Trend Macro

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FED SHADOW

When Bernanke Talks, People Sell

Thursday, March 1, 2012
Donald Luskin

It would take an economic miracle to cause the Fed to tighten. Don't bet on it.

Mario Draghi prints €500 billion and nobody seems to care. Ben Bernanke says 500 words, and it's risk-off in gold, stocks and the euro.

- We've been saying it's time for a rest in the slow-motion melt-up in stocks (see "Oil Melts Up, Too" February 24, 2012). The point of overhead supply at the level of the April 2011 top has been the perfect place for it. And it's perfect that we would reach it at the moment of execution of the European Central Bank's massive 3-year Longer-Term Refinancing Operation. We've said for two months that it will take the risk of a Lehman-type global systemic event off the table (see "Europe's Wall of Liquidity" December 21, 2011), and risk-on assets like stocks have been gradually taking that reality on board (see "Risk Reappraisal" January 20, 2012). So now it's official: Europe's banks have no funding risk (see "On the Second 3-year LTRO" February 29, 2012). Sell on the news? No, we're just in a pause. But recognize that it's not news at this point.

As to Bernanke, we are astonished that markets -- especially gold -- reacted so violently to his semi-annual monetary report to Congress yesterday, within seconds of its posting on the Fed's website. We expect that this reaction will be reversed before long, just as we said it would with gold in the low $1600's -- the last time it sold off heavily when the market got disappointed by Bernanke (see "On the December FOMC" December 13, 2011).

- Apparently much was read into Bernanke's statement that the "decline in the unemployment rate over the past year has been somewhat more rapid than might have been expected." The implication is that Bernanke has been taken by surprise, and that he now must therefore regret, and wish to revise, his dovish posture.
- This surmise is completely at variance with both the facts and Bernanke's views. Whatever improvement we observe over the last year in the unemployment rate, the reality remains that the size of the US civilian labor force was shattered in the Great Recession, and remains 2.5% below its long-term trend (please see the chart on the following page). Improvement or no over the last year, that

Update to strategic view

GOLD, US STOCKS, US FED, US MACRO: A few seemingly optimistic words in Bernanke's testimony triggered a sharp correction in gold, and paused the slow-motion melt-up in stocks at the level of last year's top. This is a mistaken interpretation of Bernanke's views, and it ignores significant caution signs for the economy. The major central banks of the world are unanimously easy, and there's no reason for that to change anytime soon. It's a good environment to buy pauses, dips, corrections and shake-outs.

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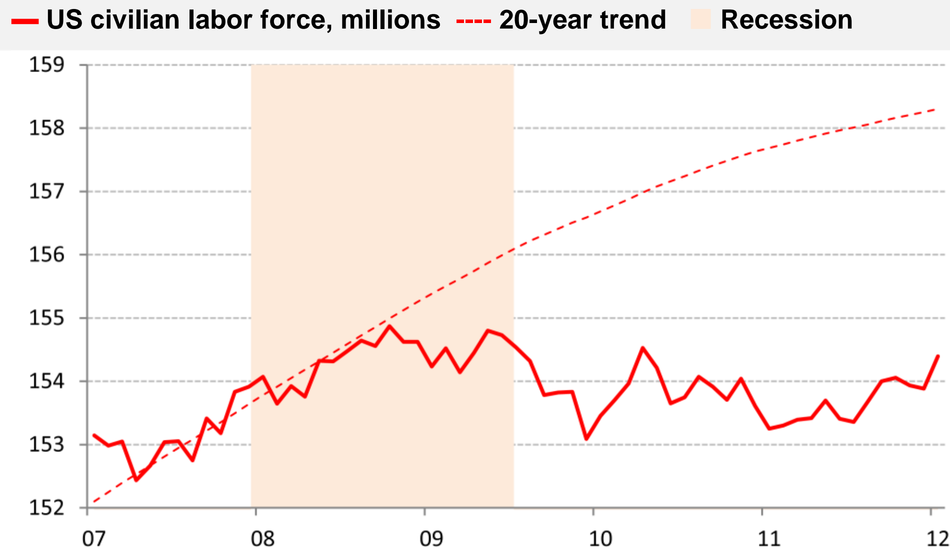

Source: Bureau of Labor Statistics, TrendMacro calculations

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2.5% still has to be added back to the 8.3% reported unemployment rate. This is a historically unique development, of which Bernanke is well aware. It is an entirely different argument than the usual bear rant about U-6 "underemployment," which is *always* above the reported unemployment rate even in the best of times.

