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FED SHADOW

# QE Steps Down Before Bernanke Does?

Thursday, May 23, 2013

**Donald Luskin**

**His signal was unmistakable. But with deflation risk increasing, he can't follow through.**

We were practically alone, early in the year, when we said the Fed would start to prepare the market for the tapering of its large-scale asset purchases (LSAPs) as soon as this summer (see "2013 Outlook: Doves Ruled Out at the Fed" January 25, 2013). Our logic was simple. The downward path of the unemployment rate was strongly on-trend to hit the "Evans Rule" trigger-point of 6.5% in November 2014. And when the Rule was announced at the December FOMC, the statement said the trigger would come into play "a considerable time ***after*** the asset purchase program ends" [our emphasis]. *Q.E.D.*

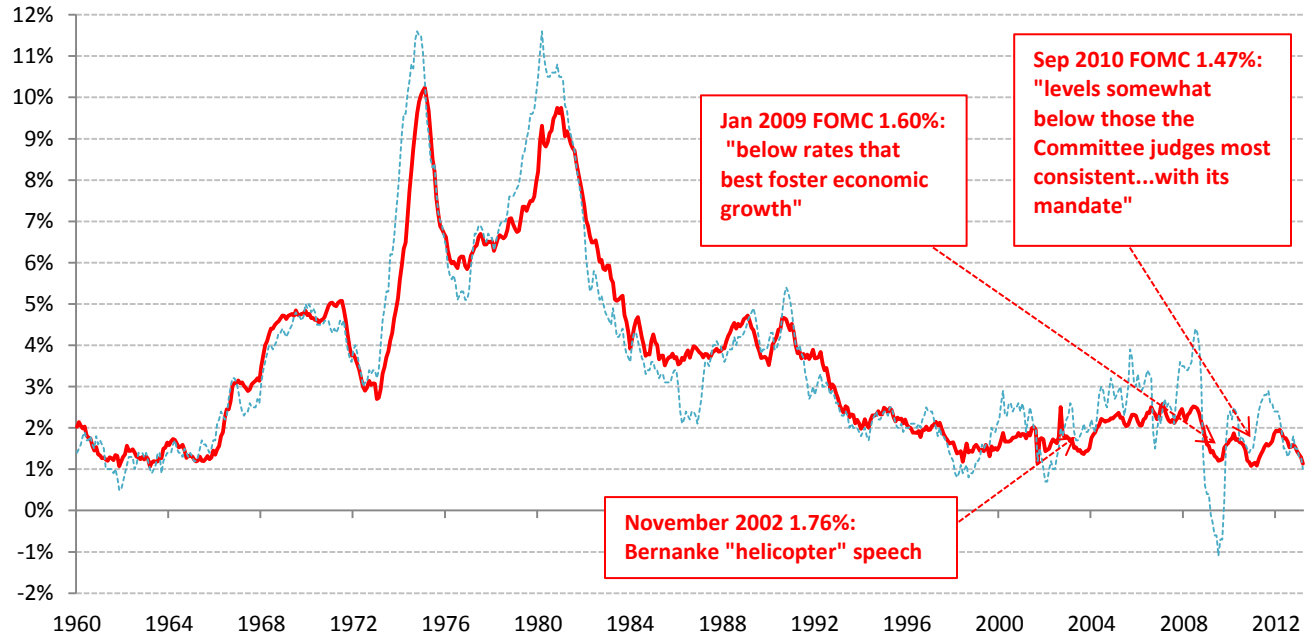
Since then, we changed our view. *Since then inflation has fallen sharply, here and around the world*. Core PCE inflation at 1.13% year-on-year is lower than at any of the three times over the last eleven years that the Fed justified easing programs based on fears of deflation (please see the chart below, and "Gold and Commodities: Breaking Bad" April 15, 2013). We

**Update to strategic view**

**US FED:** Bernanke's remarks to Congress yesterday that "in the next few meetings we could take a step down" in the size of monthly Fed bond purchases was an unmistakable signal, and exactly fulfills our expectation from early…

