Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
Thomas Demas, Managing Director
Michael Warren, Energy Strategist

FED SHADOW

For the Fed, Wrong is Better than Stupid

Tuesday, May 31, 2016

Donald Luskin

We still say no rate hike. If there is one, at least this time it won't fly in the face of recession.

With the fullness of time, we've come to rethink the alarmist position we took eleven days ago when we said "markets will unravel" if the Fed proceeds with rate hikes this year (see "Is the Fed Stuck on Stupid?" May 20, 2016). That said, we don't think the Fed *should* do it, and we can't quite bring ourselves to believe it *would* do it. But we can't ignore the reality that the Fed's Harker, Bullard, Powell and now even Chair Janet Yellen have joined the mighty chorus chanting that it *will* do it. And neither can we ignore the reality that, for all that threatening noise, markets haven't particularly reacted.

- *The key here is to understand the confluence of events that came together after the Fed's December liftoff to create a harrowing January and February for global markets. It wasn't liftoff alone that did it. It was the confluence.*
- By December, we were already into the first couple months of what was shaping up to be the first-ever recession caused by too-low oil prices (see "The Recession Caused by Low Oil Prices" January 8, 2016). As it turned out, though, the double-bottom in oil in January and February, and oil's subsequent rapid recovery, ruled out a full-on recession (see "Have We Suffered Enough?" February 26, 2016). All we had was a mini-recession.
- *The mistake of the Fed's December liftoff – the element that created the confluence that was so dangerous for markets – was to recklessly hike rates in the face of visibly deteriorating macro data.*
- *That is not the case today – the global macro environment is improving. Then, the Fed was stupid. Today, it is just wrong.*

What made the Fed spectacularly stupid in December was that it damaged its credibility by lying to the markets – and itself.

- In the October FOMC statement, the Fed made the rosy claim that "economic activity has been expanding at a moderate pace." We showed that the evidence presented for that was "a pack of lies" (see "On the October FOMC" October 28, 2015). The FOMC repeated it *verbatim* in December at liftoff, and we called them on it again (see "On the December FOMC" December 16, 2015).
- The Fed even called *itself* on it in the January FOMC statement, admitting that "economic growth slowed late last year."

Update to strategic view

US FED, US MACRO, US STOCKS, US BONDS, FX: Yellen joins the rate-hike chorus, saying "in the coming months…a move would be appropriate," but that the Fed would proceed "gradually and cautiously." Considering that the most recent FOMC statement said "growth in economic activity appears to have slowed," this is an epic flip-flop. We still don't think there will be a hike at least until December, with "cautiously" ruling the day. If the Fed does hike, we take back our over-excited call for markets to "unravel." At December liftoff, the economy was visibly falling into recession, and the Fed was lying about it. This time the economy is accelerating out of what turned out to be a mini-recession, so a hike will be unhelpful, but less deleterious than last time. Accelerating earnings give stocks scope to rally, and long-term yields should stay low, with the Fed's saber-rattling only adding to deflationary expectations. Rising oil prices should keep USD from getting too strong.

[Strategy dashboard]

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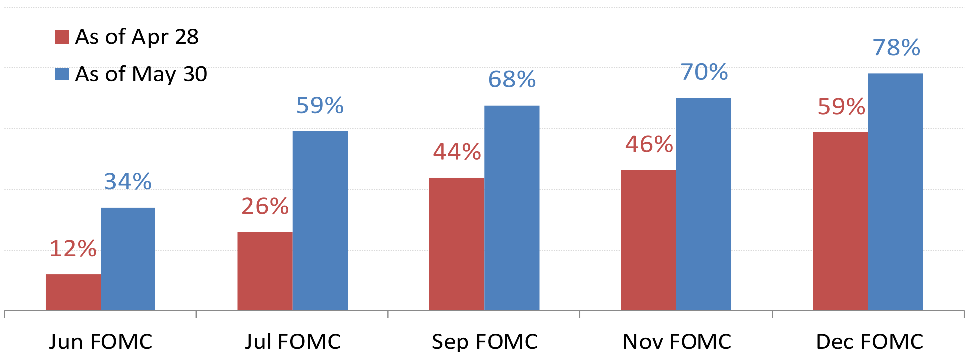
- Then in the March FOMC statement, the lie came back *verbatim* as the economy obviously weakened: "economic activity has been expanding at a moderate pace."
- Then, suddenly, some truth. In the April FOMC statement, "growth in economic activity appears to have slowed."
- *Now lies have given way to sheer surrealism.* The minutes of that very same April FOMC meeting said that "participants generally saw…leaving open the possibility of an increase in the federal funds rate at the June FOMC meeting." And that started the present rate-hike chorus.
- *This is an epic flip-flop. An FOMC statement that says "growth in economic activity appears to have slowed" produces minutes that warn of a rate hike at the very next meeting.*
- *Between the April FOMC statement and now, markets that had ruled out a July hike give it the same probability as it had previously not expected until December* (please see the chart below).

