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FED SHADOW

Good Problems to Have

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Donald Luskin

The Fed won't go broke (at least not on paper), and rising rates won't squelch growth.

We continue to judge QE2 to be a success. Ben Bernanke seems to feel the same way, and for the same reasons. In informal remarks yesterday he gave a 2011 outlook for "a 3 to 4 percent-type of growth number," apparently upgrading the FOMC's latest official forecast of 3% to 3.6%. He said the risk of deflation has "receded considerably," and thinks interest rates have moved up "mostly because the news is better." He acknowledged that this is "not going to reduce unemployment at the pace we'd like." We think he's right on all counts -- indeed, these are all points we've been making for quite a while now. We think markets agree, too. The slow-motion melt-up in stocks continues, while gold stalls out in high-level consolidation. We interpret this combination as indicating an improved outlook for self-sustaining growth not subsidized by endless Fed infusions of liquidity.

We continue to encounter profound skepticism from many clients on this.

- As an aside, whether or not this skepticism is justified, it confirms our view that sentiment has *not* run away to the bull-side as stocks have made new recovery highs (see "A Question of Sentiment" January 6, 2011).

It strikes us that after the trauma of the Great Recession, investors have become conditioned to believe that all cycles are vicious cycles, and that even apparently good news is in fact bad news. In the case of what seems to us as the self-evident success of QE2, we hear often that the rising interest rates caused by QE2 will squelch the growth we think they reflect. Less frequently, but more intensely, we hear worries that the balance sheet losses the Fed may have to take as the result of rising rates will deplete its capital, creating a uniquely intractable insolvency problem beyond the hope of any bail-out.

- To the latter point, we acknowledge that the Fed has become over the last two years what amounts to the world's largest hedge fund (see "When PhD's Attack" August 25, 2010), with a portfolio that amounts to the world's largest and most leveraged carry trade.

Update to strategic view

US BONDS: QE2 is a success -- it has raised growth expectations, and bond yields along with them. Arguably, Treasury yields would be higher if not for the Fed's presence in markets. We expect a 4% top in the 10-year yield in 2011.

HIGH YIELD BONDS: Improving growth expectations are collapsing spreads faster than intermediate term Treasury yields are rising, so high yield continues to be the sweet spot in US fixed income.

US MACRO: Rising yields are a sign of improving growth expectations. Absent an exogenous upward shock, we see capital in surplus, and don't expect higher rates to squelch growth.

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- So far so good on that. The Fed remitted this week a record $78.4 billion annual profit to the US Treasury, driven mostly by income on its portfolio of agency mortgage-backed securities financed entirely by excess reserve balances on which it is paying only 25 bp.
- Last week the Fed changed its accounting policies in such a way as to virtually rule out the risk of capital depletion should it have to take losses on the liquidation of bonds originally purchased at lower yields. The announcement was made stealthily, as a technical note appended to last week's H.4.1 report on reserve balances -- there was no press release, and we have seen no comment in the media.
- Under the new policy, capital losses would not hit capital, which is only about $52 billion -- but rather they would hit the account that accrues profits to be remitted to the Treasury. Thus Bernanke's statement last week in response to a question following his Senate testimony: "It's possible that there might come a period where we don't remit anything to the Treasury for a couple of years."

Setting aside that systemic and political issue, will higher interest rates squelch growth?

- Rates are the equilibrium price of capital. If there were an exogenous upward shock to that price, growth would slow. We're well aware of the familiar stories about potential exogenous shocks. But we don't see any evidence that any of those are at work in the recent rise in rates. It's the result -- as we predicted in August (again, see "When PhD's Attack") -- of the uptick in growth expectations engendered by QE2, and a perfect replay of what happened in March, 2009 after QE1.
- Or high rates could cause growth to slow for endogenous reasons, simply because the demands of growth had outstripped the growth of scarce capital. We don't see this as a structural inevitability, because growth *creates* capital -- it doesn't merely use it up. Nevertheless, imbalances and timing disconnects in which growth gets ahead of capital are certainly possible. We are unaware of any credible case to be made that such conditions could exist in the near future -- if anything, the imbalances run the other way, with capital in surplus.
- At the moment, growth is driving rates, not *vice versa*. Last April Treasury yields briefly hit 4%, reflecting the same optimism that had driven stocks to the peak of the first leg up from the March, 2009 bottom. After the European debt crisis and the Gulf oil spill emerged as issues in late April, optimism vanished, stocks corrected, and yields fell. Now some measure of optimism has returned, and rates have risen -- it's really just that simple.

