THE CENTRAL BANK EASY MONEY GAME:
TAKING CREDIT, STRAINING CREDIBILITY
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Mr. Incredible (a famous crime-fighting superhero in Metroville) declares: "No matter how many times you save the world, it always manages to get back in jeopardy again. Sometimes I just want it to stay saved! You know, for a little bit? I feel like the maid: I just cleaned up this mess! Can we keep it clean…for ten minutes!" The 2004 film, "The Incredibles" (Brad Bird, director)

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OVERVIEW AND CONCLUSION

The Federal Reserve Board continues to stress via its wonderful forward guidance strategy that it will keep policy rates extremely low. However, the sustained rally in United States Treasury government yields shows that marketplace confidence in the Fed's ability to manage (repress) interest rates, especially at the long end of the yield curve, has fallen. Look at the UST 10 year note. Not only did its yield bottom around 1.38 percent on 7/25/12. Not only did yields climb further from lows near 1.55pc (11/16/12 and 12/6/12). They have spiked from 5/1/13's 1.61pc, touching 2.75pc 7/8/13. And this spike has continued even after the Fed underlined in recent weeks that it would not "taper" its money printing (and other easy money games) too quickly.

The S+P 500 advanced to a record summit of 1687 on 5/22/13. Yet it took only mild Fed talk in mid-June (remember Chairman Bernanke's 6/19/13 Press Conference after the Fed meeting in particular) about slowing its bond-buying bandwagon to help precipitate a sharp dive (close 1652 on 6/18/13). Keep in focus the Chinese central bank tightening (higher money market rates) in mid-June in this context. This recent slump in the S+P 500 (and many other stock marketplaces) underlines that the global economic recovery is no longer robust. Admittedly stocks have rebounded since then. But that bounce back occurred after the Fed and Chinese authorities quickly and substantially pulled back from (qualified significantly) their June warnings.

The European Central Bank and the Bank of England last week embarked on allegedly new easing measures. As these European shifts occurred not long after the Fed and Chinese backtracked, how strong is the worldwide recovery? And remember the precipitous dive in Japanese equities (Nikkei peak about 15945 on 5/23/13) despite "Abenomics" and the Bank of Japan's additional easing in early April 2013. Besides, emerging marketplace stocks not only tumbled since spring 2013, but have been in a bear trend since spring 2011 (Morgan Stanley's "MSCI Emerging Stock Markets Index" peaked 4/27/11 at 1212, 5/9/13 interim high 1065).

The ability of central bank maneuvers to sustain substantial economic growth (and repress government yields and rally the S+P 500 and related equities) probably has weakened.

Rising sovereign debt yields do not always reflect or portend economic growth (recovery) or higher stock marketplace prices. In the current marketplace playing field, rising interest rates in America (and elsewhere) also seem to be "leading" equity marketplace declines. Suppose the US government 10 year rate marches higher from current levels (or even if it stays relatively high versus its summer 2012 and May 2013 bottoms). Suppose the S+P 500 is unable to exceed (or break much above) its May 2013 height and that it declines beneath its late June 2013 low around 1560. The rising yields and falling equities will underscore that the easy money game of the Fed and its central banking allies increasingly strains credibility and thus has diminished substantially in its effectiveness.

TAKING CREDIT

Recall the most dangerous and fearsome periods of the worldwide economic disaster that erupted in 2007 and accelerated in 2008. Since that time, the Federal Reserve and other big league central banks indeed built monumental credibility for themselves via their incredible actions. The Federal Reserve Bank and its key central banking teammates surely congratulate themselves nowadays. The extraordinary and sustained highly accommodative policies of the Fed, European Central Bank, Bank of England, Bank of Japan, and Bank of China inspire noisy cheers from devoted fans on Main Street and Wall Street. The superheroic efforts of the Fed and its allies have not merely helped to rescue and support the financial (and banking) system in general. These glorious guardians (with noteworthy assistance from monumental deficit spending from the political players) also ignited and thus far generally have sustained a worldwide recovery. Admittedly, significant difficulties remain. For example, much of Europe is in or close to recession, and unemployment remains stubbornly high in Europe and the United States.

