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MACROCOSM

Will the Fed do QE3? Should It?

Thursday, June 2, 2011

Donald Luskin

No, and no -- even though the economy looks weaker today than a year ago.

One year ago, we were (we think) the first to predict that the Fed would do what has become known as QE2 (see "So Much For The 'V'" May 21, 2010). Today, especially after yesterday's big drop in stocks, the chatter is either that QE3 is now inevitable, or that its absence will be a disaster. We don't believe QE3 will happen, at least not unless the economy deteriorates further, and we don't think its failure to happen dooms the economy to such deterioration (see "Will the World End when QE2 Does?" April 4, 2011).

It's useful to recall how the world looked a year ago, when QE2 was first being discussed, and compare that to today. On the surface, by some important metrics, the economy looked *stronger* then than it does now.

- **Real GDP** was reported as having grown at 3.0% in the first quarter of 2010 (it has since been revised up to 3.7%). *Today, first quarter real GDP for 2011 is reported as having grown 1.8%.*
- **The ISM Manufacturing Index** was at 57.8, having risen 0.7 points over three months. *Today, it is at 53.5, having fallen 7.9 points over three months.*
- **The ISM Non-manufacturing Index** was at 54.6, having risen 3.9 points over three months. *Today, it is at 52.8, having fallen 6.6 points over three months.*
- **Forward S&P 500 EPS** had grown 8% over three month. *Today, they have grown 5% over three months.*
- **10-year Treasury yields** were at 3.26%, having fallen 35bp over three months. *Today they are at 2.94%, having fallen 45bp over three months.*
- **The Case-Shiller Housing Index** was at 156.2, having fallen 1.2% over three months. *Today it is at 151.7, having fallen 2.8% over three months.*

So if the Fed was willing to start considering QE2 *then*, why not *now*? It's primarily because the data that directly impacts the Fed's mandate for price stability and maximum employment tell a very different story.

Update to strategic view

FED FUNDS, US MACRO: There will be no QE3 without a substantial uptick in unemployment and/or a substantial downtick in inflation, neither of which we expect. Recent macro weakness is due primarily to one-off exogenous shocks, and should be temporary. Some data may be weaker than a year ago, but now we're making it mostly on our own, without "stimulus" -- and the Fed is no longer too tight. Our base case is for improved growth in the second half.

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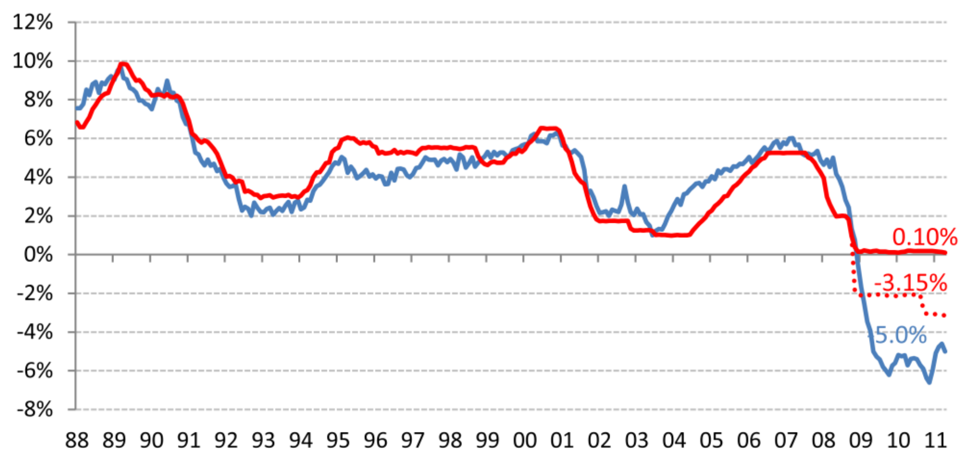
- **The unemployment rate** was at 9.8% a year ago, having risen 0.1% over three months. *Today it is at 9.0%, unchanged over three months.*
- **Non-farm payroll jobs** stood at 129.7 million, having risen just 434,000 over three months. *Today jobs stand at 131.0 million, having risen 700,000 over three months.*
- **Headline CPI inflation** had grown at an annual rate of just 0.3% over three months -- very nearly deflation. *Today it has grown at an annual rate of 6.2% over three months -- above the Fed's inflation target*.
- **Core CPI inflation** had grown at an annual rate of just 0.5% over three months -- very nearly deflation. *Today it has grown at an annual rate of 2.1% over three months -- right about at the Fed's inflation target*.
- **The 10-year TIPS breakeven inflation rate** was 1.99%, having fallen 14bp over three months. *Today it is 2.25%, having falling 14bp over three months.*

Putting such inflation and employment data into the Taylor Rule (see "Fixed Income Strategy: Take The Low Road" June 16, 2010), it was clear a year ago that the Fed had to act (please see the chart below).