Looking ahead to where rates could go in 2011, we have to ask ourselves why, with stocks at new highs above last April's peak, the 10-year yield is so far below last April's 4% level. One can't be sure, but possibly this is an implicit result of QE2 -- while it caused rates to rise by reviving growth expectations, the Fed's presence in the market may have also kept them from rising as much as they otherwise would have.

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Recommended Reading

Historical Evidence on the Benefits of Rules-Based Economic Policies
John B. Taylor
American Economics Association and the American Finance Association
January 7, 2011

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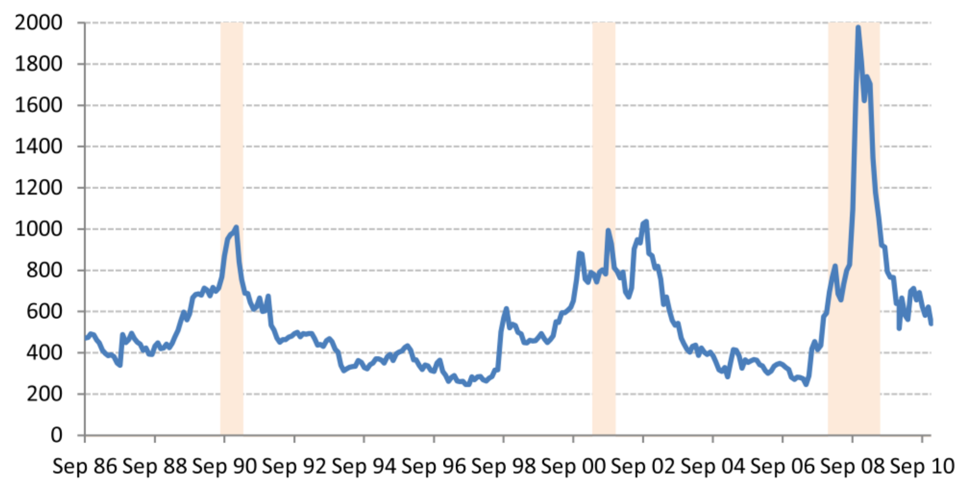
- Our rough-and-ready forecast for rates in 2011 is a central tendency of 3.25% to 4.0% on the 10-year. We see more risk to the upside of that range than to the downside. We think this is consistent with our real growth forecast in the high 3's.
- We don't expect a lot of movement in the short end, because we expect the Fed to do nothing with the funds rate all year.
- We don't have a strong opinion about it at the moment, but we don't expect the Fed to make additional asset purchases after QE2 runs its course (we have little doubt that QE2 will be completed).
- We have been correct so far that the place to be in bonds is high yield (see "Eyeing an Exit from 'No Exit'" November 18, 2010), and we stand by that view. Since our August forecast that rates would rise as the result of QE2 (again, see "When PhD's Attack"), the 10-year yield has risen 76 bp and driven a 5.9% loss on a total return basis. At the same time, junk yields have *fallen* by 113 bp as spreads have narrowed (please see the chart below), driving a 7.4% total return *gain*. Is this not drop-dead evidence that the rise in Treasury yields has been a function of growth expectations? We think those expectations will continue to improve, and that spreads have further to narrow.

Merrill Lynch High Yield Master Index **Recession**
Spread to 5-year Treasury, monthly except for current data point



Source: Merrill Lynch, TrendMacro calculations

Bottom line

QE2 is a success -- it has raised growth expectations, and bond yields along with them. Arguably, Treasury yields would be higher if not for the Fed's presence in markets. We expect a 4% top in the 10-year yield in 2011. Improving growth expectations are collapsing spreads faster than intermediate term Treasury yields are rising, so high yield continues to be the sweet spot in US fixed income. Rising yields are a sign of improving growth expectations. Absent an exogenous upward shock, we see capital in surplus, and don't expect higher rates to squelch growth.