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FED SHADOW

To Taper or Not to Taper?

Monday, June 17, 2013

Donald Luskin

Rising Treasury yields may be saying the Fed doesn't need so much foam on the runway.

Fed Chair Ben Bernanke's unmistakable hint to Congress almost four weeks ago (see "QE Steps Down Before Bernanke Does?" May 23, 2013) and purported Fed-leaker Jon Hilsenrath's *Wall Street Journal* article ten days ago -- and the sharp global back up in bond yields -- make it seem pretty much a sure thing: the Fed will announce its intention to taper its Large-Scale Asset Purchases (LSAPs) at Wednesday's FOMC meeting.

We still have our doubts. Last January we predicted that exactly this would be the timing (see "2013 Outlook: Doves Ruled Out at the Fed" January 25, 2013). But we have since changed our minds. *Tell us why, oh dear God why, would the Fed back off now with core PCE inflation at the lowest rate in the history of the data, and the labor market looking no better than it has for the last three years* (see "On the May Jobs Report" June 7, 2013, and Hilsenrath's somewhat revisionist article this morning).

- Besides, even if Hilsenrath was right and the FOMC says on Wednesday that it is poised to taper, any statement is bound to be highly qualified. Bernanke's hint during Congressional Q-and-A was, too. He used the word "if" no less than five times when he spoke of tapering "in the next few meetings." So the FOMC may say it Wednesday, but the Fed may not end up doing it.
- Or perhaps the point of all the hinting and linking is to discipline the market -- to rein in speculative impulses that have perhaps become over-reliant on a presumed "Bernanke put."

Update to strategic view

US FED, US BONDS, US STOCKS: It seems the Fed is on track to overtly mention tapering QE at Wednesday's FOMC, but we think it makes little sense given low inflation and no acceleration in jobs growth. Either the Fed is attempting to discipline the market from over-reliance on the "Bernanke put," or perhaps the Fed is only ratifying the global back-up in government yields underway for the better part of a year, driven by the diminution of systemic threats that was the true purpose of QE3 in the first place. Taper or no taper, yields will likely drift higher, putting pressure on equity risk premia that have already mean-reverted around the world.

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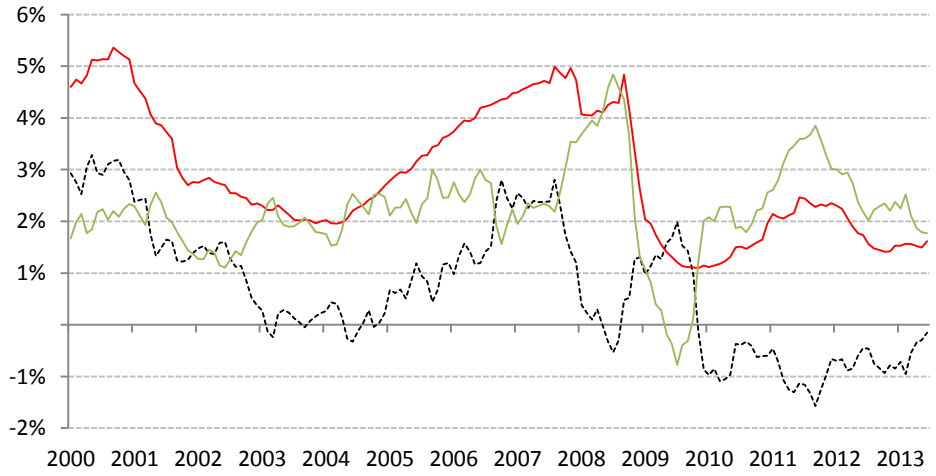
A tapir at "The Dawn of Man" from *2001: A Space Odyssey*

But let's take all the hints and leaks at face value. If the Fed *is* going to taper, let's try to understand *why would it do so, and what would it mean if it did?*

- We have always said that the true purpose of the present quantitative easing program was to create a great cushion of liquidity to protect against various systemic risks the Fed feared when it was announced last September (see "Rethinking QE3" September 18, 2012).
- At that time the FOMC was still saying that "strains in global financial markets continue to pose significant downside risks to the economic outlook." It was referring to the risks of a chaotic break-up of the euro currency, a real estate crash or other form of hard landing in China, and a bargaining failure in the year-end fiscal cliff. QE3 was intended as "foam on the runway" in case one of these risks eventuated -- but now all of them have receded to near-insignificance.
- *This is entirely consistent with our overarching theme for 2013: it will be the first year since the trough of the Great Recession in which markets won't have to worry about existential systemic risks* (see "Oh What a Relief It Is" January 23, 2013).
- That, in turn, is consistent with the mean-reversion of formerly lofty equity risk premia all over the world (see "What the ERP Isn't Telling Us" May 15, 2013).
- And it is consistent with the back-up this year in interest rates and bond yields all over the world, as investors have begun to assign lower value to safe-haven asset classes (please see the chart below, and "Data Insights: Global Real Rates" June 12, 2013).

