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The Fed is from Venus, The ECB is from Mars

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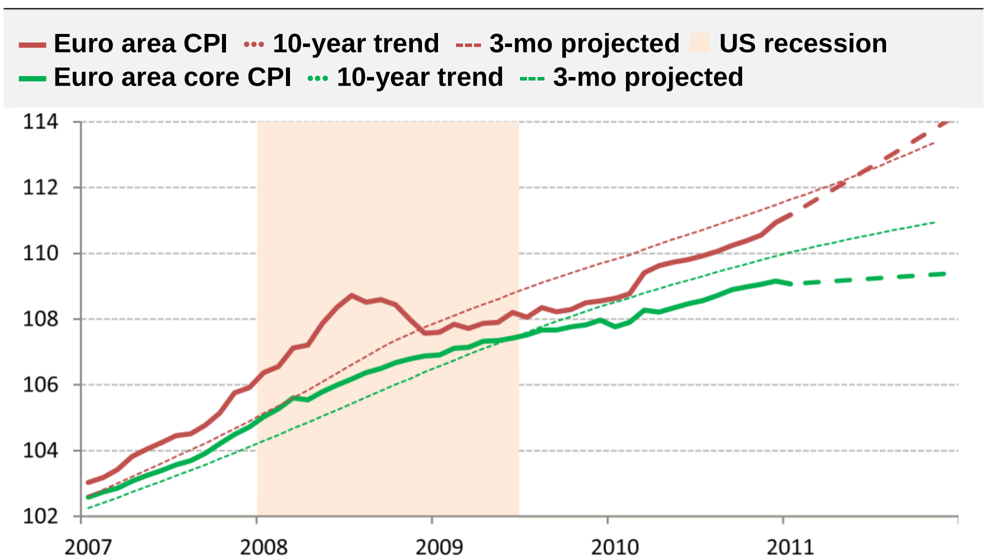
Europe is a basket case, and the US is growing. The ECB is raising rates, the Fed isn't.

We've said for several months that the upshift in US growth would mean an end to "no exit" from endless fiscal and monetary support, and from the doctrine of "low rates forever" (see "Eyeing an Exit from 'No Exit'" November 18, 2010). It will be tricky for the authorities to get this transformation exactly right, and they know it. It is upon us, with the European Central Bank talking about a rate hike next month, and the impending end of the Fed's QE2 at mid-year.

First to the ECB. At the March press conference last week, ECB president Trichet said in Q-and-A that "an increase in interest rates at the next meeting is possible," having emphasized in his prepared text that "It is essential that the recent rise in inflation does not give rise to broad-based inflationary pressures over the medium term. Strong vigilance is warranted…"

- We think this is wrong-headed and dangerous. Euro Area inflation is running above target at 2.4%. But things aren't that simple. Consumer prices are still below trend (please see the chart below), and will not catch up with trend for several months at current rates.



Source: Eurostat, NBER, TrendMacro calculations

Update to strategic view

FED FUNDS, US MACRO, US BONDS, EURO BONDS: The ECB's strong hint for a rate-hike next month is reckless and politically motivated, and it probably won't really happen. Europe faces no inflation threat, lags well below peak output, and is still teetering on the edge of credit collapse. If it placates Merkel's hawkish opponents then it may help Europe's efforts to stabilize, but it risks fomenting another round of crisis short-term. The US economy is stronger, but the inflation outlook is even more benign. There's no reason for QE3, but the Fed is still a long way from hinting at rate hikes. The natural end of QE2 should not lead to a spike in rates or any other particular ill effect. An oil shock is a wild-card but would likely only drive the Fed to get easier.

