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TRENDMACRO LIVE!

On the September FOMC

Thursday, September 13, 2012
Donald Luskin

Has Bernanke joined John Roberts as a Bush appointee working to re-elect Obama?

The FOMC announced new easing today -- an open-ended asset purchase program of $40 billion in MBS each month, and an extension of the zero rate pledge by six months to mid-2015. We've been expecting a new easing program from the FOMC since March (see "On the March FOMC" March 13, 2012), and in June we thought the extension of "Operation Twist" would ultimately be seen by the Fed as insufficient (see "On the June FOMC" June 20, 2012). So while we saw Fed Chair Ben Bernanke's Jackson Hole speech as less than a full-throated promise of immediate action, this is no surprise to us. Nor should it be to the markets. According to CNBC's survey, 67% of respondents expected the zero rate promise to be extended in 2015, and 69% expected new asset purchases.

By bowing to such expectations, now Ben Bernanke -- like his fellow Bush appointee Chief Justice John Roberts (see "On the SCOTUS Obamacare Decision" June 28, 2012) -- has made a decision that may be the factor at the margin that re-elects President Obama.

He demurred to take such a step at the August FOMC meeting, where we believe he was subject to intense pressure by the high-powered

Futures-implied probability of GOP White House win 2012

Source: Intrade, TrendMacro calculations

Update to strategic view

US FED, US STOCKS, US MACRO: More QE via MBS, and an extended zero rate pledge. It is highly debatable at this point whether this will do any good for the real economy, as the Fed was already objectively easy before. But strong expectations of this had already driven stocks to new recovery highs. By not disappointing, the Fed has let the stock market stand as a stimulant to sentiment, perhaps enough at the margin to re-elect President Obama. It's possible we now stand at the doorstep to our nightmare "reflexivity" scenario in which a rising stock market will create a political environment in which a bargaining failure will throw the US off the fiscal cliff, and into debt default. If that's where we're headed, when markets wake up to it, stocks won't be at new highs for long.

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Democrats who now outnumber him on the Board of Governors (see "On the August FOMC" August 1, 2012). That was the last chance for easier policy to have any hope of affecting the real economy in time for November. *This* FOMC was the last chance to goose the stock market -- to lift sentiment, not reality -- enough to re-elect the incumbent.

- The strong expectations that the FOMC would act today have *already* contributed to the stock market's rise to new recovery highs. Like last April, this has coincided with a sharp drop in the probability of the GOP winning the White House in the November election (please see the chart on the first page).
- This is precisely the scenario we first described this summer (see "The Fiscal Cliff Bites" July 12, 2012) -- in which a rising stock market lifts sentiment enough to re-elect a president whose anti-growth policies will ultimately erode equity values.
- The risk is now greater than ever that this turns into a near-term nightmare "reflexivity" scenario. Having defeated a GOP ticket that includes the iconic conservative champion Paul Ryan, a victorious Obama would believe he has a mandate to take an ultra-hardline stance on the extension of the expiring Bush era tax rates at year-end. This would trigger a legislative bargaining failure that would throw the US headlong off the fiscal cliff, and lead to a Treasury default as the GOP retaliates by refusing to allow the debt ceiling to be raised (see "On Ryan as VP Nominee" August 13, 2012).
- The Fed's decision to bow to the expectations that have driven stocks to new highs have sharpened the edge on this risk.
- That dynamic aside, Romney isn't doing himself any favors with very poorly executed media appearances this week, and commercials that tend more toward protectionist pandering than growth -- while Obama, for his part, basks in the warm afterglow of Bill Clinton's ringing convention endorsement.
- We're by no means willing to call the election yet. But with Romney's chances of winning almost down to 35% in the political futures markets, we're on higher alert than ever for the possibility that our nightmare scenario will begin become operative.

Turning aside from the politics and looking just at the economics, the FOMC's decision was problematic.

- By our reading, the textual changes in today's FOMC's statement, compared to the last meeting's statement, on net seemed to shift a bit toward the optimistic. As of this writing, we haven't yet seen the new Governor's economic forecasts.
- While the $40 billion/month MBS purchase program is formally open-ended, at that pace the Fed's current $894 billion in MBS will match the historic high at $1.172 trillion in seven months. Back in April 2010 when that high was reached, the Fed terminated early its announced plan to acquire $1.250 trillion in MBS, finding itself to be pretty much the only bid in the market.
- Despite this natural limit on the ultimate size of the Fed's bond purchases, we suspect that buying more Treasuries at this time --

