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FED SHADOW

Rethinking QE3

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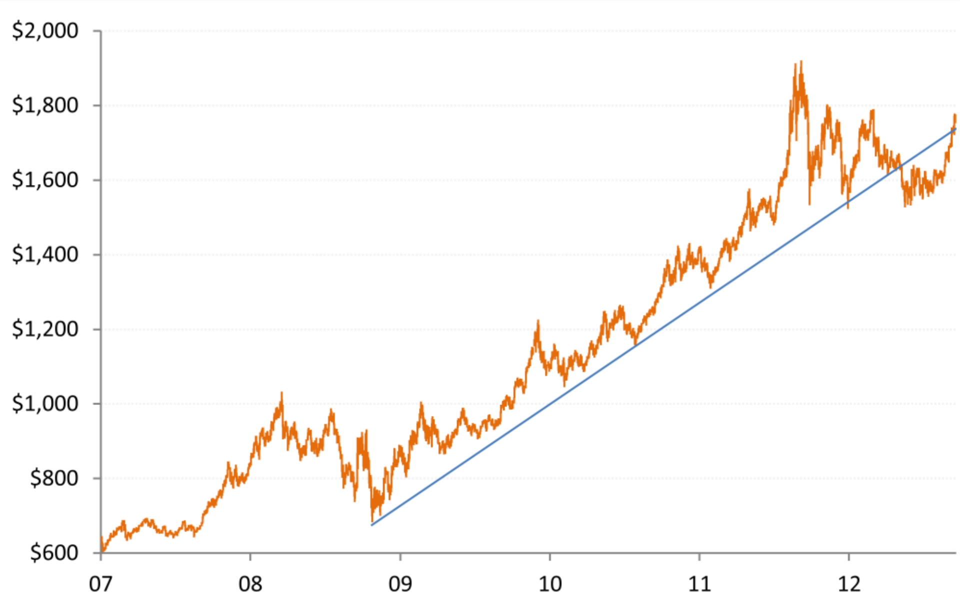
Less than meets the eye for the economy, but more than meets the eye for gold.

Now after several days and numerous client conversations, we have further thoughts on the FOMC's announcement of QE3 last week (see "On the September FOMC" September 13, 2012). Our view is that the Fed's new posture is in most ways less than meets the eye -- but in one critical way, more. We will also discuss in this report how the QE3 relates to gold.

UNLIMITED? Much emphasis has been put on the idea that QE3 is an "unlimited" or "unbounded" or "all-in" program, scaled at $40 billion per month indefinitely.

- *All* Fed programs are unlimited in the sense that the FOMC meets and sets policy every six weeks, or *ad hoc* if needed. This is true in normal times when all that's at stake is setting the fed funds rate, and it's true now when asset purchases are involved. When the first asset purchases were announced in November 2008, they were "limited" to $500 billion in MBS -- but that limit was revised upward

Gold (USD)



Source: Bloomberg, TrendMacro calculations

Update to strategic view

US FED, GOLD: QE3 has stimulated much excitement that it is "unlimited," shifts the Fed to a new "jobs mandate," and sets in place a strong "Bernanke put." We think this is mostly rhetoric, not substance, and won't ultimately make much difference in the economy or the markets. But the Fed's commitment to a stay loose for a "considerable period" following recovery is the realization of our longstanding upside case for gold.

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repeatedly for QE1, the MBS reinvestment program, QE2, "Operation Twist," and the extension of "Operation Twist."

- So not one of these programs was actually "limited." Indeed, in practice, the specified total dollar amount and duration of each program turned out to be *floor*, not a *ceiling*. So now if QE3 is "unlimited," what that really means is that there is no *floor* -- no "limit" to how *small* the program can be. If QE3 has no *ceiling*, then what has been gained, since in practice the prior programs turned out not to have ceilings either?
- The current program of buying $40 billion in MBS each month has a natural limit, which will be hit quite quickly. As we pointed out last week, the Fed's current $901 billion in MBS will grow in less than seven months to match the April 2010 high at $1.17 trillion. Back then the Fed cut its MBS program short by more than $100 billion, discovering to its chagrin that it had effectively cornered the market (again, see "On the September FOMC").
- When that happens again in less than seven months, the Fed will have to turn to Treasuries. At that point we will just have endured -- and hopefully survived -- another debate about raising the statutory debt ceiling. It will be very difficult politically for the Fed to buy Treasuries -- so just what will it buy?

JOBS MANDATE? Because the FOMC promised in its statement that QE3 will remain in place as long as "the outlook for the labor market does not improve substantially," many have commented that this effectively takes the Fed off its dual mandate in favor of a mono-focus on jobs.

