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TRENDMACRO LIVE!

On the December FOMC

Tuesday, December 13, 2011

Donald Luskin

A more optimistic Fed isn't likely to ease, but there are new sources of global liquidity.

Markets reacted very badly in September, two FOMC meetings ago, when the Fed alarmingly first described "significant downside risks" in its economic outlook, even as it introduced "Operation Twist" at the same time to ameliorate those risks (see "On the September FOMC" September 21, 2011). Those three scare-words were there again in today's statement, and the market's initial reaction to hearing it was negative once again. That's probably because overall today's statement took a decided turn for the *optimistic* (this time around, even the ominous "significant downside risks" were downplayed by attaching them exclusively to "strains in global financial markets"). So if the market expected more easing programs from a pessimistic Fed, it was disappointed. In concert with a similar disappointment from the European Central Bank Thursday (see "On the ECB Monetary Policy Decisions" December 8, 2011), markets are having to a look at global future with less central bank emergency liquidity than they may have wished for.

- The big tell is gold, which fell more than $35 in the immediate wake of the FOMC statement -- making it a drop of more than $110 since the ECB's policy announcement Thursday.
- We take gold's signals seriously. But we think the market is underestimating the liquidity that is still to come from the Fed and other central banks, especially the ECB.
- The sovereign national central banks that make up the ECB's Eurosystem are poised to execute about €200 billion in what amounts to quantitative easing by creating funding for the International Monetary Fund, to be invested to ease Europe's debt crisis.
- When we first proposed this idea less than two weeks ago (see "Saved by an Acronym" November 30, 2011), it seemed like an impossible hope. Yet it was seized upon in the European financial media, and immediately found its way into policy adopted at last week's EU summit (see "E Pluribus 26" December 12, 2011).
- We feared that the conservative Bundesbank, always opposed to QE, might scuttle the deal -- but it was reported today that it has acquiesced. It even hinted that the Fed and the People's Bank of China might get involved.

Update to strategic view

US FED, GOLD, ECB: The Fed took a turn toward the optimistic in the December statement, a disappointment to anyone who was expecting new easing programs. On top of a similar disappointment from the ECB last week, it seems the market is bracing for less central bank liquidity than it might have liked, as evidenced by a $110 drop in gold since late last week. We think there are numerous underappreciated sources of central bank liquidity in the world emanating from Europe, and perhaps from China as well. We see the reaction in gold as overdone, and presenting an interesting speculative opportunity.

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- The ECB's new 3-year Longer Term Refinancing Operations (again, see "On the ECB Monetary Policy Decisions") open the door to enormous liquidity-creating carry trades with European debt.
- The ECB's auctions of dollar liquidity, with dollars provided by what we think will be unsterilized money creation by the Fed, amount to unofficial *ad hoc* QE3 (again, see "On the ECB Monetary Policy Decisions").
- We note that inflation in China -- which ran as high as 6.5% in July -- has, without much fanfare, slipped down to only 4.2% (see "Europe Gets MAD" November 15, 2011). This gives scope -- indeed, it may give a mandate -- to the PBOC to at least stop tapping on the breaks, and perhaps even to start tapping on the accelerator.
- Finally, if the note of increasing optimism that crept into today's FOMC statement is correct -- that is, if the economy actually does avoid a recession and strengthens a bit -- we doubt strongly that the Fed would tighten promptly. The failure to tighten when conditions demand it is logically identical to easing.

Bottom line

The Fed took a turn toward the optimistic in the December statement, a disappointment to anyone who was expecting new easing programs. On top of a similar disappointment from the ECB last week, it seems the market is bracing for less central bank liquidity than it might have liked, as evidenced by a $110 drop in gold since late last week. We think there are numerous underappreciated sources of central bank liquidity in the world emanating from Europe, and perhaps from China as well. We see the reaction in gold as overdone, and presenting an interesting speculative opportunity.

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