Futures-implied probability of rate hike, from after April FOMC to now



Source: Bloomberg, TrendMacro calculations

To put it kindly, the Yellen Fed has emerged fully – as we predicted at the very beginning (see "Yellen and Screamin' at the Fed" December 5, 2013) – as an extremely poor communicator. But what they're saying now isn't wrong: the economy *is* strengthening.

- *If the Fed does hike rates, it will be a very different event than liftoff in December. Then, the economy was heading into recession. Now, the economy is coming out of a narrowly-avoided recession.*
- *Then, the rate hike was an error of direction. Now, another would be an error only of magnitude. Still an error, but an error of a different order.*
- Let's look one-by-one at the economic variables that the Fed seems to consider.
- We'll know more about the labor market on Friday. Last month's April jobs report was terrible (see "On the April Jobs Report" May 6, 2016). Unless it is perks up considerably on Friday, that alone will stay the Fed's hand for at least a meeting or two.
- Business investment looks just awful. Non-defense cap goods (ex-aircraft) is down now three months running (see "Data Insights: A Few of Our Favorite Things" May 26, 2016).

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

Michael Warren
Houston TX
713 893 1377
mike@trendmacro.energy

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Trends in oil supply and demand
James Hamilton
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July 29, 2016

Bridgewater secures $22m in state aid
Mary Childs
Financial Times
May 28, 2016

Neoliberalism: Oversold?
Jonathan D. Ostry, Prakash Loungani and Davide Furceri
IMF Finance & Development
June 2016

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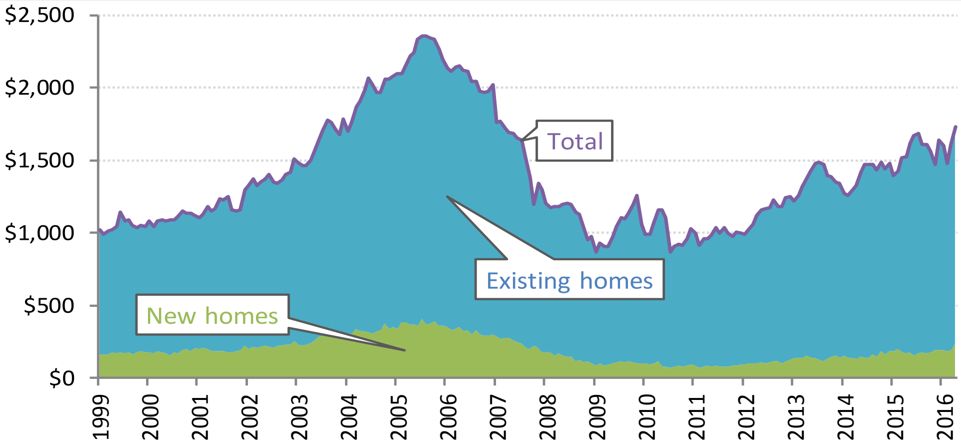
- Housing looks bright. TrendMacro's Housing Transaction Value Index has now moved to new cycle highs, preserving a multi-year uptrend (please see the chart below).

TrendMacro Housing Transaction Value Index USD billions



Source: TrendMacro calculations

- Consumer spending looks okay, with retail sales ex-autos accelerating monotonically across all of the last three months.
- Exports look okay, too, rising across both of the last two months.

All that said, as we try to make sense of the Fed's confused and inconsistent signals, we still think that the Fed won't actually hike rates again this year, at least not until after the presidential election.