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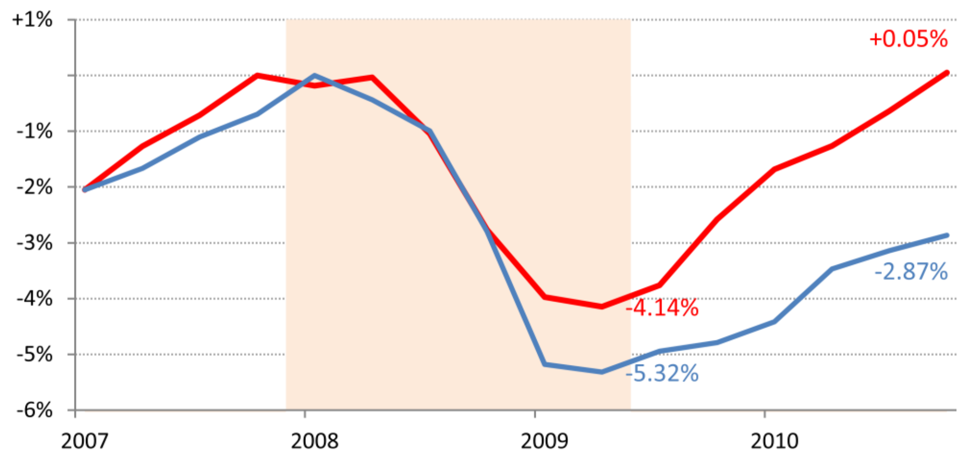
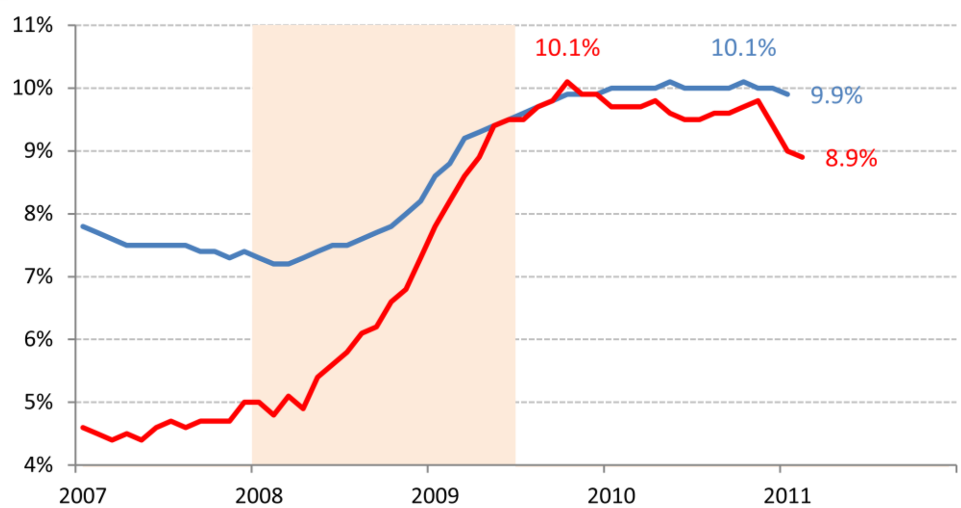
Core prices are far below trend, and trending flat.

- At the same time, the Euro Area still remains far below pre-recession output, and very far below trend. Output fell 5.3% in the Great Recession, and is still 2.87% below peak (please see the chart below). This stands in sharp contrast to the US experience, where the loss was a milder 4.14%, and has been followed by a complete recovery.

Euro Area real GDP **US real GDP** **US recession**
Change from respective peak, SAAR



Euro Area unemployment rate **US UE rate** **US recession**
Seasonally adjusted



Source: Eurostat, BEA, BLS, NBER, TrendMacro calculations

- Similarly, the Euro Area has made virtually no progress at all in reducing its unemployment rate (please see the chart above).
- At the same time, the Euro Area continues to stumble through an ongoing sovereign debt and banking crisis that still demands extraordinary and unconventional fiscal and monetary support (see "The Libyan Connection" February 22, 2011).

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Key documents

Systematic Monetary Policy and the Effects of Oil Price Shocks
Ben Bernanke, Mark Gertler and Mark Watson
Economic Research Report, CV Starr Center for Applied Economics, June 1997

