Trend Macro

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MACROCOSM

Being Ben Bernanke

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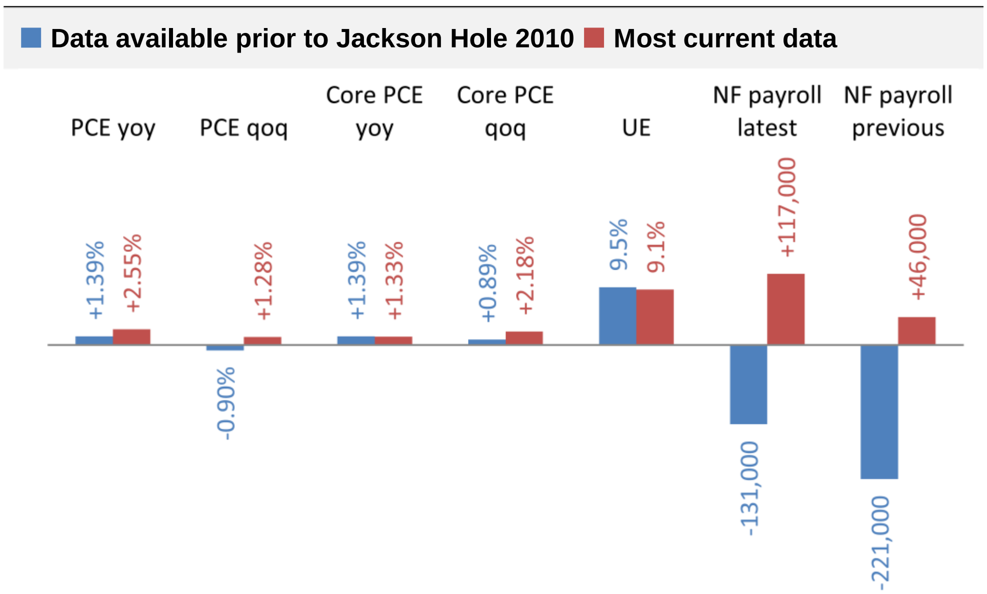
The mythology of Jackson Hole says "do something!" -- but he probably won't, and needn't.

If you were Ben Bernanke, preparing for your Jackson Hole speech this week, what would you do? The whole world is watching, because a myth has built up that last year at Jackson Hole Bernanke announced QE2. With world markets in turmoil, surely he'll do something similar now. But it is only a myth that Bernanke announced QE2 at Jackson Hole last year (see "On Bernanke at Jackson Hole" August 27, 2010) -- he just listed it as a possibility, one among several. And then it wasn't enacted until the *second* FOMC meeting afterward (see "On the November FOMC" November 3, 2010) -- after economic conditions had worsened.

Bernanke is going into Jackson Hole this year contending with what may prove to be another myth, too -- the myth that the economy is inevitably falling back into recession, or worse. For all the panic in markets of the last several weeks, *by the numbers that count most heavily for the Fed*, the US economy looks *better* today that it did one year ago (please see the chart below).



Source: BEA, BLS, TrendMacro calculations

Update to strategic view

US FED: Bernanke is under a severe demand effect to announce further policy easing at Jackson Hole this week. But we don't think he'll do anything more than he actually did last year -- despite the mythology to the contrary about that -- which is to promise to stand ready to act if need be, with a still considerable toolkit. The next policy move may have to be to reduce the rate on excess reserves, as it is now totally out of whack with the money markets.

US MACRO, US STOCKS: There is scant objective evidence of a new recession, and insufficient cause for one given our starting point 10% below long-term trend GDP. Volatile markets have over-reacted. We continue to believe that stocks are only in a correction, and represent a substantial value here. We don't know what will catalyze recognition of that value and support a bottom -- but a Jackson Hole bail-out probably won't be it.

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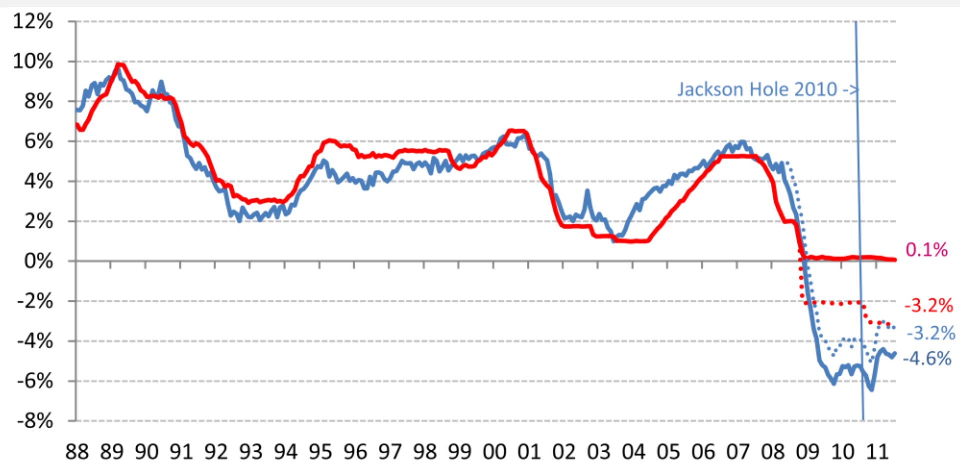
- Coming into Jackson hole this time last year, headline inflation as measured by price changes in personal consumption expenditures [had been reported] at +1.39% year-on-year, and -0.90% quarter-on-quarter. Core was +1.39% YOY and +0.89 QOQ. These were rates that Bernanke considered deflationary.
    - *Today, headline PCI inflation is reported at +2.55% YOY and +1.28% QOQ. Core is +1.33% YOY and +2.18% QOQ. These rates are probably right about where Bernanke likes to see them.*
- Coming into Jackson hole this time last year, the unemployment rate had been reported at 9.5%. The most recent two months of non-farm payrolls had been reported at -221,000 and -131,000.
    - *Today, the unemployment rate is reported lower, at 9.1%. The two most recent months of non-farm payroll jobs have been stronger, at +46,000 and +117,000.*

