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FED SHADOW

Bernanke's Deathbed Confession

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Donald Luskin

As he ponders his legacy, he says don't worry about tapering: QE never mattered anyway.

It felt like a valediction after "quite a long time" at the Fed. And markets are interpreting Fed Chair Ben Bernanke's remarks yesterday following his speech at the National Bureau for Economic Research as an extravagantly dovish recantation, supposedly reversing his warnings at the June FOMC press conference that Large-Scale Asset Purchases (LSAPs) would be tapered and terminated (see "On the June FOMC" June 19, 2013). We disagree. His remarks yesterday change nothing.

- To be sure, in the context of the severe allergic reaction the markets have had to the prospect of tapering, yesterday's staging by Bernanke of obviously prearranged "questions" and "answers" must have been intended to be soothing.
- But in fact he said nothing of substance about policy yesterday that he didn't say at the press conference.
- *Indeed, we think that when we look closely at the arguments he adduced in order to soothe, we find an even more emphatic commitment to taper and terminate LSAPs.*
- There were two main threads in Bernanke's soothing narrative yesterday. The first was to repeat that even after LSAPs are terminated, policy will remain accomodative because the funds rate will likely remain very low, and wouldn't necessarily be hiked immediately just because the unemployment rate reached the 6.5% thresshold given in the so-called "Evans Rule." As he put it, "the issue has to do with not so much with the overall accommodation, but rather with the mix of instruments."
- Is the illogic of this not glaringly obvious?
- When the funds rate is stuck at the zero bound, there is in fact no choice in the "mix of instruments." Of necessity, at that point the only way to change policy is via LSAPs. When they are tapered or terminated, there is no way the funds rate -- already at zero -- can be reduced further to keep policy as accomodative as it was before.
- The second thread -- as though to make up for the obvious inadequacy of the first -- was to depreciate the importance of LSAPs. Gone is the aura of shock and awe that accompanied the introduction of LSAPs just nine months ago (see "On the September FOMC" September 13, 2012). Forgotten, apparently, are the arguments for LSAPs that Bernanke made in his infamous 2002 "helicopter speech" about lowering long-term interest rates

Update to strategic view

US FED, US STOCKS, US BONDS: Intended to soothe markets with dovish reassurances, Bernanke in fact yesterday made it even clearer that he is committed to tapering and terminating LSAPs. By arguing that policy will remain accommodative without them -- and that they never mattered anyway -- he is rationalizing their removal. We still think soft data will delay tapering. But either way, Bernanke has confessed the truth: today's celebration aside, the data show that LSAPs don't matter to bonds or to stocks.

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when short rates are stuck at zero, or at Jackson Hole last year about the "portfolio balance channel."

- No, yesterday LSAPs got demoted to "pretty small," and merely "providing some near-term momentum." It would seem that Bernanke is confessing, as he contemplates riding off into this history books, that LSAPs don't matter. That, in fact, is exactly what we've been arguing throughout this whole episode of taperphobia (see, most fully, "US Fixed Income Strategy: The Fed Irrelevancy Hypothesis" July 2, 2013).
- *The policy forecasting implcation is unambigous. If Bernanke is trying to persuade you that policy won't be any less accomodative without LSAPs -- and that LSAPs don't matter anyway -- then he's most definitely telling you that LSAPs are going away.*
- That is his message, loud and clear. But that doesn't mean it's really going to happen. As we've been saying repeatedy, we think the evolution of sluggish and deflationary macro data will militate against *any* steps that make policy any less accomodative (see, most recently, "Taper Your Tapering Expectations" June 27, 2013).
- And Bernanke, especially as he faces retirement, isn't the only decision-maker here. Indeed, the minutes of the June FOMC meeting released shortly before Bernanke's NBER speech, stated that "many members indicated that further improvement in the outlook for the labor market would be required before it would be appropriate to slow the pace of asset purchases."
- Further, the minutes stated "For one member, such a decision would also depend importantly on evidence that inflation was moving back toward the Committee's 2 percent objective."
- In fact, if we had to come up with anything at all that was newly dovish in Bernanke's remarks yesterday, it was his acknowledgement of this point -- which had been made in the FOMC by the president of the St. Louis Fed, whom Bernanke called "my good friend Jim Bullard." Bernanke admitted that "inflation is now about 1 percent, which is below our 2 percent objective." This deflation threat -- which Bullard has been highlighting stridently -- has been the linchpin of our argument against tapering, and it's good to hear Bernanke admit it's a legitimate policy constraint.
- But in the end perhaps it doesn't really matter to Bernanke now. The fact that inflation is so low, despite massive LSAPs, is just another argument that LSAPs are impotent policy tools at this point -- along with the empirical fact that LSAPs have no reliable impact on long-term rates.
- So that makes Bernanke right, if for the wrong reasons. If LSAPs are tapered, policy won't really be any less accommodative.
- We think bond yields will continue to drift higher because, in a world now with substantially reduced systemic risk, safe-haven assets are less valuable. They've been rising back to normal levels for the better part of a year -- before QE3, during QE3, and now that QE3 is expected to end -- because the level of systemic risk has returned to normal.
- Similarly, stocks probably won't do much from here tapering or no tapering. They are fully valued for the new lower level of systemic

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risk (see "Escape from Taperphobia" July 8, 2013) -- and stagnant forward earnings growth is doing nothing to replace what used to be a value case with a growth case.

Bottom line

Intended to soothe markets with dovish reassurances, Bernanke in fact yesterday made it even clearer that he is committed to tapering and terminating LSAPs. By arguing that policy will remain accommodative without them -- and that they never mattered anyway -- he is rationalizing their removal. We still think soft data will delay tapering. But either way, Bernanke has confessed the truth: today's celebration aside, LSAPs don't matter to bonds or to stocks.