···· Global 90-day real rates — Nominal interbank rates — YOY inflation
US, EA, Japan, UK, Brazil, India and China weighted by nominal USD GDP



Source: Various, TrendMacro calculations

- In other words, we don't need the prospect of tapering to explain the back-up in yields. *Indeed, the back-up in yields explains the prospect of tapering.*

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Shinzō Abe
June 5, 2013

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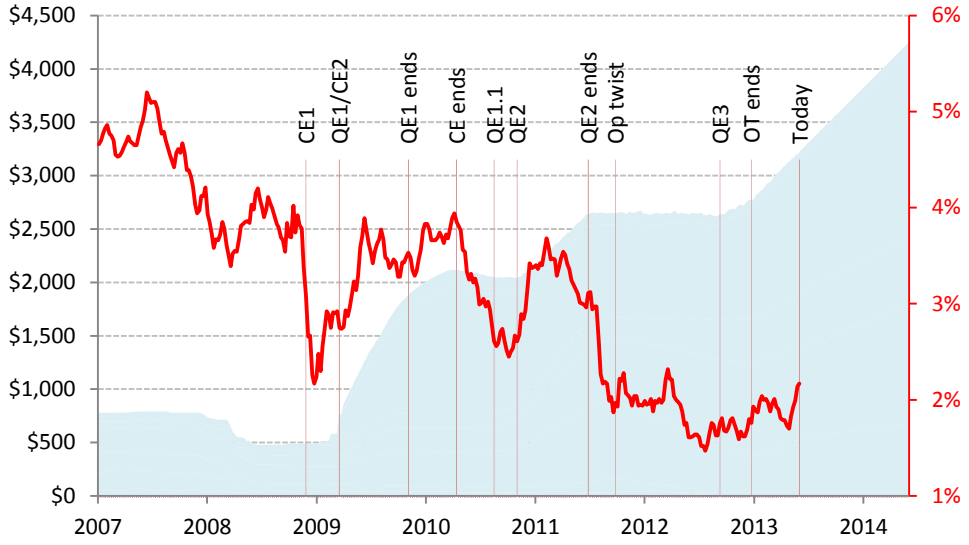
- Remember, the US 10-year yield bottomed about a year ago, three months *before* QE3 was announced, and has been gently trending *higher* ever since. Since we cannot say that QE3 *lowered* the 10-year yield, we can't believe that the prospect of diminishing it would *raise* the 10-year yield.
- That contradicts a pattern established over the almost four and a half years of Fed QE. So far, yields have *fallen* every time the Fed has *stopped* LSAPs, and *risen* every time the Fed has *begun* LSAPs (please see the chart below).

US 10-year yield
Fed Treasury, agency and MBS USD bil, with *status quo* 1-year projection



Source: Federal Reserve, Bloomberg, TrendMacro calculations

- In our view, despite the casual claims by central bankers around the world, successful LSAPs *raise* the yields of government bonds they buy, because they increase inflation and growth expectations and reduce systemic risk. When yields fell in the past, upon the termination of LSAPs, it indicated that those LSAPs had not been sufficient.
- Now, government bond yields rising globally even as the Fed hints at exit from QE suggests that this time the Fed has done enough.
- What does "enough" mean, with inflation falling to levels once deemed deflationary, and no acceleration in labor market recovery? Perhaps, in this context, "enough" just means "the best we could do." In other words, at this point, all the Fed could do was put "foam on the runway" to absorb the shocks of potential systemic risks. We might even wonder whether the fact that it did so starting last September was a factor in preventing those risks from eventuating to begin with.

This way of thinking about the interaction of Treasury yields and Fed expectations puts at least a somewhat friendly face on the prospect of yields moving higher still.

- By our dead reckoning, the drop in global equity market volatility in this less-risky year justifies a US 10-year yield in the low 3's and a 30-year in the mid-4's.
- We don't see that as especially alarming. Such yields prevailed for most of the first two years of the present business cycle expansion -- the better two years.
- To be sure, higher yields will put pressure on the equity risk premium. In other words, high yields will offer stronger competition than lower yields for the earnings yield of stocks. It would be nice to think that a less-risky global economy driving higher yields would also drive higher earnings. But unless earnings yields rise *more* than Treasury yields, equity valuations would have to suffer.
- At the same time, exit from LSAPs would diminish the power of what Bernanke calls the "portfolio balance channel" -- the Fed's pushing investors into higher-risk asset classes such as equities and non-investment grade credits (see "Is the Fed Moving the Stock Market?" March 11, 2013).
- But unless the Fed starts actually *selling* assets, this effect would only be a deceleration, not a reversal, of the Fed's enablement of investor risk-bearing. So while it disempowers the Fed-based bull case for stocks and other risky assets, it is not a bear case.