- All that aside, as a practical matter, Bernanke simply cannot have been surprised. All but 20 bp of the drop in the unemployment rate from 9.1% to 8.3% over the last year was known at the January FOMC meeting, yet on that day Bernanke took the extraordinarily dovish step of committing to hold the funds rate near zero through the end of 2014 (see "On the January FOMC" January 25, 2012). It's not plausible that he now regrets doing so because he was supposedly surprised, a week later, when the unemployment rate ticked down a little more.
- At the same time markets chose to ignore something much more important, something avowedly *not* a surprise to Bernanke: "As we had expected," he said, taking a victory lap as it were, the burst of high inflation early in 2011 "proved transitory, and inflation moderated to an annual rate of 1-1/2 percent during the second half."
- Set that against the FOMC's statement of longer-run goals and policy strategy, a separate announcement made the same day as the January meeting, formally setting the Fed's inflation target for the first time, at 2%. This was repeated in yesterday's testimony. Gone is the Fed's oft-heard slogan that "the 'mandate-consistent' inflation rate is judged to be 2 percent or a bit less." With inflation below the target to begin with, why would the Fed raise the target unless it wishes to stay very dovish?

And the Fed is hardly alone. Every major central bank in the world is easing, comfortable that inflation is no longer the threat it was feared to be

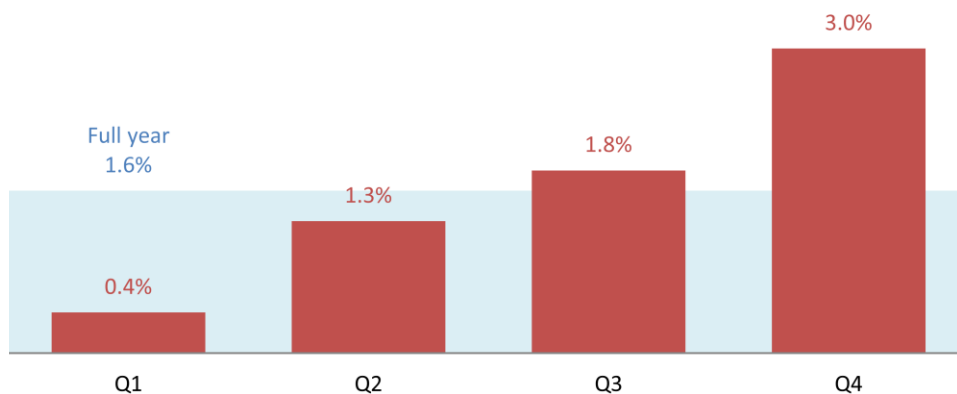
a year ago. The ECB has offered itself as an object lesson in what happens when an overweening aversion to inflation causes a central bank to tighten prematurely, when its banking system is fragile (see "EUicide" April 7, 2011).

- The ECB has learned from its mistake, in spades. It just executed the second of two long-term liquidity operations, vaulting its balance sheet to a new all-time high (again, see "On the Second 3-year LTRO"), printing over a two-month period 20% more money than the Fed did over six months of QE2.
- The Bank of Japan announced more quantitative easing, and for the first time, announced a formal inflation target, "a positive range of 2 percent or lower" and "1 percent for the time being." This is a remarkable move for a central bank that has, on net, delivered *deflation* over almost 15 years. The results have already been striking, with the ultra-strong yen weakening more than 3% against the US dollar over the two weeks since the announcement. By setting a formal inflation target, the BOJ has belatedly followed the policy prescribed for it nine years ago by Bernanke.
- The People's Bank of China last week cut its Required Reserve Ratio for the second time.