- It has been generally ignored that the same sentence that included that labor market promise ended with the phrase, "in a context of price stability." In fact, the dual mandate slogan "maximum employment and price stability" appears twice in the statement.
- That said, the statement seems to have been geared rhetorically to put employment front and center. But the Fed has the luxury to do that only because inflation is so low. The Fed's official target is 2% year-over-year for headline personal consumption expenditures inflation -- it is currently far below target at 1.3%.
- At 1.3%, inflation is running at a dangerously low level that in the past the Fed has deemed deflationary.
- It's not a surprise that the FOMC chose to emphasize its intention to increase employment over increasing inflation. Everyone can understand how more jobs is a good thing, while it is difficult to explain why inflation should ever be higher -- especially in a bitter election year, with Fed-bashing *de rigueur* among conservatives.
- Today's low inflation -- and the apparent difficulty in this Not So Great Expansion of getting inflation durably higher even with massive asset purchase programs -- gives the Fed a great deal of runway before it runs afoul of its price stability mandate.
- But make no mistake about it: the price stability element of the dual mandate has *not* gone away.

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Recommended Reading

The Magnitude of the Mess We're In
George P. Shultz, Michael J. Boskin, John F. Cogan, Allan H. Meltzer and John B. Taylor
Wall Street Journal
September 17, 2012

Back to Basics: A Better Alternative to Basel Capital Rules
Thomas M. Hoenig
Federal Deposit Insurance Corporation
September 14, 2012

The dog and the frisbee
Andrew G Haldane and Vasileios Madouros
Bank of England
August 31, 2012

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BERNANKE PUT? Many clients have commented that QE3 and the seeming strength of the FOMC's commitment place a "Bernanke put" under the economy and risk-on assets.

- We suppose that this is exactly what the Fed wants you to think -- so if you think it, then that's a good thing. The idea here is to drive investors from risk-off to risk-on with the carrot of a free put and the stick of zero interest rates.
- But prior to this, did anyone *doubt* there was a "Bernanke put?" And before that, didn't we always speak of a "Greenspan put"?
- The problem is that over the years the value of that put has eroded. The "Greenspan put" existed in an era of strong growth and generally tight money, in which all that was required was an occasional emergency easing.
- Today's "Bernanke put" exists in a time of sluggish growth and easy money. It has already been demonstrated through repeated exercises of the "Bernanke put" that even easier policy isn't effective and spurring growth. The best that can be said of it -- indeed, the best thing that ever *is* said of it -- is the unprovable assertion that things would be worse without it.
- Why put any particular faith in a demonstrably ineffective "Bernanke put" -- any more faith than one would put in an insurance policy issued by a bankrupt underwriter?

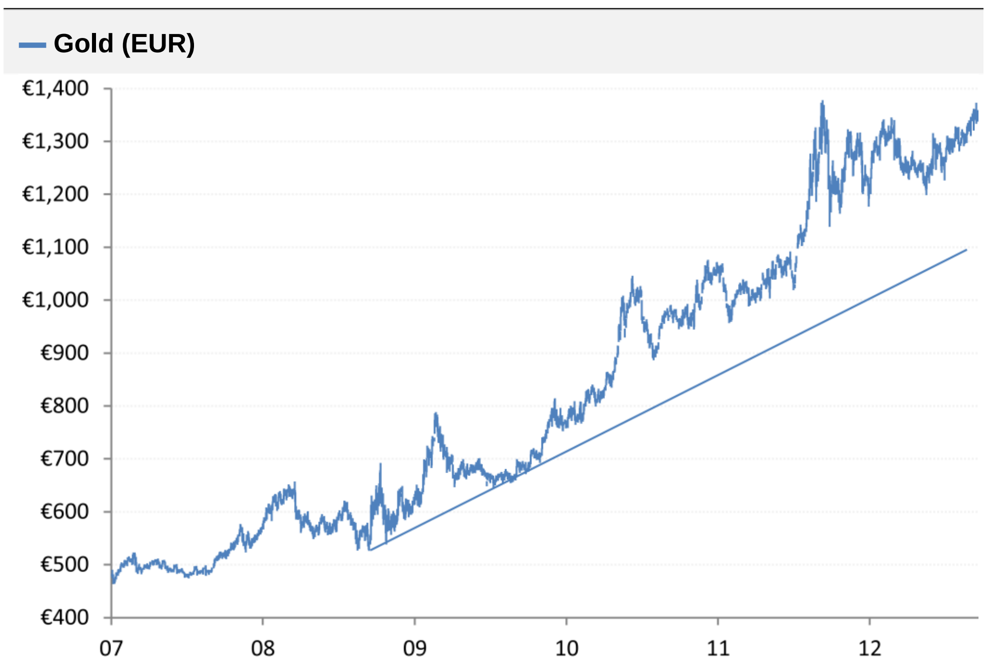
"CONSIDERABLE TIME" So far we have talked about the elements of QE3 that do not, in our view, change the game. There is one that does.