The dark side of the Fed's talk about tapering is the risk arising from its seeming obliviousness to the threat of deflation. Again, core inflation is now at the lowest level in the history of the data -- so it is lower than all the times over the last eleven years that Bernanke used it as the reason for launching easing programs.

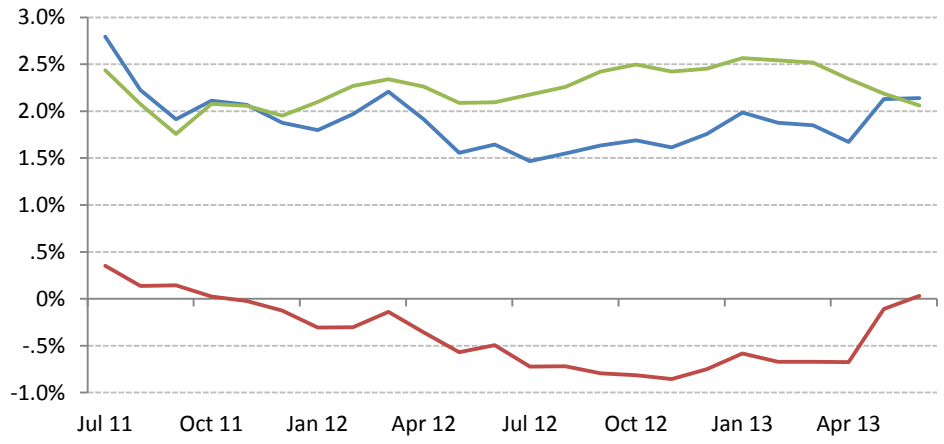
- We're still true believers in the basic premise underlying Bernanke's notorious "helicopter speech" in November 2002 -- that deflation is an economic cancer far worse than inflation, to be prevented at all costs.
- *Why has Bernanke given up the fight?*
- Perhaps he simply doesn't believe the reported numbers. He's not alone -- it's a rare client meeting in which someone doesn't say that the low inflation reported in official statistics is grossly at variance with daily experience.
- Bernanke has special reason to be skeptical. In a 2010 speech defending the Fed against charges that it caused the housing bubble by holding rates too low for too long starting in 2003, Bernanke admits

> …that core PCE inflation for 2003 was initially reported, in the first quarter of 2004, as having slowed to about 1 percent, and it appeared to be on a steep downward trajectory. These data heightened concerns about deflation on the FOMC. In contrast, the CPI data released at the same time showed core inflation for 2003 of about 2 percent. In this case, data revisions ultimately raised estimates of PCE inflation for that period [to 1.5%], implying that deflation was less of a risk than was thought at the

time. But that such revisions would occur could not be known in advance, and policy decisions, of course, must be made based on the information available at the time.

- Today, while core PCE inflation is running at 1.05% year-on-year, core CPI inflation is running at a far less alarming 1.7%. Though the Fed has always preferred the PCE measure, its entirely possible that Bernanke is betting that it's wrong again this time.
- Treasury markets don't seem to be panicking about Bernanke getting this wrong. If *deflation* expectations were getting embedded, we'd surely see *lower* yields, not *higher*.
- Yet *inflation* expectations are clearly falling. The 10-year TIPS breakeven is down 55 bp from the highs of the first quarter, while the 10-year TIPS yield -- a proxy for real yields -- has risen 82 bp, moving into positive territory for the first time in one and half years (please see the chart below).

US 10-year yield **TIPS** **Nominal** **Breakeven**



Source: Bloomberg, TrendMacro calculations

- We think the greatest threat to the Fed following through on its hints to taper LSAPs will be if core CPI inflation moves lower over the coming months toward the levels now seen in PCE inflation. There's nothing to do there but wait and see.

Bottom line

It seems the Fed is on track to overtly mention tapering QE at Wednesday's FOMC, but we think it makes little sense given low inflation and no acceleration in jobs growth. Either the Fed is attempting to discipline the market from over-reliance on the "Bernanke put," or perhaps the Fed is only ratifying the global back-up in government yields underway for the better part of a year, driven by the diminution of systemic threats that was the true purpose of QE3 in the first place. Taper or no taper, yields will likely drift higher, putting pressure on equity risk premia that have already mean-reverted around the world.