That Bernanke was over-interpreted on the improvement in unemployment is consistent with something we now hear regularly from clients. In just about every conversation, we hear the observation that "things seem to be getting better" or "the economy is really improving."

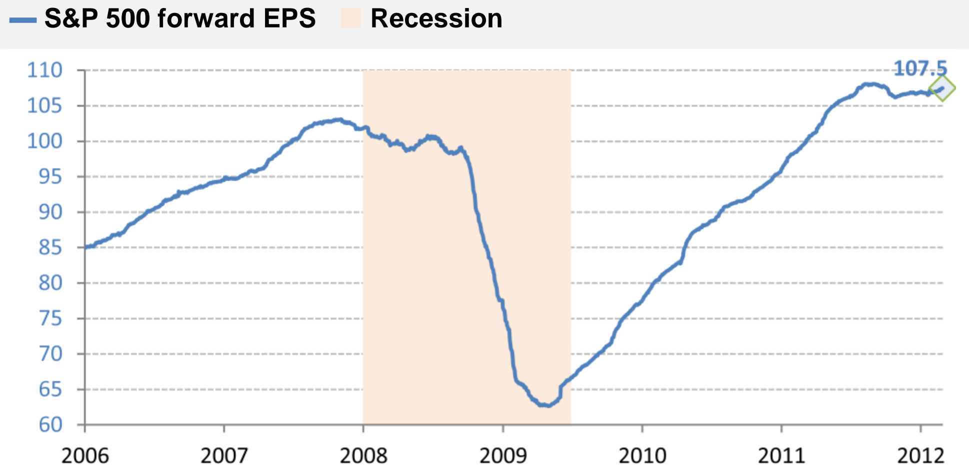
- It *is* improving. Sequential real GDP growth has improved steadily for the last three quarters. This has shown up in labor market statistics, which have improved with the same time-path.
- But this is exactly what you'd get if growth was held back in the first quarter by high oil prices and in the second quarter by the Japan earthquake, and then simply bounced back in the third and fourth quarters. With that in mind, we wouldn't look at the time-path at all, but at the year overall -- in which real GDP grew by a mere 1.6% (please see the chart below).