There's one other key difference between then and now. Then, the Fed hadn't done QE2 yet -- now, it has. That means the *policy starting point* is different now, and that makes a huge difference. Coming into Jackson hole this time last year, Bernanke was just awakening to the fact that the Fed had been too tight for more than a year, even at the zero-bound on short-term interest rates. He had just started to use a modified version of the Taylor Rule showing that the fed funds rate should be sharply negative (for our first of many discussion of it, see "Fixed Income Strategy: Take The Low Road" June 16, 2010).

- Specifically, according to the rule, the funds rate should have been -3.9%, given what Bernanke knew then about unemployment and inflation -- and assuming, as Bernanke does, that the natural unemployment rate is 5.5% (please see the chart below).

Rule-based funds rate .... **Assuming 5.5% natural UE rate**
Actual funds rate .... **QE-adjusted "funds rate-equivalent"**
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)

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- Based on the size of the Fed's balance sheet at the time, Bernanke thought of the fed funds rate as being *equivalent* to -2.1%, making the Fed too tight by 1.8%.
- By the time QE2 was actually implemented in November 2010, conditions had worsened -- and the Taylor Rule was calling for a funds rate of -4.9%, making the Fed too tight by 2.8%.
  - *Now, according to the rule, the funds rate should be -3.2%.*
  - *Now, with QE2 completed, based on the size of the Fed's balance sheet, the funds rate is equivalent to -3.2% -- putting it exactly on target.*

So unemployment would have to rise, and/or inflation would have to fall, and/or Bernanke would have to lower his estimate of the natural rate of unemployment -- in order for the Fed to want to execute QE3 (or its equivalent).

And there are other factors, too.

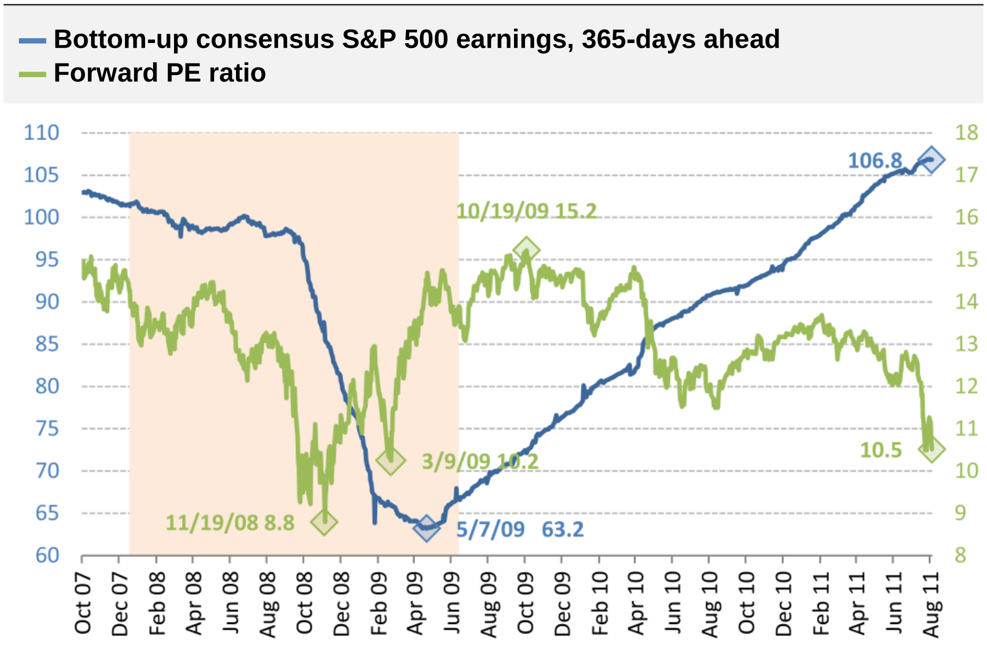
- Our Taylor Rule analysis doesn't include any impact of the Fed's announcement two weeks ago that the funds rate will likely be held at zero until mid-2013 (see "On the August FOMC" August 9, 2011). *Adding that to the mix, surely the Taylor Rule now has the Fed already postured on the accommodative side.*
- Additionally, we think the Fed may be forced to reduce the rate it pays on excess reserves. At 25bp for riskless overnight money -- with the funds rate now promised to be zero for two years -- it has to be the most attractive money market investment on the planet. The Fed cannot accept further excess reserves because it has nothing it wishes to do with them -- buying more assets with them would be QE3. So we can only assume that the privilege of depositing excess reserves at the Fed is somehow being informally rationed now. A lower rate on reserves will make it official.

