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FED SHADOW

Will Yellen Get Trumped?

Thursday, February 11, 2016

Donald Luskin

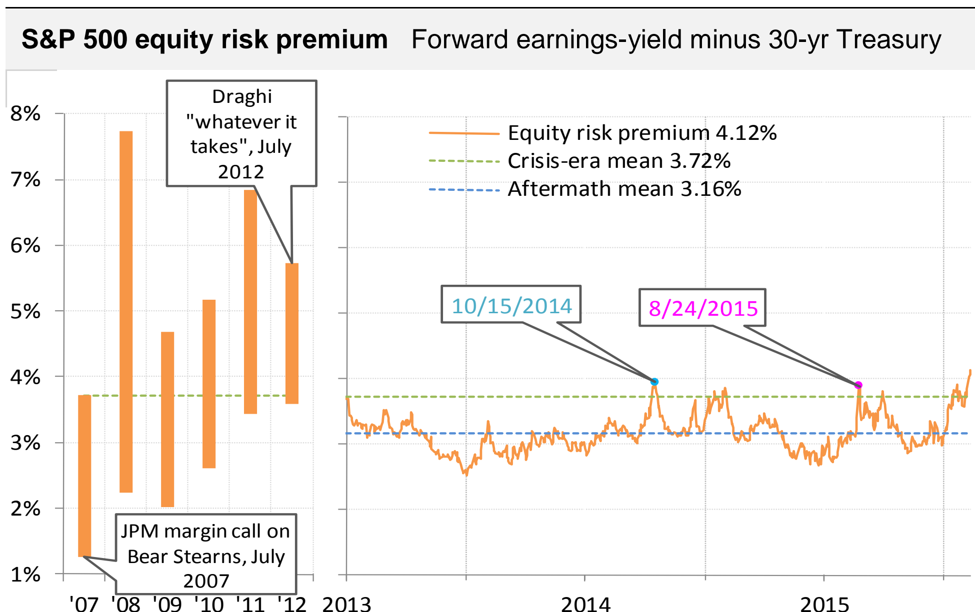
She'll never let go of the Phillips Curve. The coming election may make her change course.

Sadly, everything is going according to our expectations. The New Year has started out with a big correction, as the world comes to terms with the first-ever recession caused by too-low oil prices (see "2016: Two Charts, Six Words, One Man" December 31, 2015). The stresses in bond and bank-loan markets first induced by decaying creditworthiness of oil-producing companies and countries has, as we expected, turned into a crisis of confidence in banks in general. With oil having fallen further this year than we expected, those stresses are stronger than we expected. They are seeing their worst expression in still-fragile Europe, where banks are also laboring under the birthing pains of a new Dodd-Frank-like regulatory regime governing resolutions.

The whiff of fear is in the air, with the S&P 500 equity risk premium moving about its crisis-ear mean, and above its prior two peaks (please see the chart below).

The Fed's December "liftoff" has proven to be a costly mistake (see "On the December FOMC" December 16, 2015). *And Fed chair Janet Yellen's*

S&P 500 equity risk premium Forward earnings-yield minus 30-yr Treasury



Source: Bloomberg, TrendMacro calculations

Update to strategic view

US FED, EUROPE STOCKS, US STOCKS, US MACRO, GOLD, US ELECTION MODEL: "Liftoff" stands revealed as a mistake. With the oil price lower than we expected, financial stresses are stronger than we expected, interacting with new regulations in Europe to destabilize already fragile banks. As expected, stocks have probed below their August lows, and are now trying to make a stand at the lower October 2014 lows. The equity risk premium is above the crisis-era mean, making stocks relatively attractive here, but betraying the whiff of fear. Yellen's testimony yesterday made matters worse. Not even knowing the Fed's legal footing to implement negative rates, Yellen is showing poor leadership – an inability to comfort markets that she will do "whatever it takes." She comprehends the risks we face, but clings to the flawed logic that led to the "liftoff" error. With an election coming up, and with deepening recession likely to throw it to the GOP, Yellen may be forced to change course.

