TrendMacro

Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
Thomas Demas, Managing Director
Lorcan Roche Kelly, Chief Europe Strategist

FED SHADOW

2013 Outlook: Doves Ruled Out at the Fed

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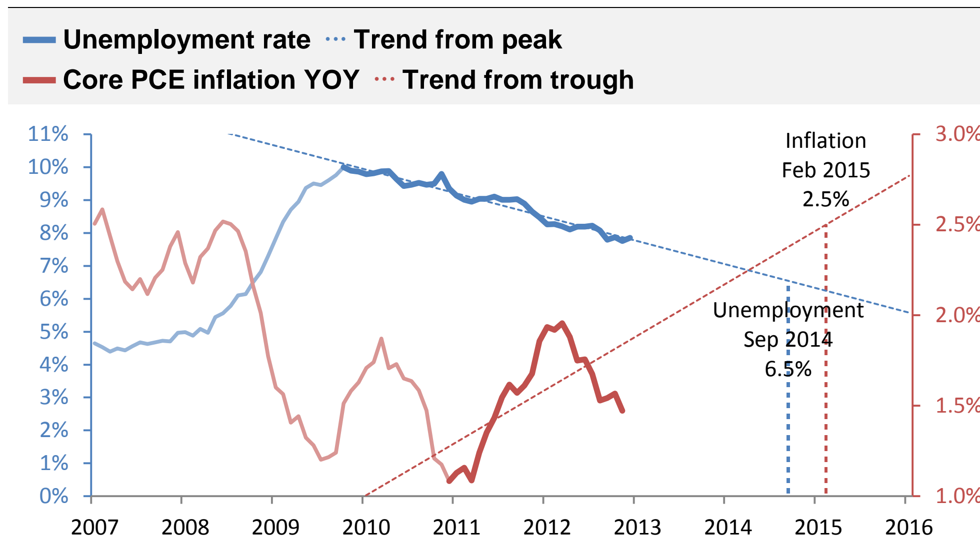
Donald Luskin

By its own formulas, asset purchases ought to stop this year, and rates hikes start in the next.

Our outlook for Fed policy is more hawkish than the consensus. Having just passed the $3 trillion mark on its balance sheet, we think it's likely that asset purchases will be scaled back this year, perhaps even terminated. We think that under the new Evans Rule announced in December (see "On the December FOMC" December 12, 2012) the funds rate could be hiked well before the mid-2015 mark that the Fed has conditioned the market to expect. Our view is not based on a belief that the US economy will shift into higher gear in 2013, as many seem to expect now based on the stock market's melt-up this month. We still expect economic performance in 2013 very much like that of 2012 -- another year of Not So Great Expansion after the Great Recession (see "Tax Hikes Have Consequences" January 2, 2013). Even with only that, we expect the Fed to back off on its present easing regime this year.

Taking the Fed's "Evan's rule" trigger levels of 6.5% unemployment and 2.5% inflation at face value, the funds rate should start to get hiked in mid-to-late 2014, not mid-2015.

- The chart below linearly extends the unemployment rate and the core PCE inflation rate into the future -- thus assuming that the pace of economic expansion stays about as it has been. So we can



Source: BLS, BEA, TM calculations

Update to strategic view

US FED: Don't look for many clues at next week's FOMC meeting. But assuming that the US macro background in 2013 is much like 2012, the Fed's trigger level of a 6.5% unemployment rate will be hit in September 2014, nine months earlier than mid-2015 as the market has been conditioned to expect. If this is true, then asset purchases will have to start winding down, and perhaps even cease, in 2013. Even so, the Fed is so easy now that any conceivable tightening trajectory will still leave it too easy for too long.

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forecast on what date the Evans Rule trigger levels would kick in.

- The unemployment rate trigger of 6.5% comes first, in September 2014. The inflation trigger of 2.5% comes later, in February 2015, but presumably whichever trigger that comes first would govern. Either way, the Fed would start hiking the funds rate before mid-2015.
- In the December FOMC statement where the Evans Rule was articulated, the definition of inflation was a little more complex than the measure used in the chart. It was defined as "inflation between one and two years ahead" with the qualifier that "longer-term inflation expectations continue to be well anchored." Swapping such measures into the chart doesn't change the conclusion.

Even if we are right, and strict observance of the Evans Rule brings tightening forward into 2014, that still leaves open the question of when the Fed will decelerate or cease its asset purchases.

- The December FOMC statement said the tightening under the Evans Rule would occur "a considerable time *after* the asset purchase program ends" [our emphasis].
- Thus, of necessity, the asset purchase program must end a considerable time *before* -- that is, *before September 2014*.
- And if this is correct, then the pace of purchases will likely be reduced before that -- and informal signals and formal announcements will likely come before *that*. We could be looking at 2013.
- It's unthinkable it will be this quarter, especially considering the ongoing political wrangling over the debt ceiling, the sequestrations and the continuing resolution (see "Oh What a Relief It Is" January 23, 2013). Even if it wished to -- which it probably doesn't yet -- the Fed would not change its posture in the Treasury market while these matters so important to that market hang in the balance. Such reticence is one of the ways the Fed's independence is compromised now because it carries out monetary policy using securities that are necessarily implicated in fiscal policy.