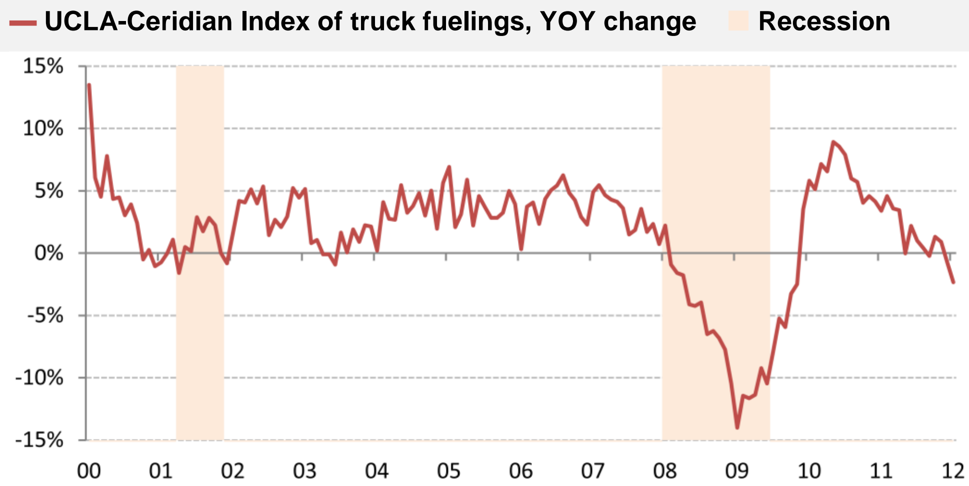
US 2011 real GDP growth SAAR

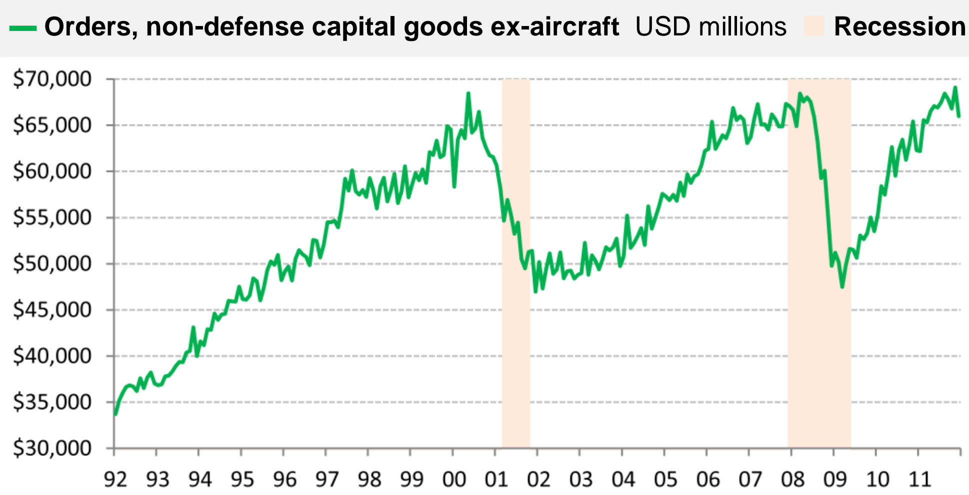


Source: Bureau of Economic Analysis, TrendMacro calculations

- While in our hearts we share the sentiment that things are getting better, if we wanted to make a case for caution it would be easy. While some macro statistics do look better, it is sadly the case that our *favorite* macro indicators look awful (please see the charts below).







Source: Bloomberg, UCLA, Census Bureau, TrendMacro calculations

But none of this actually matters in the question at hand -- *what will Bernanke do, and how will it affect liquidity-driven assets like gold?*

- If the economy *is* in fact improving, it will still be a very long time before Bernanke does anything to tighten.
- For one thing he is precommitted to keep interest rates near-zero until late 2014, and to not begin to reduce the Fed's balance sheet until rates are higher.
- Even if Bernanke were not precommitted, he would stand pat while a great deal of improvement took place. That's because it will take an extraordinary amount of improvement to get the economy to full capacity. Already real GDP is growing at its long-term trend *rate*, at least it did in the fourth quarter based on yesterday's upward revision to a 3% SAAR. But for Bernanke it's not the *rate* that primarily matters now. The *level* of GDP is 10% below its trend *level* of full output, and that level is itself rising at 3% per year. So if real GDP were to leap by 13% in the single year of 2013, that extraordinary event would do no more than restore the economy to the trend it was on just four years ago. Such a large "output gap" hasn't been seen since the Great Depression, and against that backdrop Bernanke will be eager to stay very easy.
- If Bernanke stands pat while the economy improves -- even if he doesn't proactively do anything more to ease -- *Fed policy will automatically get easier* as monetary velocity increases. As the real economy starts using the existing large stock of base money that is currently idle, circulating it more rapidly, it will be as though more money were being created.
- Now let's say things *aren't* getting better, that our cautious indicators are actually correct. That's the simple case -- Bernanke proactively eases.

So as we see it, pretty much no matter what, the Fed -- and the central banks of the rest of the world -- are going to be very easy for a very long time. That's an environment that's very friendly for liquidity-driven assets, even if we do end up this year going into something that the history books will call a recession.

Bottom line

A few seemingly optimistic words in Bernanke's testimony triggered a sharp correction in gold, and paused the slow-motion melt-up in stocks at the level of last year's top. This is a mistaken interpretation of Bernanke's views, and it ignores significant caution signs for the economy. The major central banks of the world are unanimously easy, and there's no reason for that to change anytime soon. It's a good environment to buy pauses, dips, corrections and shake-outs.