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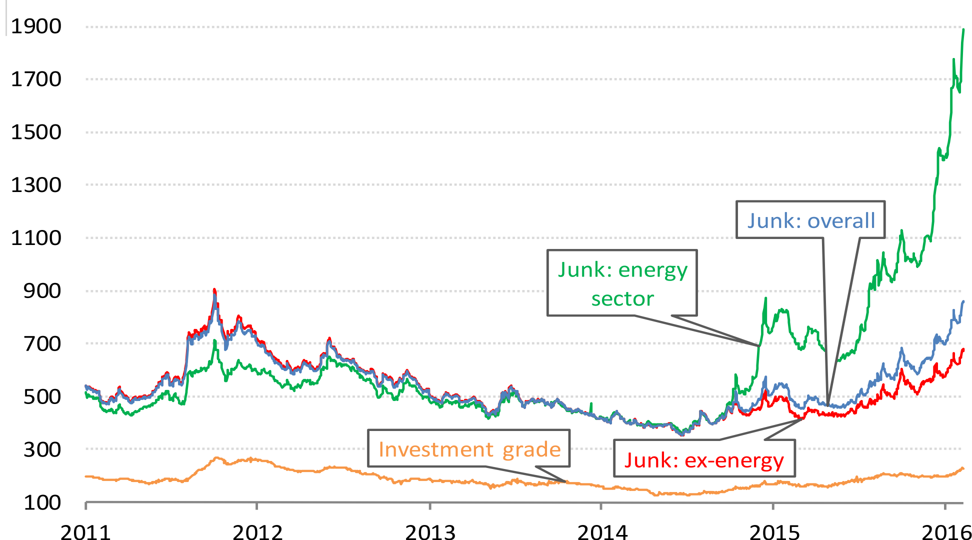
congressional testimony yesterday did little to make matters better, and in some ways made them worse.

- While other central banks around the world are finding new ways to ease, Yellen is forced by a misguided need to maintain credibility to stick to her story. No central bank would ever outright admit a mistake. But at this time Yellen can't even hint that she would reverse "liftoff" or deeply question the mistaken logic that led to it. All we heard yesterday was what markets have known for a long time, having priced out any further hikes this year – that the present market turbulence will keep the Fed on the sidelines so long as it lasts.
- We are not advocating the move to negative rates that Europe and Japan are trying. But Yellen's views on the topic do not convey a sense of confident leadership of a institution that will do "whatever it takes." Yesterday she dithered about whether or not the Fed even has the legal authority to impose negative rates. Really? After years in which she could have studied the matter, while other major central banks implement it, she doesn't even know that?
- *We're seeing the worst traits in Yellen, those that we initially feared when she was first confirmed as Chair – she's simply not a leader* (see "Yellen and Screamin' at the Fed" December 5, 2013).
- To be sure, it's constructive for Yellen to finally acknowledge the key mechanism for the first-ever recession caused by too-low oil prices, which we pointed out almost a year ago (see "Houston, You're the Problem" March 9, 2015). She testified yesterday, "strong supply conditions and high inventories, contributed to the recent fall in the prices of oil" which "could trigger financial stresses in commodity-exporting economies, particularly in vulnerable emerging market economies, and for commodity-producing firms in many countries."

US corporate bonds: spread to Treasuries



Source: BAML, Moody's, TrendMacro calculations

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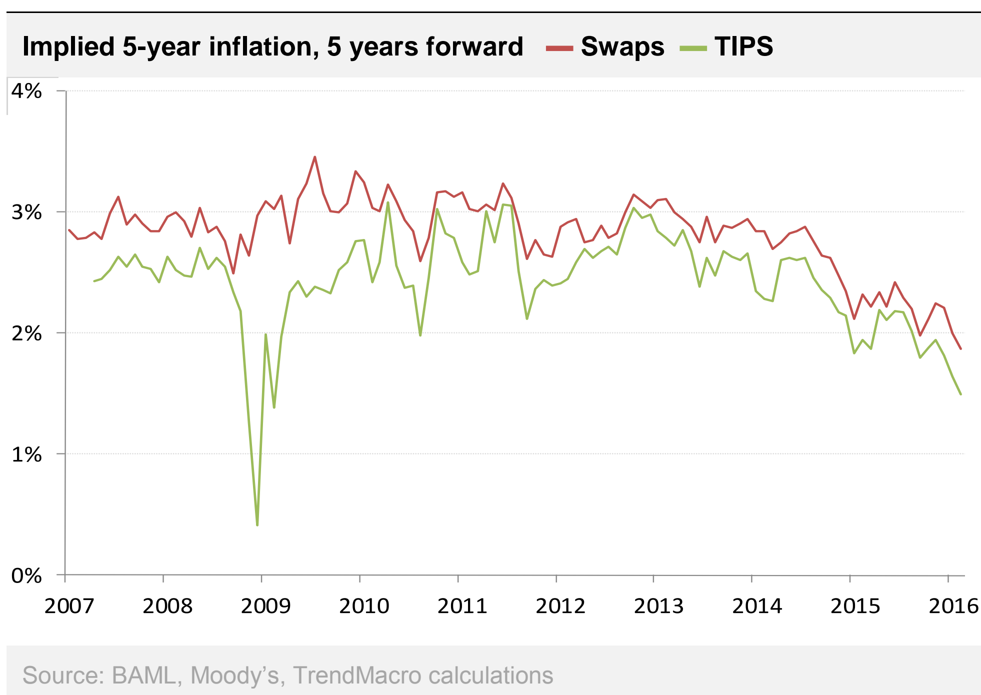
Recommended Reading

Donald Trump supporters think about morality differently than other voters. Here's how.
Emily Ekins and Jonathan Haidt
Vox
February 5, 2016