Nevertheless, we think markets aren't looking closely enough at this element of the Fed's policy evolution. The novelty of the Evans Rule got investors mono-focused on the question *when will the Fed start tightening?* The question of ending asset purchases is something else entirely -- it's *when will the Fed stop easing?*

- This question must be asked in the full awareness that the Fed is in fact quite easy.
- There was a time three years ago -- when the funds rate had already been lowered to zero for quite a while, and the first MBS and Treasury purchase programs were already completed -- when investors had to learn that nevertheless the Fed was still actually too tight. This was when the modified Taylor Rule developed by Janet Yellen's San Francisco Federal Reserve showed the correct funds rate to be as low as negative 6% (see "Fixed Income

Contact TrendMacro

On the web at
trendmacro.com

Follow us on Twitter at
twitter.com/TweetMacro

Donald Luskin
Chicago IL
312 273 6766
don@trendmacro.com

Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

Lorcan Roche Kelly
Sixmilebridge Ireland
212 537 9067
lorcan@trendmacro.com

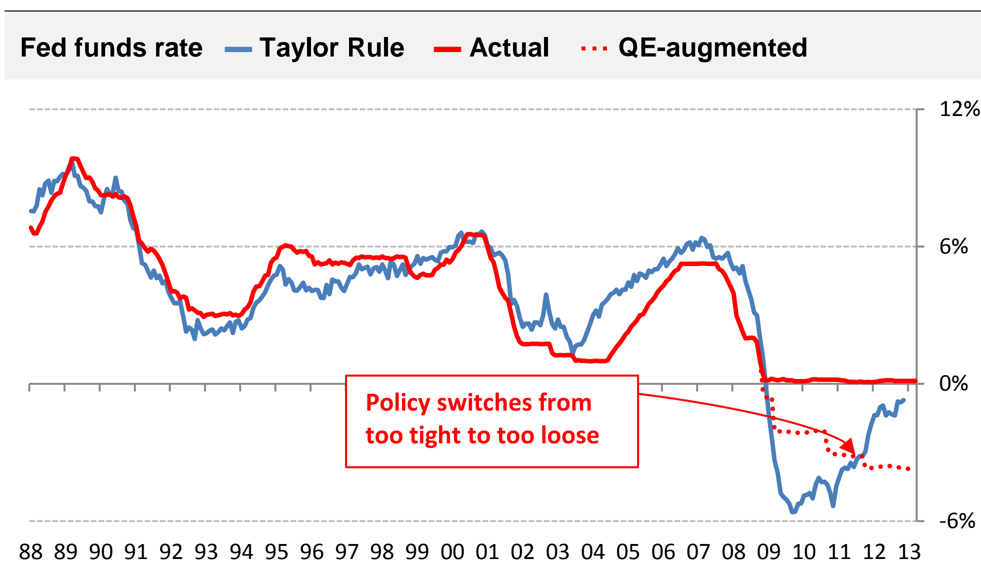
[About us]

Correction

In our Wednesday report "Oh What a Relief It Is" we were imprecise in characterizing House Bill 325 as providing a three-month hike to the statutory debt ceiling. More precisely, it leaves the level of the debt ceiling unchanged, but suspends for three months the prohibition against violating that unchanged limit. To download a corrected version of the report, please click here.

Strategy: Take The Low Road" June 16, 2010). This formed the core logic behind QE2 and Operation Twist, and most investors gradually got comfortable that the Fed was doing the right thing by undertaking those programs of further easing.

- But conditions have changed a great deal. The unemployment rate has come down and the inflation rate has risen -- so the modified Taylor Rule now prescribes a funds rate of only negative 72 basis points (please see the chart below). The slightest further drop in unemployment or rise in inflation will bring the Rule rate and the funds rate into alignment.



Source: BLS, CBO, BEA, TrendMacro calculations

- And that entirely ignores the asset purchases already on the Fed's balance sheet, which contribute to easing far in excess of the 72 bp gap between the Rule and the funds rate.
- *Thus the Fed is extremely easy now, under the same rule that said it was extremely tight three years ago.*
- As the minutes of the December meeting show, there is considerable discomfort by some on the FOMC that the present asset purchase regime is excessive. That's not a surprise to us. We believe the announcement of QE3 at the September meeting was the result of something like a panic in the face of a cluster of risks -- European depression and banking meltdown, China hard landing and the fiscal cliff (see "On the October FOMC" October 24, 2012). None of those risks materialized, and all are off the table now.
- But the reason the Taylor Rule doesn't compel the Fed to tighten now -- though it compelled the Fed to ease three years ago -- is that the Fed is operating under the doctrine of "optimal control," as articulated by Vice Chair Yellen in several speeches. To grossly simplify, one key implication of optimal control is that after making a policy error the Fed should make an offsetting error in the opposite direction -- "two wrongs make a right."
- We estimate -- and again, we grossly simplify -- the optimal control path should require the Fed to be in a neutral policy position by September 2013.

- It is essentially unthinkable that the Fed could or would accomplish this. Under current conditions, it would require selling almost all the Fed's long-term Treasuries by that date. Alternately, the Fed could leave its existing assets in place and hike the funds rate to 3%.
- Obviously those things are not going to happen. So if what we've described is a correct policy evaluation framework, then it must be the case that the Fed will stay too easy for too long -- even if we are right that asset purchases decelerate or stop this year, and even if we are right that a new rate-hiking cycle will begin in mid-to-late 2014.

Bottom line

Don't look for many clues at next week's FOMC meeting. But assuming that the US macro background in 2013 is much like 2012, the Fed's trigger level of a 6.5% unemployment rate will be hit in September 2014, nine months earlier than mid-2015 as the market has been conditioned to expect. If this is true, then asset purchases will have to start winding down, and perhaps even cease, in 2013. Even so, the Fed is so easy now that any conceivable tightening trajectory will still leave it too easy for too long.