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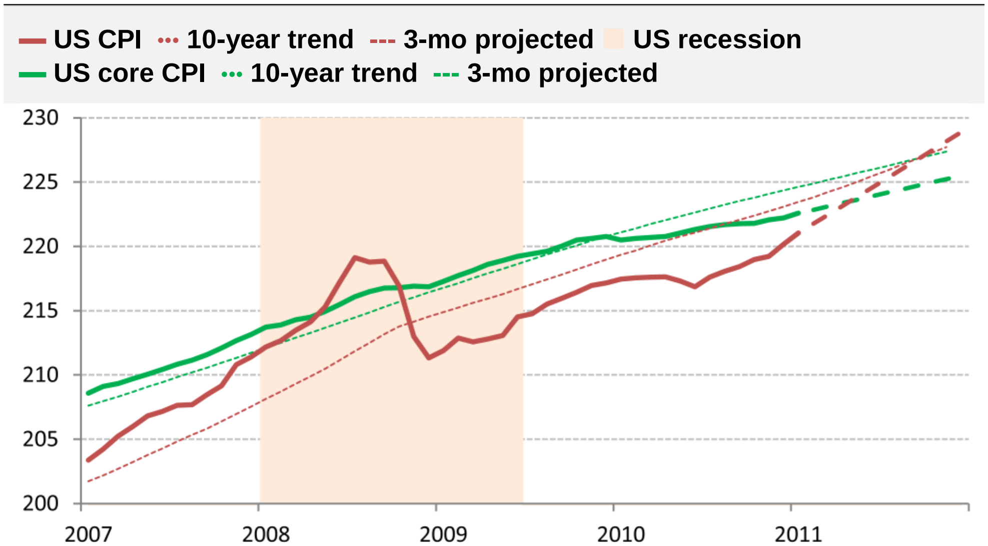
So why would the ECB seriously consider raising rates, when the comparison with the US shows so clearly that it has been too tight?

- The ECB's mandate holds price stability to be "primary," with an unofficial goal of "maintaining [headline] inflation rates below, but close to, 2% over the medium term." But many don't realize that the ECB is also mandated with "contributing to…a 'high level of employment' and 'sustainable and non-inflationary growth.'"
- That makes an ECB move to raise rates at this point a mechanistic knee-jerk response to a pop in headline inflation without regard for its context. Other than headline inflation, which is obviously being driven by the recent run-up in crude oil prices, *there is no evidence that the ECB is too loose, and much that it is too tight.*
- Raising rates next month would be a reckless act in light of the fragility of the European banking system. We will be surprised if it actually even happens when the time comes. And if it does, we would expect it to be a one-time event, and Trichet has even signaled as much. He was clear in cautioning that a possible hike "is certainly not a decision on the start of a series of interest rate increases."
- This is most likely a political gesture by Trichet to assist German chancellor Angela Merkel, who is facing increasing opposition to Germany's role in European bail-outs. After the withdrawal of the candidacy of the Bundesbank's Axel Weber for ECB president next year, talking about a rate hike signals to Merkel's critics that she is not letting hawkish German policy attitudes get thrown under the bus.
- It's reckless, but perhaps there is offsetting value in the political gesture. It wouldn't do European stability any favors to have Germany adopt a go-it-alone approach at this point. And perhaps a single 25 bp hike wouldn't make much difference in the grand scheme of things -- especially considering the ongoing power of the ECB and Europe's national central banks to overtly and covertly continue to flood the imperiled banking system with credit support (again, see "The Libyan Connection").
- So maybe a single small rate hike won't be a disaster for Europe -- if it even happens, which we doubt. But the real issue is that the ECB ought to be getting looser, not tighter.

Now let's look at the Fed, which is in a very different position than the ECB.