So the Fed is already easy, based on everything it now knows. Then the only question is -- does the turmoil in markets over the last several weeks mean there's something the Fed doesn't know, or at least something that hasn't been captured in the data available now?

- If the US stock market is to be the guide, then things only look slightly worse today than they did a year ago as Bernanke prepared for Jackson Hole.
- Yes, this time last year, after a correction that began in April 2010, stocks had already recovered somewhat from their early July bottom. But that correction had actually been quite fierce -- a drop of 16.0% (not including dividends). The present correction has only been moderately worse -- a drop of 17.9%.
- As violent as the last three weeks may seem, volatility was just as high in last year's correction -- the VIX index hit a high of 48 in May last year, the same as its high two weeks ago.
- Other than the way markets are acting, there is scant objective macro evidence that there is any serious recession risk -- certainly

not the 2008-like cliff-dive that so many commentators are talking about now as though it were an accomplished fact.

- The only hard data to that effect is last week's horrible Philadelphia Fed Business Outlook Survey.
- Our single favorite macro indicator, consensus forward earnings for the S&P 500 -- both forward-looking and high frequencey -- shows nothing like the Philly Fed's cliff-dive (please see the chart below).



Source: Zacks, TrendMacro calculations

- After a surge several weeks ago, forward earnings have been flat over the last week. If they start to fall, and continue to fall on a prolonged basis, we will be forced to worry. But we've been watching this statistic daily for many years, and there is nothing especially unusual or alarming about a flat week.
- With forward earnings intact and stock prices having fallen dramatically, the forward PE ratio has now fallen back to 10.5, within basis points of where it was at the panic bottom in March, 2009. As painful as it may be, and as much as we must admit we didn't anticipate the severity or duration of this correction, we still see it as just a correction -- and continue to believe that panic levels like this are where you buy them, not where you sell them.
- We have no idea what will catalyze a recognition of value in stocks. But given our analysis of Bernanke's options -- and our analysis of how he sees his options -- Jackson Hole won't be that catalyst. At least not if the market requires a Fed bail-out for confidence to be restored.
- We don't see how we can avoid a third-in-a-row lost quarter. The blows to confidence from the budget cliffhanger in Washington, the Treasury downgrade, and Europe's lingering debt crisis have simply been too great (see "Downgrade: At Least the News is Out" August 8, 2011 and (see "Two-Tier Europe is Born" August 17, 2011).

- But the 2008 cliff-dive everyone is reminiscing about now was an entirely different creature -- it was a hard-stop in the entire world economy driven by a global collapse of the banking and payment system. And it came on the heels of all time high real oil prices. Absent some catastrophic event, that's just not happening now.
- So far all we have is a severe blow to confidence -- *another* severe blow to confidence, on top of a number of them already absorbed. The US economy is already more than 10% below its long-term trend level. How much further can it fall, based on nothing more than diminished confidence? It was a different story in the summer of 2008 when confidence was still relatively high, and GDP was just 1% below trend.

So you are Ben Bernanke. What do you say at Jackson Hole?

- You say that you are concerned that there has been a blow to confidence.
- You say that objective indicators of economic performance don't point to recession, but rather a lingering soft-spot.
- You say that the Fed stands ready to use its still considerable toolkit to ease policy should that soft-spot worsen.
- You say there are stresses and strains in the global credit markets, but the Fed stands ready with battle-tested tools to ameliorate them, as do other central banks around the world.
- Then you say "Thank you very much, ladies and gentlemen," and you go have a stiff drink.

Bottom line

Bernanke is under a severe demand effect to announce further policy easing at Jackson Hole this week. But we don't think he'll do anything more than he actually did last year -- despite the mythology to the contrary about that -- which is to promise to stand ready to act if need be, with a still considerable toolkit. The next policy move may have to be to reduce the rate on excess reserves, as it is now totally out of whack with the money markets. There is scant objective evidence of a new recession, and insufficient cause for one given our starting point 10% below long-term trend GDP. Volatile markets have over-reacted. We continue to believe that stocks are only in a correction, and represent a substantial value here. We don't know what will catalyze recognition of that value and support a bottom -- but a Jackson Hole bail-out probably won't be it.