- Yes, we heard Yellen say in last Friday's interview at Harvard with Greg Mankiw that "in the coming months…a move would be appropriate."
- But she characterized that "move" as part of a strategy of proceeding "gradually and cautiously."
- This is consistent with her attitude at the end of March when she got so scared she had to enshrine "uncertainty" as part of her decision framework (see "Yellen Adds 'Uncertainty'" March 30, 2016).
- Yellen was chastised by the market's behavior following liftoff. One doesn't forget such a thing. Now when crunch-time comes and she actually has to put her signature on a second rate-hike, she will err on the side of caution.
- We were delighted Friday to hear Yellen put to rest one popular rationale for hiking rates – that higher rates would offer scope for future cuts in the event of a recession. We've never seen the logic there – and we're delighted to say, neither does Yellen. As she explained it Friday to Mankiw, because the terminal rate in any imaginable hiking regime would be quite low, "if we were to raise interest rates too steeply and we were to trigger a downturn, or contribute to a downturn, we have limited scope for responding." Indeed, Yellen went on to say this is "an important reason for caution."

Recommended Reading

[continued from prior page]

Reaganomics Band Gets Back Together to Advise Trump on Plan
Jesse Hamilton and Michelle Jamrisko
Bloomberg Politics
May 26, 2016

How I Acted Like A Pundit And Screwed Up On Donald Trump
Nate Silver
FiveThirtyEight
May 16, 2016

Office of the Secretary: Evaluation of Email Records Management and Cybersecurity Requirements
Office of Evaluations and Special Projects
Office of Inspector General, US Department of State
May 2016

What the hell is going on?
Tyler Cowen
Marginal Revolution
May 25, 2016

[Reading home]

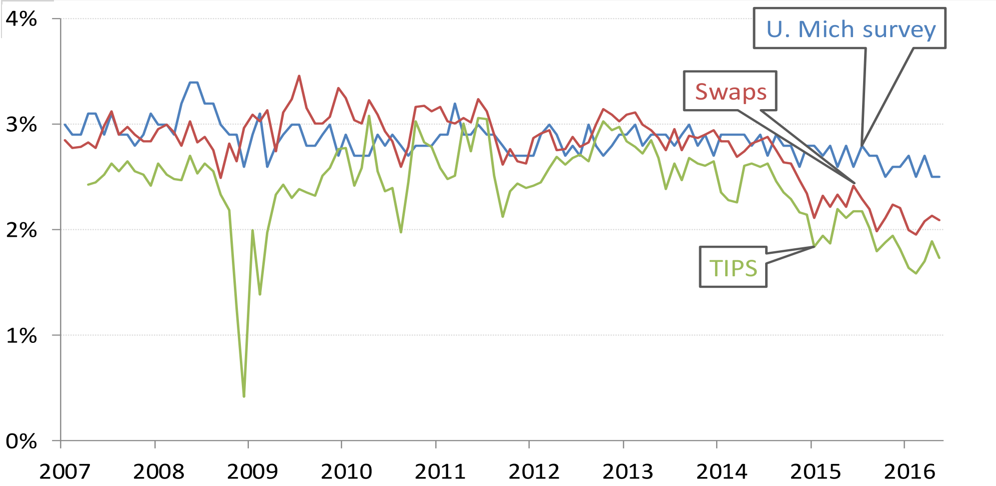
- Further supporting the idea that caution rules the day at the highest levels of the Fed, we note Governor Jerome Powell's remarks that the "easing in global financial conditions since mid-February and the associated waning in downside risks…in part reflect expectations that the FOMC would move more slowly in removing monetary accommodation."
- While we identify the oil price as the key variable determining the macro environment now, Powell is arguing here that the Fed is *itself* in that position. That is, the recovery since the first quarter is due to the Fed backing off its hawkishness post-liftoff. From that position, caution for the Fed is surely the primary consideration.

If there is so much need for caution, then there would have to be some very strong reason to overcome that caution. Otherwise the Fed shouldn't and won't dare to move. *What actually would make the Fed even consider hiking rates in the first place? Nothing.*

- It seems to us that the wish for higher rates – at least, the wish among those who have that wish – relates in some general way to an idealized notion of "normal." The narrative seems to be that since the crisis era is over, and the economy seems to have settled into a fairly "normal" configuration of unemployment and inflation, shouldn't we have "normal" interest rates?
- Such thinking implicitly underlies "policy rules" such as the Taylor Rule. If followed literally, a canonical version of the Taylor Rule now calls for a funds rate of 3.8%. That is based on calibrating the funds rate to the economic environment of the 1980s and 1990s, and imagining that somehow it is a permanent "normal." But why should that be so? Does, say, 5% unemployment in 2016 mean the same thing as 5% employment did in 1998?
- *We think it makes more sense to follow the century-old rule of Knut Wicksell, which Vice Chair Stanley Fischer quoted in a speech earlier this month. To paraphrase, when your macroeconomic objectives are where you want them, don't change the policy that got you that happy result.*
- As we keep saying, unemployment and core inflation are very close to meeting the Fed's dual mandate (see, for example, "On the April FOMC" April 27, 2016). *Just what about perfection isn't good enough for the Fed?*
- To the extent that data deviate from perfection, they do so in the direction that would call for cutting rates, not hiking them.
- There is nothing in long-term market-based or survey-based inflation expectations that calls for a pre-emptive hike. Quite the contrary. At virtually their lowest levels in the history of the data, they too call for cutting rates, not hiking them (please see the chart on the following page, and "Data Insights: US CPI/PPI" May 17, 2016).