- The final paragraph of the FOMC's statement states that "a highly accommodative stance of monetary policy will remain appropriate for a considerable time after the economic recovery strengthens."
- Yes, it was said only by way of introduction of the extension of the zero interest rate pledge to mid-2015.
- Yes, it is standard operating procedure for central banks to be tardy -- to be too loose for too long, and too tight for too long. The Fed has been both since Bernanke joined up in 2002.
- But this statement makes it a conscious commitment. Its purpose, no doubt, was to assure markets that the Fed would not take the punchbowl away too soon. Such insurance against a hair-trigger tightening is a good thing -- but it necessarily has the cost of guaranteeing that the Fed will be late to tighten.
- Since the only reason any central bank ever has to tighten would be to head off incipient inflation, this is virtually a guarantee that the Fed will let inflation run above target for a while.
- When central banks let inflation run above target, it can become difficult for them to then rein in that inflation. It often runs further above target than the central bank wishes.
- *This makes it official -- it is precisely the policy direction we have been predicting for almost two years* (see "Gold is a Hold" December 20, 2010).
- We long ago hoisted the white flag on the idea that QE would immediately produce excessive inflation. Clearly the evidence is

that in this deflationary world, it doesn't. *But that's another matter*. The Fed's commitment *going forward* is to keep the present policy in place even when we have left our deflationary world and reverted back to a world of less money demand, of higher velocity -- a world in which inflation is not only possible but inevitable if the central bank stays too loose for too long.

WHICH BRINGS US TO GOLD About a year ago when gold went to all-time highs at $1920 (and €1375), we said it had overshot any reasonable expectations for what central banks would do any time soon to create new liquidity (see "Gold's Rollercoaster" August 25, 2011). We called the bottom in mid-December after a $300 correction (see "On the December FOMC" December 13, 2011), and we've reiterated our positive view on gold four times this year (see "On the January FOMC" January 25, 2012; "When Bernanke Talks, People Sell" March 1, 2012; "On the April FOMC" April 25, 2012; and "Is Gold Changing Its Mind?" May 18, 2012).

- If we may be forgiven for our shameful abiding fascination with crude technical analysis, we were alarmed in May when gold broke its longstanding uptrend line originating in the post-Lehman deflation crisis (please see the chart on the first page of this report). As we wrote at the time, the "falling gold price has been warning that central banks won't provide enough liquidity..." (again, see "Is Gold Changing Its Mind?").
- But we weren't alarmed enough to change *our* mind about gold, saying at the time "We think gold has made an error…"
- Gold has now re-established the broken trendline.
- Priced in euros, it never broke down to begin with, and has now nearly gotten back to all-time highs, even as the euro has strengthened sharply versus the dollar over the last several weeks (please see the chart below).



Source: Bloomberg, TrendMacro calculations

- This confirms to us that the ECB has had a longer and more difficult journey than the Fed has, toward policy normality from a longstanding position of excessive tightness. Surely the ECB's new commitment to buy sovereign debt via new Outright Monetary Transactions (OMT) has had an important role to play in gold's rally over the last several weeks, no matter in what currency it is denominated (see "On the September ECB Policy Decision" September 6, 2012).
- That said, observing how gold has behaved event-by-event as QE3 unfolded as a series of trial balloons and then ultimately actual policy, there is no doubt in our minds that gold has been responding to a change at the Fed, too (see "On Bernanke at Jackson Hole" Friday, August 31, 2012; and, again, "On the September FOMC").
- Gold has now corrected its error and returned to the post-Lehman trend, priced in dollars -- and more, priced in euros. So the easy money is out of the trade based on the idea that gold had temporarily underestimated the staying power of the Fed and the ECB.
- Going forward, that news is out. For gold, the course of least resistance is to drift higher. But just as we have been saying all year, we're not looking for another run for the roses until and unless events justify it. Such events could be the ECB activating OMT -- which, at the moment, we suspect the market might regard as an out-of-the-money option that will never actually be exercised. Or it could be the Fed, staying too loose for too long as we have discussed here.
- A wild card is the fiscal cliff. In his post-FOMC press conference, Fed Chair Ben Bernanke said in response to a question about it, "I don't think our tools are strong enough to offset the effects of a major fiscal shock so we'd have to think about what to do in that contingency." Translation: *it won't help, but we'll do it anyway.*
- If a bargaining failure sends the US off the fiscal cliff, especially if a failure to raise the debt ceiling results in a default (see, among others, "On Ryan as VP Nominee" August 13, 2012), that would be a strongly deflationary event that would be very bad for gold (just as the banking collapse of mid-2008 was). However a strong Fed response that supplies massive liquidity to counteract that deflation -- even if it didn't blunt the effects of recession very much -- would be very good for gold (just as the Fed's response of late 2008 and 2009 was).

Bottom line

QE3 has stimulated much excitement that it is "unlimited," shifts the Fed to a new "jobs mandate," and sets in place a strong "Bernanke put." We think this is mostly rhetoric, not substance, and won't ultimately make much difference in the economy or the markets. But the Fed's commitment to a stay loose for a "considerable period" following recovery is the realization of our longstanding upside case for gold.