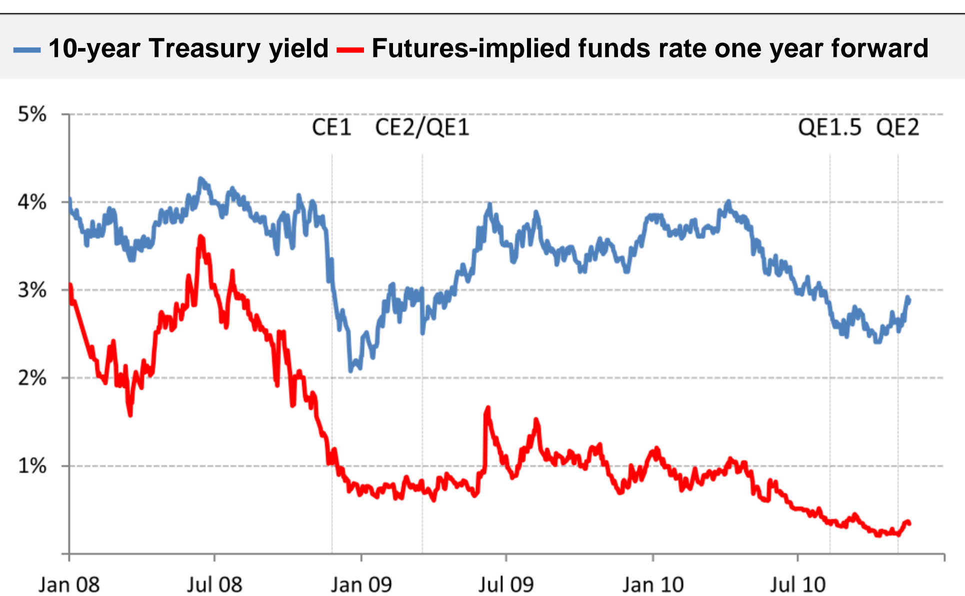
To see what's going on, let's review the history of the Fed's balance sheet programs over the last two years (please see the chart on the next page). There were two credit easings ("CE1" and "CE2") announced on November 25, 2008 and March 18, 2009 involving the purchase of MBS and GSE obligations. The second one included the first quantitative easing

("QE1"), the purchase of $300 billion in Treasuries to de-sterilize the 2008 interventions in Bear Stearns, AIG and so on. "QE 1.5" was on August 10, 2010, when the Fed committed to reinvest in Treasuries the principle payments from its MBS portfolios. QE2 was November 3, 2010, with the announced purchase of $600 billion in Treasuries.



Source: Federal Reserve, TrendMacro calculations

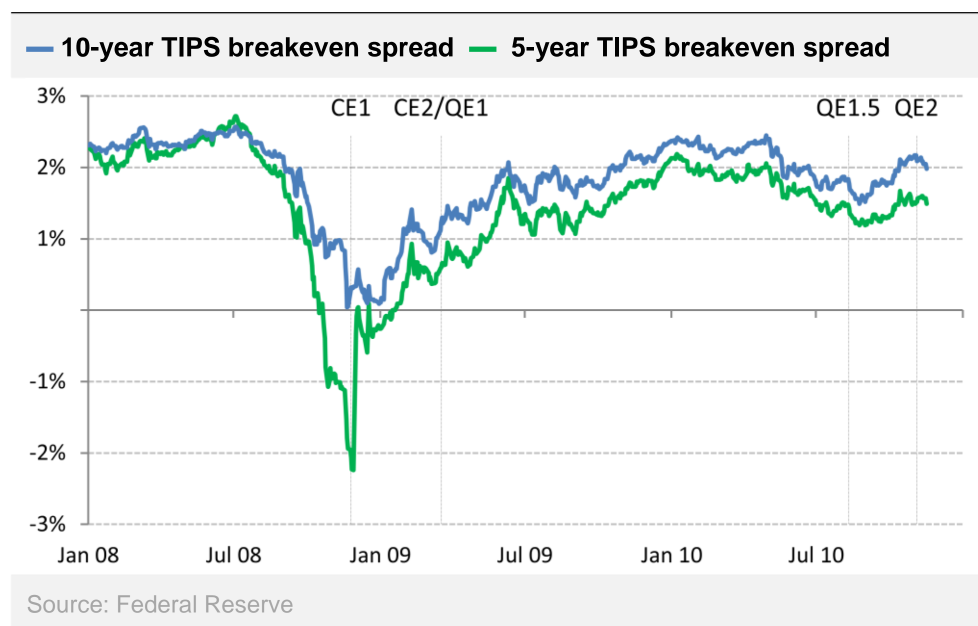
There was a similar back-up in yields after the Fed's announcement of its $300 billion Treasury buy program in March, 2009, which was a key event in ending the 2008-2009 recession (please see the chart below, and "Ben Boldly Goes" March 19, 2009). The 10-year yield dropped 51 bp within minutes of the news, but then relentlessly marched *upward* 147 bp in less than three months, ending up almost a full percentage point higher on net (please see the chart below).