Hiking rates now would be a mistake. There is no reason for it. But at least the economy isn't weakening like it was at liftoff in December – it is strengthening. So a hike later this year would be only a small mistake, and

Long-term steady-state inflation expectations

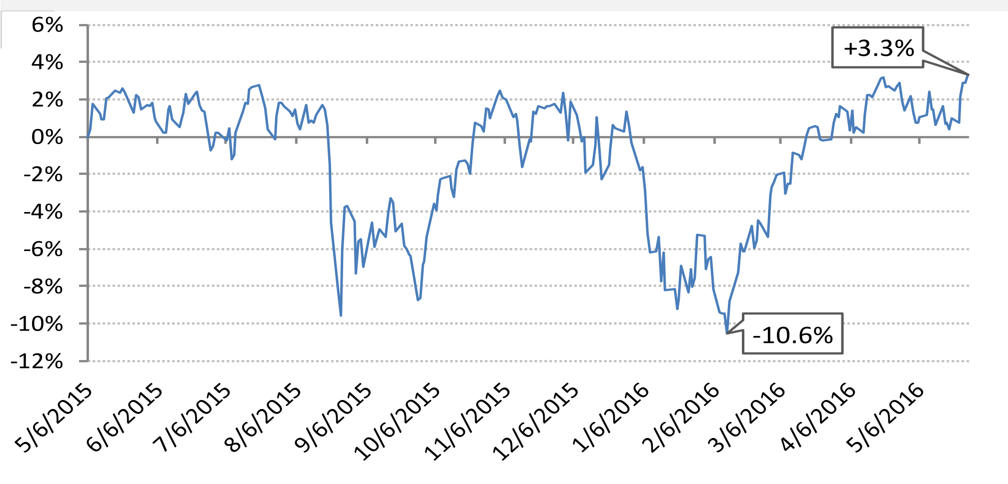


Source: Bloomberg, TrendMacro calculations

under the doctrine of "caution," a mistake not likely to be quickly compounded by repeated action.

- *So unless the Fed does something utterly insane, utterly unexpected – like hiking at the very next FOMC meeting in June, when even for all the hawkish Fedspeak the fed funds futures aren't pricing it in – we take back our over-excited call for markets to "unravel."*
- But a policy error is still a policy error. Markets may not "unravel," but a rate hike when none is called for won't be helpful.
- US stocks are now 3.3% higher (on a total return basis) than when Yellen said on May 6, 2015 "equity market valuations at this point generally are quite high" (please see the chart below).
- But we don't think the "valuations" she highlighted are what led to

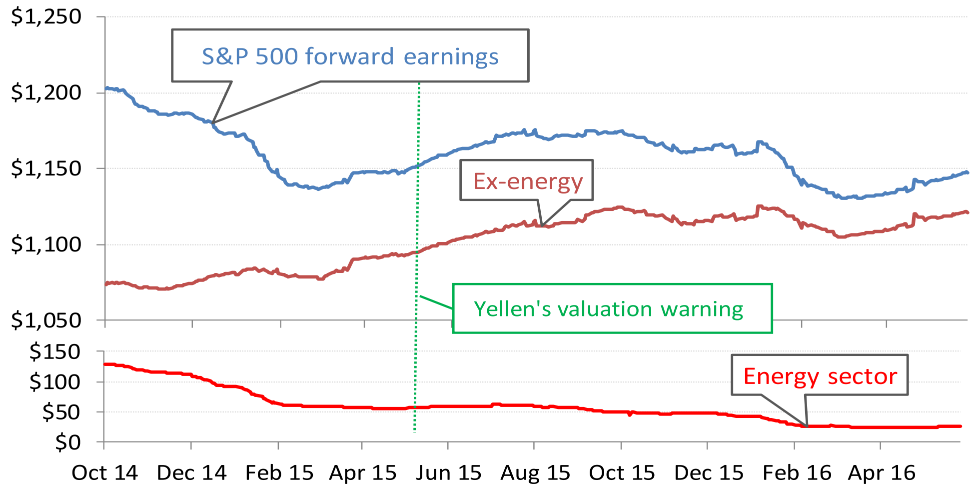
S&P 500 cumulative total return since Yellen's valuation warning



Source: Bloomberg, TrendMacro calculations such a lackluster performance-year. After all, over the same period, the “FANG” portfolio of Facebook, Amazon, Netflix and Google – nobody’s idea of a *value* portfolio – is up 50.1%, now at all-time highs.

