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TRENDMACRO LIVE!

On the April FOMC

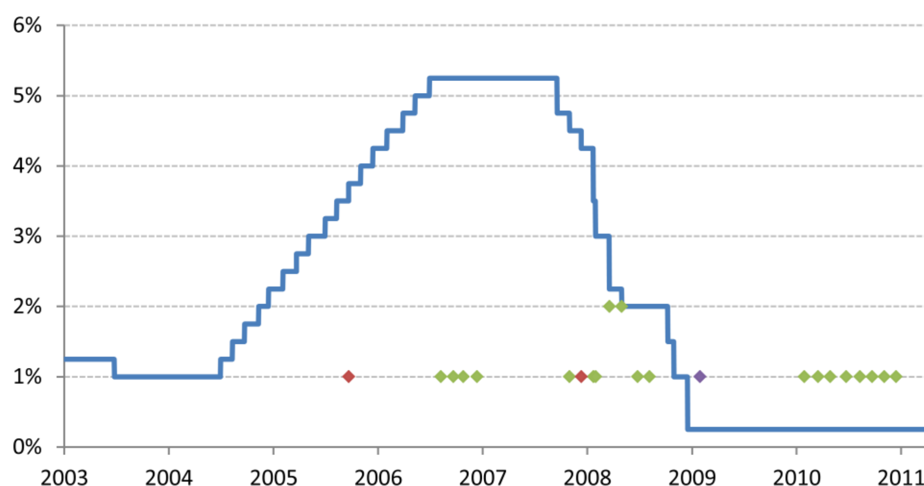
Wednesday, April 27, 2011
Donald Luskin

No one should be surprised. QE2 continues, as does the slow-motion melt-up in stocks.

Markets reacted to today's FOMC statement -- with virtually no substantive changes from last month's -- as though it were a surprise on the dovish side. We're not sure why. Was anyone really expecting the Fed to stop or scale back QE2, with this the last FOMC meeting before it is virtually complete? We certainly weren't (see "Will the World End when QE2 Does?" April 4, 2011).

- Perhaps the market is relieved that the FOMC didn't sign up for the currently fashionable panic about inflation. The statement notes now that "Inflation has picked up in recent months," but continues to regard it as "transitory."
- This is consistent with the FOMC's new economic forecast, released at the beginning of Bernanke's press conference. Headline inflation was upgraded to a range of 2.1% to 2.8%, from 1.3% to 1.7% in January. But core inflation was only upgraded to a range of 1.3% to 1.6%, from 1.0% to 1.3% in January. And the new 2012 forecasts, while modestly higher than January's, still call for sharp drops in inflation from what is expected for 2011.

FOMC dissents: ◆ Hawkish ◆ Dovish ◆ Procedural — Fed funds target



Source: Federal Reserve, TrendMacro calculations

Update to strategic view

FED FUNDS: No surprises in today's FOMC statement, or Bernanke's first-ever presser. After QE2 is completed in June, we expect the Fed to maintain near-zero rates and its full asset position until there is substantial movement in both inflation and unemployment.

US STOCKS: As we predicted in mid-March, the correction was just a correction, and now it's over with the S&P 500 at new recovery highs -- and at new all-time highs excluding financials. We expect the slow-motion melt-up in stocks to continue.