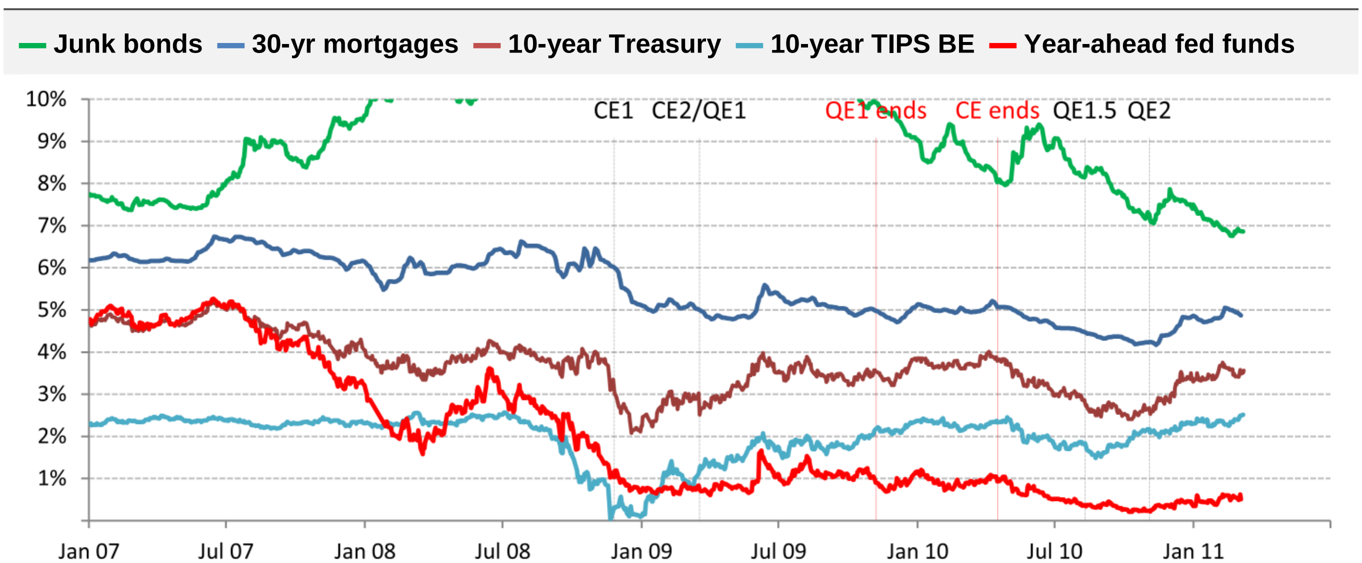
- US headline consumer prices are barely above where they were 2-1/2 years ago, and still below trend (please see the chart at the top of the following page). Core inflation is just as far below trend, having fallen off it in early 2010 -- it's now only growing at the trend *rate* -- which means it can never catch up unless it accelerates.
- The economy has obviously strengthened since QE2. But while US output is at peak, it is still very far below trend and not growing quickly enough to catch up. Unemployment is falling, but only because so far the recovery has not been strong enough to coax back into the labor force the 4.5 million persons who abandoned it

(or never joined it in the first place) over the last three years (see "On the February Jobs Report" March 4, 2011).



Source: BLS, NBER, TrendMacro calculations

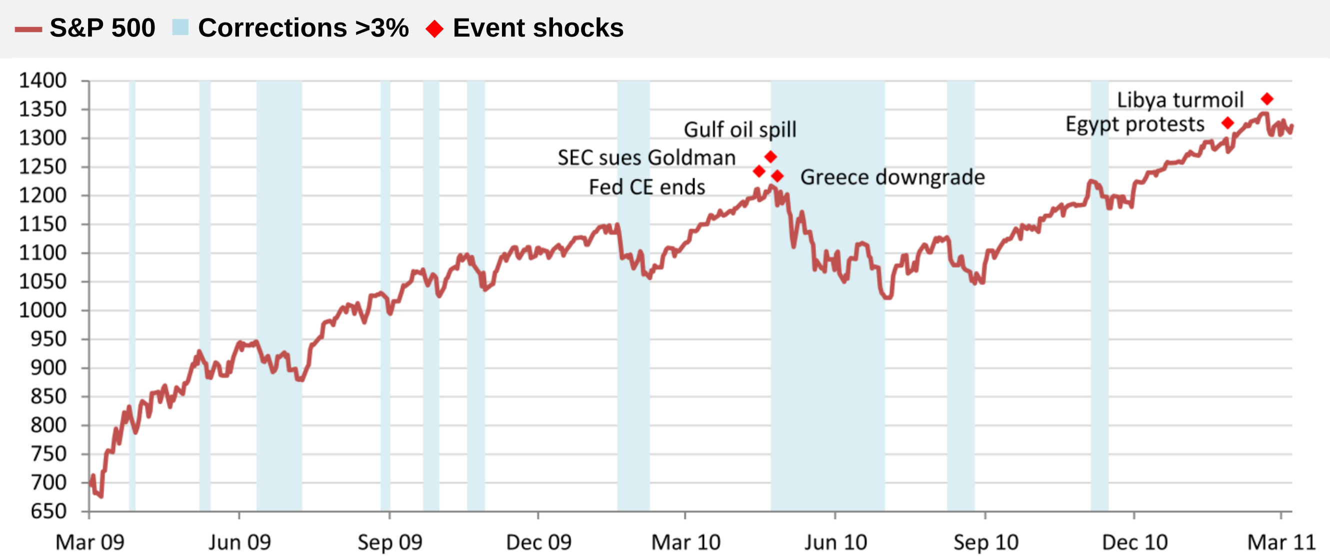
- So in our view neither inflation nor growth are binding considerations for the Fed that might cause it to follow the ECB's lead and start talking about raising rates -- or curtailing QE2 before its pre-announced end-date in June.
- However, neither are inflation or growth binding constraints that would cause the Fed to ease any further. At this point we are quite confident that there will be no QE3. There is no obvious need for it, and significant opposition on the FOMC and in Congress.
- *That view is contingent on the belief that we have not reached an oil-shock tipping point that will derail better growth in 2011 (see "An Oil Shock Tipping Point?" March 3, 2011). If it becomes apparent that we in fact have, then we would expect the Bernanke Fed to respond with QE3 no matter who may object. We know from the*