[Reading home]

- *“Could”?* One glance at US corporate spreads (please see the chart on the previous page) – or for that matter bank stock prices world-wide – shows that this is no mere maybe. *It’s happening right now.*
- *And Yellen’s observation evades the critical fact that her own “liftoff” error contributed to these stresses. It may have only been a quarter-point, but in an already credit-constrained situation, it makes matters worse for the Fed to pay banks twice as much interest on excess reserves – that is, to double the incentive to not lend money.*
- *It’s no real relief that markets have priced out further rate hikes this year, and expect less than one over three years. Markets believe – probably correctly – that the Fed won’t make its error worse so long as the present market turbulence persists. But ultimately this is a dead-end. The turbulence will persist if markets know that the Fed will just start erring again as soon as the turbulence stops.*
- The problem is that the Fed remains under the sway of the Phillips Curve concept that a low unemployment rate will cause inflation. This cause-and-effect relationship is demonstrably non-existent (see "One Small Step -- In the Wrong Direction" November 23, 2015). The concept is especially absurd in the present environment in which the unemployment rate isn’t even a sufficient statistic to capture the degree of slack in the labor market, as Yellen herself has said many times including in her testimony yesterday.
- *Yet despite these manifest fallacies, adherence to the Phillips Curve pre-programs the Fed to choke off growth so long as market turbulence doesn’t intervene to stop it – even when there is no growth to choke off.*
- The reality is that with the unemployment rate nominally at 4.9% (see “On the January Jobs Report” February 5, 2016), inflation expectations are at all-time lows (please see the chart below).

Implied 5-year inflation, 5 years forward



Source: BAML, Moody’s, TrendMacro calculations

- Yesterday Yellen said correctly that “market-based measures of inflation compensation have moved down to historically low levels”. This is the Fed’s strongest acknowledgement yet of this gathering threat to price stability.
- And Yellen admitted that “inflation expectations play an important role in the inflation process,” and that “the inflation outlook depends importantly on the degree to which longer-run inflation expectations remain well anchored.” But then she explained away the evidence that expectations are not well-anchored, arguing that “changes in risk and liquidity premiums over the past year and a half contributed significantly to these declines.” That’s possibly true to some extent for TIPS, but it shouldn’t be a factor at all in swaps.
- Even granting Yellen’s argument, at best it would mean that this market-based evidence is not pointing to a *deflation* threat. But that wasn’t at issue. *What’s at issue is whether there is any evidence – other than the 4.9% unemployment rate and the Phillips Curve, which are no evidence at all, but merely a theory, a theory based on an inadequate statistic – that there is any inflation threat worth hiking rates into the teeth of a recession.*

Again, it’s out of the question that the Fed would ever admit that “liftoff” was a mistake. It would be ideal if it would, but it doesn’t have to in order to reverse course. We hate to disagree with Goldman Sachs, but we think the this hiking cycle is going to one-and-reverse, as we first said early last December (see "On the November Jobs Report" December 4, 2015).

- We are gratified to see gold rallying sharply during this time of panic. It signifies to us that, by hook or by crook, liquidity conditions will be made adequate to meet the exigencies of the moment.
- In a liquidity crisis such as the one we faced after Lehman failed in September 2008, and the US Congress, the Treasury and the Fed flailed with legislating and implanting the Troubled Asset Relief Program (TARP), gold prices fell sharply along with prices of all other risky assets. But then gold was the first to recover, bottoming in late October when the Fed announced its program to backstop money market funds.
- We are also encouraged by the otherwise disturbing reality that a most interesting and risky presidential election is coming up (see “Trumped!” December 14, 2015).
- Based on our election model – which correctly predicted in real-time Obama’s election, and predicted the spread in the Electoral College within a mere 4 points – is now saying that the GOP candidate will win in November by 117 Electoral College votes (see "On the 2012 Election" November 7, 2012), based on today’s economic variables.
- Those variables are all likely to be weaker by election day, moving the model further toward the GOP.
- *This recession is going to get worse before it gets better – especially if Yellen doesn’t change course. This is Yellen’s chance to make America great again, before someone else does.*

Bottom line

"Liftoff" stands revealed as a mistake. With the oil price lower than we expected, financial stresses are stronger than we expected, interacting with new regulations in Europe to destabilize already fragile banks. As expected, stocks have probed below their August lows, and are now trying to make a stand at the lower October 2014 lows. The equity risk premium is above the crisis-era mean, making stocks relatively attractive here, but betraying the whiff of fear. Yellen's testimony yesterday made matters worse. Not even knowing the Fed's legal footing to implement negative rates, Yellen is showing poor leadership – an inability to comfort markets that she will do "whatever it takes." She comprehends the risks we face, but clings to the flawed logic that led to the "liftoff" error. With an election coming up, and with deepening recession likely to throw it to the GOP, Yellen may be forced to change course.