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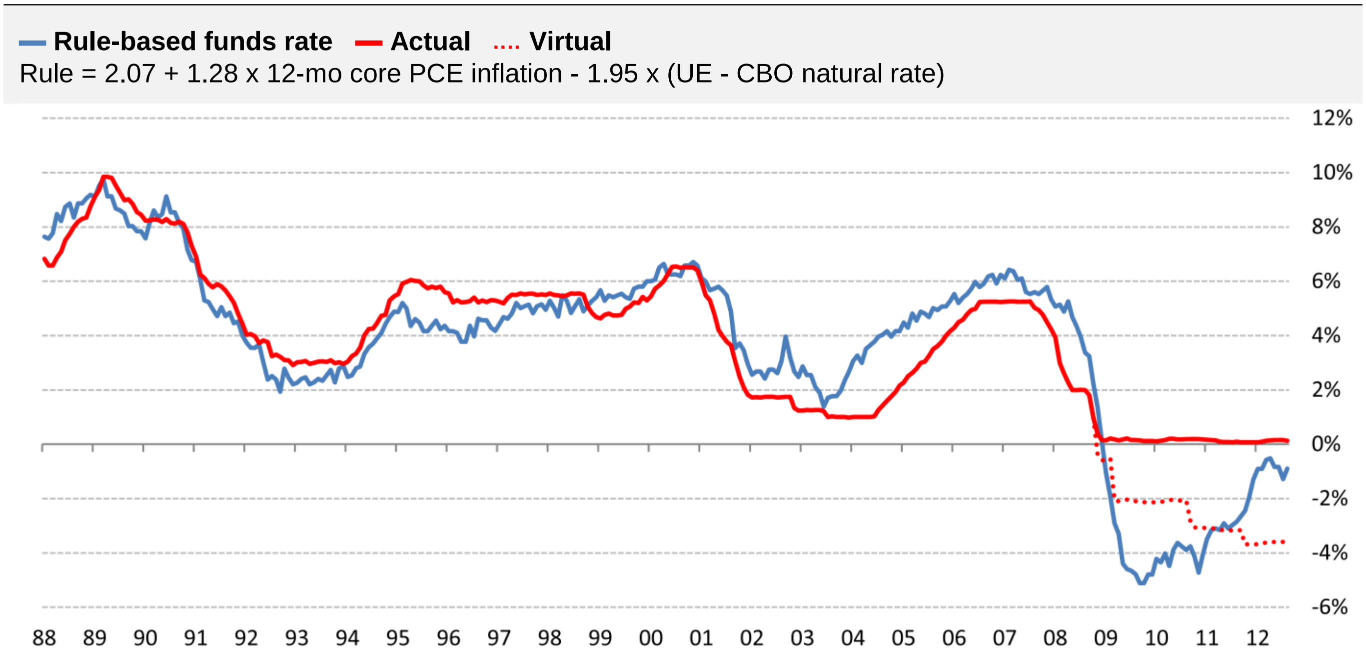

Source: Federal Reserve, BEA, CBO, TrendMacro calculations per [Rudebusch (2009)]

with the fiscal cliff approaching and the GOP making it a campaign issue -- was politically just too hot to handle.

While problematic, today's decision was defensible within the Fed's analytical framework.

- At this point, with so many non-conventional policy strategies already in place at a large scale, it's not obvious that today's commitment to acquire $600 billion in additional assets will actually have any real world effect. Indeed, in the CNBC survey, 59% said it would not lower the unemployment rate. Yet there are risks, as Bernanke himself pointed out at Jackson Hole. For example, 43% of the poll respondents worry that this step will impair pricing in the markets.
- By the version of the Taylor Rule that the FOMC has been operating under since early 2010 (see "Fixed Income Strategy: Take The Low Road" June 16, 2010), policy is already extremely easy (please see the chart above). The rule-based rate is now 2.73% above the "virtual funds rate" -- the nominal zero rate adjusted lower to account for the effects of the Fed's various non-conventional strategies.
- By this metric the Fed became too tight (the rule rate *below* the virtual rate) starting in January 2009, and stayed that way for 25 months, normalizing in February 2011.
- The Fed turned too loose (the rule rate *above* the virtual rate) in May 2011, and has been too loose now for 16 months.
- Under a simple version of the doctrine of "optimal control" articulated by Vice Chair Janet Yellen (see "On FedSpeak" June 7, 2012) -- summing the time-weighted differences to the rule rate -- the Fed would have to hold policy where it already was before

today's decision for another seven months to "make up for" having previously been too tight for so long (holding exogenous economic variables constant).

- Today's decision suggests that the Fed is in a hurry, loosening policy so that it can be held at that looser level for fewer months, with the same effect. Curiously, at this looser level the Fed runs out of room in the MBS market in the same seven months needed at the prior level.
- The key here is where the FOMC promises to continue easing if "the outlook for the labor market does not improve substantially."
- This effectively puts the Fed on a single labor-focused mandate. For now, with inflation persistently low, employment may indeed be the only relevant variable.
- It remains to be seen whether that will be so when the Fed, as it concludes in its statement saying it "expects that a highly accommodative stance of monetary policy will remain appropriate for a considerable time after the economic recovery strengthens." Then the Fed may have to decide whether to fulfill this commitment to stay too easy for too long in the face of what might, finally, be rising inflation. Perhaps that's what gold is hinting at today, rising $40 as of this writing since the FOMC's announcement. We'll be writing more on that early next week.

Bottom line

More QE via MBS, and an extended zero rate pledge. It is highly debatable at this point whether this will do any good for the real economy, as the Fed was already objectively easy before. But strong expectations of this had already driven stocks to new recovery highs. By not disappointing, the Fed has let the stock market stand as a stimulant to sentiment, perhaps enough at the margin to re-elect President Obama. It's possible we now stand at the doorstep to our nightmare "reflexivity" scenario in which a rising stock market will create a political environment in which a bargaining failure will throw the US off the fiscal cliff, and into debt default. If that's where we're headed, when markets wake up to it, stocks won't be at new highs for long.