Source: Federal Reserve, Freddie Mac, CME, TrendMacro calculations *way Bernanke dealt with the run-up in oil-prices 2008, and from his academic writings, that he'll be much more worried about the growth effects than the inflation effects.*

Many clients tell us they see the end of QE2 as a major risk, believing that the constant dollar flow from it has been the only thing keeping longer-term interest rates low. History does not support these worries (please see the chart at the bottom of the previous page). The onset of both QE1 and QE2 triggered *rises* in interest rates, and the wind-up of QE1 had no effect at all. The onset of the first "credit easing" triggered falling rates, but its end did, too.

There is a more negative way of telling this history, however. The end of the "credit easings" that had the Fed ultimately buy over $1.2 trillion in agency MBS and $200 million in agency direct obligations corresponded perfectly with the April 2010 top in stocks, and ushered in several months of intense "double dip" fears. This was not the only event shock that impacted the stock market and the global economy at that time (please see the chart below). But we do think it was a very important contributory factor, although not for the reason we've heard several clients articulate.



Source: S&P, TrendMacro calculations

We don't see the Fed's asset purchase programs as operating primarily by means of cash-flows -- in other words, we don't see the Fed acting as a "plunge protection team" supporting stocks and other assets with daily doses of POMO. Rather, we take Bernanke at his word -- these operations are simply monetary policy by unusual means, necessitated when the funds rate is at the zero bound. They are nothing more than easings -- like all easings, expansions of liquidity through the exchange of non-interest bearing (or low-interest bearing) debt for interest-bearing debt. All that went wrong last April is that the Fed didn't ease *enough*. We began arguing shortly thereafter that the Fed was too tight, despite what then seemed like extraordinary efforts (see "So Much For The 'V'" May 21, 2010). So the completion of such an easing doesn't necessarily mean a break-out in bond yields, or any other event risk for markets. Hopefully it will simply mean that the Fed has gotten it right, and can stand pat for a while.

- That said, remember that the Fed getting it right is a growth-positive development, which itself argues for somewhat higher bond yields. QE1 and QE2 were both advertised as designed to lower yields, yet they *raised* yields because they were growth-positive -- thus achieving their higher-order goal. So we continue to expect higher yields as an externality of better growth, but not as a technical event-effect of the end of QE2.

Will the Fed have done enough when QE2 is complete in June? Even monetary policy by conventional means is difficult to calibrate -- now with the Fed's balance sheet above $2.5 trillion, it's just a guess. Our intuition at this time is that, all else equal -- particularly, assuming no oil-shock tipping point -- it is enough. If the Fed will have correctly supplied the economy with the quantity of liquidity it needs, then the fact that it will be no longer supplying even more every day will be a good thing, not a problem.

Bottom line

The ECB's strong hint for a rate-hike next month is reckless and politically motivated, and it probably won't really happen. Europe faces no inflation threat, lags well below peak output, and is still teetering on the edge of credit collapse. If it placates Merkel's hawkish opponents then it may help Europe's efforts to stabilize, but it risks fomenting another round of crisis short-term. The US economy is stronger, but the inflation outlook is even more benign. There's no reason for QE3, but the Fed is still a long way from hinting at rate hikes. The natural end of QE2 should not lead to a spike in rates or any other particular ill effect. An oil shock is a wild-card but would likely only drive the Fed to get easier.