- The problem for stocks has been that forward earnings have stagnated – falling 34 basis points since Yellen’s “valuation” warning. 34 bp isn’t a big drop, but any drop at all is extremely unusual unless the economy is in recession. Indeed, the rollover in forward earnings that actually began all the way back in October 2014 was our first and most important clue leading us to worry about the first-ever recession caused by too-low oil prices (please see the chart below, and among others, "Houston, You're the Problem" March 9, 2015).

S&P 500 consensus forward earnings USD billions



Source: Bloomberg, TrendMacro calculations

- More than all of the drop in forward earnings is due to the energy sector, where earnings have fallen 53.7% since Yellen’s warning. Excluding energy, forward earnings have grown by 2.4% over the same period, so it hasn’t entirely been a “lost year.” But close to that, and again, virtually unheard of outside a recession.
- Overall, valuations seen through the lens of the S&P 500 equity risk premium haven’t changed much. The ERP has widened by 35 bp, making stocks slightly more attractive relative to long-term Treasuries – with most of that improvement coming from the fall in 30-year yields of 33 bp.
- *From here, while – again – it is unhelpful for the Fed to hike rates (especially for no good reason), we are now coming out of that earnings bald-spot and the mini-recession of Q4-15 and Q1-16 with some real momentum.* As oil prices have recovered, energy sector forward earnings are up 12.7% from their bottom just over a month ago. Overall, over the last month, S&P 500 forward earnings are growing at a 12% annual rate.
- *As long as long-term Treasury yields stay low, that earnings resurgence should be enough to produce a pretty decent year for*

US stocks.

- *Will yields stay low, despite the Fed's seemingly more hawkish intentions? Yes – because the mistake the Fed may make here will keep already-depressed inflation expectations lower than they already are* (again, please see the chart on page 4)*. Those expectations are, in the end, pretty much all that matters for long-term yields.*
- Of particular concern is the dollar, which has strengthened over this recent period of resurgent Fed hawkishness. USD strength is especially unhelpful to China, which – thanks to extreme USD strength when oil crashed starting in mid-2014 (see "Dollar Strength: A Crude Connection" April 23, 2015) – is saddled with a severely overvalued currency in relation to all its non-US trading partners (see "On the RMB Devaluation" August 11, 2015).
- One reason why the global economy – led by emerging markets – has stabilized since oil double-bottomed in February is that pressure from a too-strong USD was significantly lessened (see "Yuan Direction" February 16, 2016).
- We think that oil will generally move higher for the rest of 2016 (see "How High Can Oil Go?" May 10, 2016), and that will keep USD from strengthening as much as it might otherwise, given the error the Fed seems to want to make.
- All that said, provided that the Fed moves "gradually and cautiously" – which we still think means no move at all this year, at least until December – markets won't have to labor under the extraordinary burden of a central bank that lies about the data in order to hike rates into an incipient recession. That's a central bank, as we said, stuck on stupid.
- No, this time, markets being cheered by rising oil prices – gaining relief from the credit stress, CAPEX collapse, and extreme USD strength that went with the oil crash – merely have to deal with a Fed that is stuck on good old fashioned wrong.

Bottom line

Yellen joins the rate-hike chorus, saying "in the coming months…a move would be appropriate," but that the Fed would proceed "gradually and cautiously." Considering that the most recent FOMC statement said "growth in economic activity appears to have slowed," this is an epic flip-flop. We still don't think there will be a hike at least until December, with "cautiously" ruling the day. If the Fed does hike, we take back our over-excited call for markets to "unravel." At December liftoff, the economy was visibly falling into recession, and the Fed was lying about it. This time the economy is accelerating out of what turned out to be a mini-recession, so a hike will be unhelpful, but less deleterious than last time. Accelerating earnings give stocks scope to rally, and long-term yields should stay low, with the Fed's saber-rattling only adding to deflationary expectations. Rising oil prices should keep USD from getting too strong.