Source: Federal Reserve, CME Group, TrendMacro calculations

For us it's not hard to think that the market would upgrade its growth expectations at this point. We've upgraded our own growth expectations (again, see "Stock Outlook: Differences Make a Difference"). The stock market has responded positively over the last couple months as QE2 became more and more of a certainty. It responded well after the surprise March, 2009 QE1 episode, too -- in fact, mounting the fifth best rally in the history of US stocks.

And we don't see much evidence that the back-up in yields is driven by a catastrophic rise in inflation expectations, beckoning the "bond vigilantes" back to the market -- even though the threat of runaway inflation is the central narrative of most QE2 critiques. If anything, we'd like to see a greater rise in inflation expectations, as nudging the inflation rate upward is a key mechanism in QE's success of lowering *real* rates with the Fed stuck at the nominal zero-bound in the funds rate (see "Risk-On Hearts QE2" October 14, 2010). Gold has risen and the dollar has fallen on net as QE2 has evolved. But gold hasn't even hit our price target of $1500 yet (see "More Upside for Gold" June 10, 2010). And while TIPS breakeven spreads have widened, they're still well below their first quarter levels (please see the chart below).



Source: Federal Reserve

We also note that the back-up in yields has extended to futures-implied expectations for the funds rate. Two weeks ago futures markets were implying no probability of a rate hike until the March 2012 FOMC -- now there is a small probability implied for as soon as the September 2011 meeting, and a strong probability by December 2011 (please see the chart on the previous page). If political backlash were to derail QE2, it's not likely the Fed would hike the funds rate. The only thing that could cause *that* would be substantive improvement in the economy, which is consistent with our explanation for the back-up in Treasury yields.

Implications for markets

We do see the economy improving, but "substantive" could take a long time. We think we could see real GDP growth with a 4-handle in 2011. With that, the Fed will likely not feel it has to move on to QE3. But with low inflation expectations so deeply embedded, and with the labor force so far below trend, we think we won't see enough improvement in inflation or unemployment for the Fed to need to hike the funds rate, or begin dismantling its balance sheet.

- This is all perfectly consistent with our view that stocks will likely be at least 25% higher a year from now (again, see "Stock Outlook: Differences Make a Difference").
- But a corollary is that bond yields will be higher, too. We've been saying for some time now that rates will be low "forever" (see, for example, "Fixed Income Strategy: Take The Low Road" June 16, 2010). Now it's time to quote that great economist Elvis Costello, who said, "Forever doesn't mean forever anymore."
- Note that our expectation of somewhat higher rates is part of an optimistic case. We don't expect what we are now hearing many of our clients worry about -- a sudden chaotic leap higher in Treasury yields. We think that's a very unlikely inflation-driven bear case. For us, a better bear case has more to do with aftershocks of the credit crisis -- Ireland, Greece, California, and so on. Those cases would drive rates lower, not higher, especially if the political world moves away from "no exit," making such aftershocks more dangerous.
- Our moderately optimistic case says only that next year 3 will be the new 2 for the 10-year Treasury.
- This environment should be most friendly to non-investment grade bonds, where a still reasonably wide risk premium has room to narrow as the economy improves, cushioning a back-up in Treasury yields.
- On the face of it, our evolving optimistic outlook and a view to the end of "no exit" ought to moderate our enthusiasm for gold. In some sense it does, in that the most extreme bull case relies on the idea of strong and persistent economic underperformance, met with continuing heavy doses of reflationary monetary policy. That's why we're not considering raising our $1500 price target at this time.
- But we're not lowering it yet either, and are looking for an entry point to buy the current correction -- as much as anything else a speculative shock after a run-up so steep as to cause a hike in futures margin requirements. Our economic view isn't optimistic enough to think that the Fed will tighten anytime soon -- and remember, even if the fed funds futures are literally right, and there is a 25 bp hike by the end of next year, that's hardly tightening. For all the talk about inflation fears, we think the dominant market expectation is still for deflation, so if the Fed succeeds in engineering a moderate reflation, against such expectations gold will move higher.
- If the economy improves, we think the Fed will be slow to react, seeking an insurance policy against deflation. *That's* when an

undesirable level of inflation could start to be a serious concern, in which case a stronger bull case for gold would be activated.

- Also, if the Congress moves away from "no exit," for all the populist backlash, that in fact moves the Fed deeper into "no exit." Surely as Congress withdraws its safety net, the Fed will have little choice but to make its safety net all the more robust. And in the event of a sudden emergency to which Congress won't quickly react, the Fed will be the first responder -- and it will respond with reflation.

Bottom line

While the GOP takeover of the House stabilizes politics and creates a better growth environment, at the same time it moves the US away from "no exit" from guarantees against systemic financial risk. Long-term that's a positive as it removes significant incentive distortions, but it means we're performing without a net for the first time in a long time. Higher Treasury yields are telling us that QE2 is working, as counterintuitive as that may seem. We expect a continued moderate rise in bond yields over the coming year, and are becoming open-minded about a possible first hike in the funds rate in the first half of 2012. The non-investment grade sector is the best defense. We stand by our $1500 price target, but our upgraded growth outlook reduces the strongest bull case for gold.