*[Continued on next page]*

**Personal consumption expenditures inflation, year-on-year** — **Core** ···· **Headline**



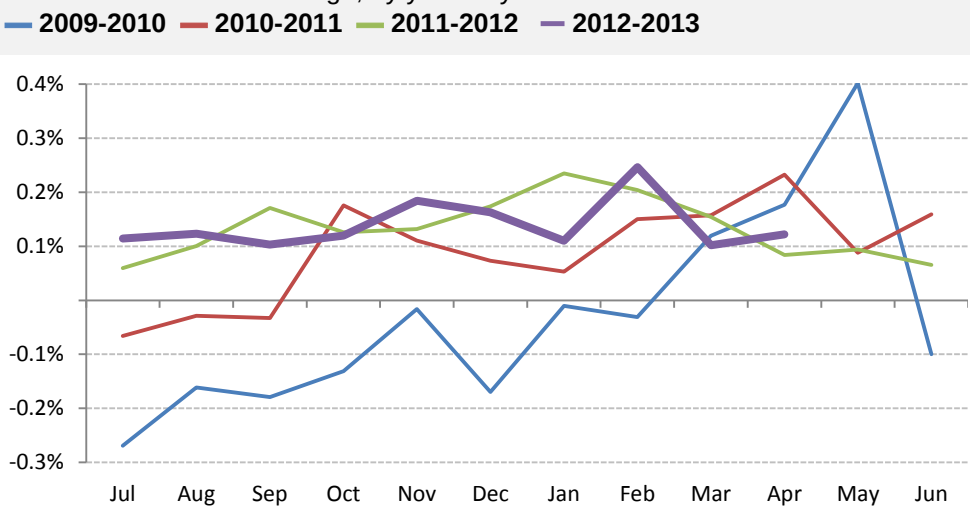

Source: BEA, TrendMacro calculations

just don't see how the Federal Reserve of inflation-targeting Depression historian Ben Bernanke could possibly become less easy with inflation at levels regarded over and over as deflationary, and still falling.

Which leaves us wondering why, oh why, in his question-and-answer session following his testimony before the Joint Economic Committee of Congress he said "in the next few meetings we could take a step down" in the size of monthly bond purchases.

- There's nothing absolutely dispositive there. He kept all his options open, as always. But even as a hypothetical, the specificity of it -- "in the next few meetings" -- was an unmistakable signal.
- We still don't believe it will happen.
- Nothing is likely to turn inflation back to the upside in time for "the next few meetings." Indeed, disappointing PMI manufacturing data from China today, which has thrown Asian markets into a sudden correction, points to a likely continuation of the secular trend of deflationary relief from demand pressure on commodities prices (again, see "Gold and Commodities: Breaking Bad").
- So versus Bernanke's target of 2% we'll still effectively be in *deflation* over "the next few meetings."
- In his prepared testimony Bernanke credited asset purchases with having kept "inflation from falling even further below the Committee's 2 percent longer-run objective." And he warned that "premature tightening of monetary policy could…carry a substantial risk of…causing inflation to fall further."
- In the end, we think the fear of deflation will be the trump card for Bernanke as it always has been.
- And so, too, with his likely successor as Fed chair, Janet Yellen, whose views on this will surely carry more weight at crunch-time than those of the regional Fed presidents from whom there has been a spate of statements recently to advocate tapering.

**Non-farm payrolls, sequential month growth rate**
From Great Recession trough, by year July to June




Source: BLS, TrendMacro calculations

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…in the year. But that expectation changed for us as inflation has lapsed into near-deflation. We have to take Bernanke at his word now -- but as inflation continues to fall further toward deflation, we don't see how he can follow through. At the same time, we see the jobs market being as weak as ever. Bernanke takes a rosier view -- but we don't see how it could be strong enough to trump the risk of deflation when the time comes.

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- Remember, Yellen is the one who, in February, strongly conditioned the Fed's Evans Rule to mean that "action is possible but not assured" when unemployment falls to 6.5%. Her argument was that if inflation were too low at the time, the Fed would not tighten. The same logic, for her, should apply to the decision of when to taper asset purchases.

Besides, it's not as though the employment situation -- the other half of the Fed's mandate -- is improving so much that it calls for any diminution of easing.

- To be sure, Bernanke himself repeated in his prepared testimony a deceptively rosy statistic about jobs we hear often now: "gains in total nonfarm payroll employment have averaged more than 200,000 jobs per month over the past six months, compared with average monthly gains of less than 140,000 during the prior six months."
- But the reality is that net payroll growth is no different now than it has been in the prior two years of this Not So Great Expansion following the Great Recession. Indeed, to the extent that it is different at all, it is worse (please see the chart on the previous page).
- When push comes to shove, as Bernanke prepares to ride off into the sunset, he'll be facing the reality of a weak jobs market -- *and deflation.*

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**Bottom line**

Bernanke's remarks to Congress yesterday that "in the next few meetings we could take a step down" in the size of monthly Fed bond purchases was an unmistakable signal, and exactly fulfills our expectation from early in the year. But that expectation changed for us as inflation has lapsed into near-deflation. We have to take Bernanke at his word now -- but as inflation continues to fall further toward deflation, we don't see how he can follow through. At the same time, we see the jobs market being as weak as ever. Bernanke takes a rosier view -- but we don't see how it could be strong enough to trump the risk of deflation when the time comes.