Rule-based funds rate **Actual** .... **Adjusted for balance sheet**
Rule = 2.07 + 1.28 x 12-mo core PCE inflation - 1.95 x (UE - CBO natural rate)



Source: BEA, BLS, Federal Reserve, TrendMacro calculations per Rudebusch (2009) and Chung *et al* (2011)

- A year ago the Fed funds rate should have been negative 5.7% (according to the Taylor Rule). With the quantitative and credit easing already completed at that point, the virtual funds rate stood at about negative 2.0%, leaving the Fed too tight by 3.7%.
- *Today the funds rate should be negative 5.0% (according to the Taylor Rule). With QE2 mostly in place on top of previous quantitative and credit easing, the virtual funds rate stands at about negative 3.2%, leaving the Fed too tight now by only about 1.8%.*

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[About us]

Note: We are aware that John Taylor, the creator of the Taylor rule, disputes these numbers. Clients interested in discussing this should contact us.

So while there is still an argument based on the Taylor Rule for the Fed to do QE3, it is far less compelling than the open-and-shut case of a year ago. Ben Bernanke said it straight out at last month's post-FOMC press conference: "The tradeoffs are getting…less attractive at this point. Inflation has gotten higher. Inflation expectations are a bit higher. It's not clear that we can get substantial improvements in payrolls without some additional inflation risk."

Further influencing the Fed's thinking in the same direction, today it has less motive to act in the context of its duty to assure the stability and smooth functioning of the banking system.

- **The high yield bond spread to Treasuries**, an indicator of financial confidence, was at 7.04% a year ago, above the long-term average, having risen 18bp over three months. *Today it is 5.15%, below the long-term average, having fallen 4bp over three months*.
- **The VIX volatility index**, another indicator of financial confidence, was at 35.5, having risen by 84% over three months. *Today it is at 18.3, having fallen 13% over three months.*
- **Commercial and industrial loans** had contracted at an annual rate of 14.0% over three months. *Today they have expanded at an annual rate of 9.3% over three months.*

Yet for all that, how can the Fed ignore the data we looked at on the first page of this report, indicating that the economy is weaker today than it was a year ago?

- A dark way to answer that question would be to say that the Fed has simply done everything it can at this point, without violating the binding constraint of inflation risk implied in Bernanke's "trade-off" analysis. If that's not enough to get the economy growing robustly, then monetary policy is out of bullets, and so be it.
- We think this approximately true. We've never believed that monetary policy had the power to "stimulate" the economy. The best it can do is be neutral -- not too tight and not to loose, as *either one* is damaging to growth. We have been in favor of QE2 because, according to the Taylor Rule, it moved the Fed away from being *too tight*. That's a good thing, and we think it both removes an obstacle to growth and creates a solid platform for growth. But it's no magic wand.
- But that analysis presumes that the economy is, in fact, alarmingly weak -- that the Fed *ought* to do something, even if there is nothing it *can* do. We don't agree that the economy is actually weaker than it was a year ago, despite the numbers we cited at the outset.
- Context is very important here. A year ago the economy was just three quarters from the trough of the Great Recession (in fact, the official declaration that the recession was over was still four months in the future). At that point growth should be well above trend, especially after a year's worth of applying the massive and front-loaded "stimulus" enacted in February 2009. But we experienced only a single quarter like that, the strong fourth quarter in 2009 --

and even that was explained mostly by a lessening of inventory liquidation.

- So given the backdrop, the economy was in fact very weak a year ago. One very likely reason was that the Fed was too tight, even at the zero bound on the Fed funds rate.
- QE2 was a perfect response, as it was aimed precisely at the problem: the too-tight Fed.
- Today's seemingly weaker growth statistics are far less alarming, because they are not occurring in the context of having just spent hundreds of billions of dollars to "stimulate" growth that then didn't occur.

The weakness we're seeing now is disappointing to us. We had expected better. But it seems perfectly sensible, and not really alarming, in light of two exogenous shocks that hit in the first quarter -- first the sharp rise in oil prices driven by the exogenous geopolitical risks unleashed by the "Arab spring" uprisings (see "An Oil Shock Tipping Point?" March 3, 2011), and then the earthquake in Japan (see "Meltdown in Japan" March 15, 2011). We see these exogenous shocks as one-off, and of only temporary impact.

It is encouraging that the economy is as strong as it is, given these shocks and other ongoing risk factors (see "Tear Down This Wall of Worry" May 20, 2011 and "The Political Brick in the Wall of Worry" May 27, 2011) -- and considering that at this point most of the "stimulus" program of February 2009 has run its course. We think this explains why, while stocks are in a correction from the April recovery high, it is a mild one -- especially considering that the April high represented a double from the March 2009 bottom.

Bottom line

There will be no QE3 without a substantial uptick in unemployment and/or a substantial downtick in inflation, neither of which we expect. Recent macro weakness is due primarily to one-off exogenous shocks, and should be temporary. Some data may be weaker than a year ago, but now we're making it mostly on our own, without "stimulus" -- and the Fed is no longer too tight. Our base case is for improved growth in the second half.