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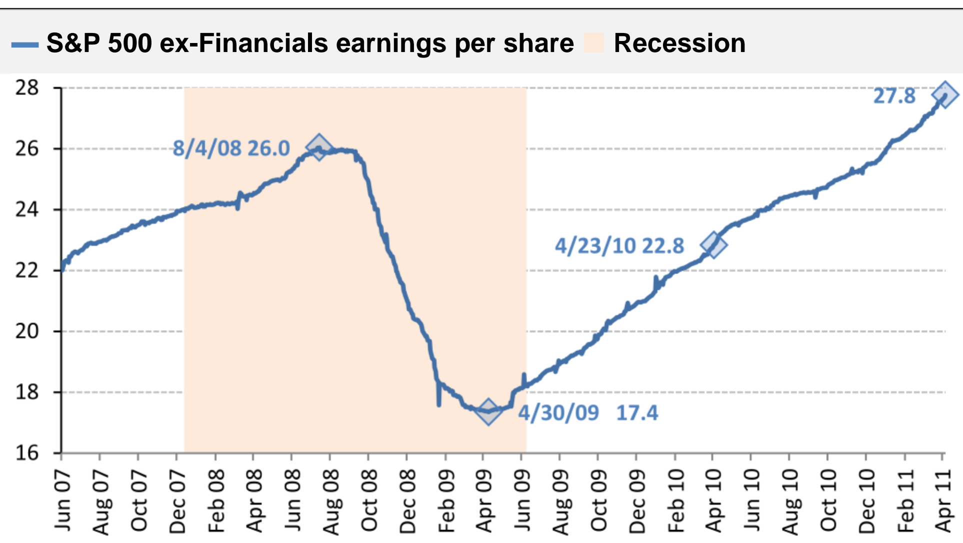
- And maybe there was some small surprise that there was no dissent from either of the two increasingly vocal hawks on the Committee -- Richard Fisher of Dallas and Charles Plosser of Philadelphia (please see the chart at the bottom of the previous page).
- All that moderately shifts the balance of expectations toward a longer future period of a near-zero funds rate and the maintenance of the Fed's asset positions.

Ben Bernanke's first-ever post-FOMC press conference -- touted as a world-transforming event by the Fed-watching industry -- yielded some useful clues.

- Bernanke made it fairly clear that there would be no QE3, arguing that with inflation higher and unemployment lower, the tradeoffs were not currently as favorable as they were last year -- very much what we've argued based on the Taylor Rule (again, see "Will the World End when QE2 Does?").
- Bernanke also indicated strongly that it is unlikely that the Fed's reinvestment of MBS proceeds will end when QE2 does.
- It especially caught our attention when Bernanke characterized the "extended period" of a near-zero funds rate as meaning "a couple of meetings probably." We don't take this is a hint that the funds rate will be hiked after "a couple of meetings" from this one. We take it as a rather sloppy figure of speech -- and one certainly falsified by the fact that the Fed has been using that expression now for more than two years.

Bernanke took some moderate heat in the conference about high energy prices. But he maintains that QE2 is working, and we think it's self-evident that indeed it is. Even if first quarter GDP comes in a little soft tomorrow, from our standpoint there is little doubt the economic recovery is on a firmer footing than it was a year ago when we were among the very first to

S&P 500 ex-Financials earnings per share **Recession**



Source: Zacks, NBER. TrendMacro calculations

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Peter Allen and Gary Evans
VoxEU, April 24, 2011

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predict that QE2 was coming (see "So Much For The 'V'" May 21, 2010). Stocks have now moved to new recovery highs, up almost 8% from when we called the bottom in the recent correction in mid-March (see "Meltdown in Japan" March 15, 2011). In fact, taking the damaged financial sector out, the S&P 500 has already been at new *all-time* highs for several weeks (on a total-return basis). S&P 500 forward earnings per share are now just 1% off all-time highs. Excluding the financial sector, they have been at new highs for three months (please see the chart at the bottom of the previous page).

We continue to expect no ill effect on the economy or in markets when QE2 is completed in June. In the press conference, Bernanke expressed the same view and for the same reason -- because he sees QE2 as operating by creating a "stock" of liquidity, not operating by means of its "flows" (again, see "Will the World End when QE2 Does?"). The longer that "stock" of liquidity is in place, the more QE2 will work -- inflation will rise and unemployment will fall. Precisely because it is already working, it's proper to think more about eventual exit (see "Eyeing an Exit from 'No Exit'" November 18, 2010). But while exit needs to be on everyone's strategic radar, it's still not on the tactical dashboard. We continue to think the Fed will stay on hold at least for the rest of this calendar year.

Bottom line

No surprises in today's FOMC statement, or Bernanke's first-ever presser. After QE2 is completed in June, we expect the Fed to maintain near-zero rates and its full asset position until there is substantial movement in both inflation and unemployment. As we predicted in mid-March, the correction was just a correction, and now it's over with the S&P 500 at new recovery highs -- and at new all-time highs excluding financials. We expect the slow-motion melt-up in stocks to continue.