Focus on the American playground. Highly accommodative policies such as sustained ground floor interest rates (Federal Funds) and several rounds of mammoth money printing have played crucial parts in sparking economic growth and restoring consumer balance sheets. The tremendous rise in the S+P 500 from its 3/6/09 depth at 667 to its 5/22/13 summit at 1687 is a home run in this context. Stock owners (particularly investors) and their media friends joyously applauded. Corporate earnings soared. Owners (especially investors) of interest rate instruments prized the sustained decline in US government and many other yields. Debtors (borrowers) likewise praised yield declines and repression (even if creditors booed).

LATE IN THE GAME

"Looking out at the road rushing under my wheels…
I don't know where I'm running now, I'm just running on
Running on- running on empty
Running on- running blind
Running on- running into the sun
But I'm running behind…
Everyone I know, everywhere I go
People need some reason to believe…" Jackson Browne, "Running on Empty"

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The Federal Reserve Bank remains enthralled by its extremely accommodative monetary policy. It preaches that it remains devoted to its mandate. This marketplace guardian heralds that rock-bottom policy interest rates (Federal Funds) will persist. Its explosive money printing (quantitative easing; now in round QE3/QE4) of recent years may taper relatively soon, but such a slowdown does not constitute a reversal. Yet although this coach claims to possess an "exit strategy", at best this plan currently is a rather vague framework (fans of the Fed undoubtedly would label this prudent flexibility). Fed policy guidance indeed is amazing and awesome! Surely we all should have faith that this enlightened manager will know how to do what and when to benefit us all! Of course the mighty Fed will remain suitably vigilant, even into the late innings of the economic contest! Its charming wordplay regarding the merit of central bank communication in general and "forward guidance" in particular, like its exit strategy rhetoric, comforts many in the grandstands.

The revered all-star Bernanke pitched out one of his favorite phrases again in his 6/19/13 Press Conference. "However, any need to consider applying the brakes by raising short-term rates is still far in the future." But four years after spring 2009 and into the related recovery, why does the Fed show such dogged determination to repress yields and manipulate stock prices? They arguably are more terrified of very mediocre growth (or even a renewed downturn) than they dare confess. How long can it continue to fix the game?

Several big hitting Fed officials rushed to the plate and started talking on 6/27/13 to reduce fears of QE being cut back quickly (Dudley, President of NY Fed; Fed Governor Powell; Lockhart, President of the Atlanta Fed), only days after the 6/19/13 FOMC meeting and Bernanke's Press Conference (summarized in the NYTimes, 6/28/13, ppA1,3 and the Financial Times, 6/28/13, p1). The recent bottom in the S+P 500 was about 1560 on 6/24/13. The noble Fed definitely was scared quite quickly by the modest 7.5 percent slide in the S+P 500 from its May 2013 top at 1687. This hurried Fed rhetoric looks like a quest to prop up American stocks. It also targets the related and intertwined goal of sustaining confidence in the Fed's substantial ability to influence (and perhaps even manage) the economy.

Around 6/20/13, just after the Fed meeting, China's short-term money market rates dramatically spiked. Though the government probably encouraged the substantial rate jump, its extent and consequences apparently worried them. The Shanghai Composite and Hong Kong stock indices rapidly raced downhill; the Shanghai Composite established a new low in its long run bear voyage on 6/25/13 around 1850. Chinese policy makers reacted, though they often confided their aims indirectly through the media. They sought to talk the rate leap lower, with some success. They asserted that adequate liquidity existed. There was no widespread credit crunch, only a misallocation of funds- as in the shadow banking realm- was a problem (Financial Times, 6/24/13, p2). The central bank will provide liquidity support to banks (FT, 6/26/13, p1). Reporters were told to quit "hyping the so-called cash crunch" (Financial Times, 7/7/13, p4).

Compare this rush by and motivations for Chinese officials to clarify the jump in short term rates with the explanations by the three Fed officials in late June. The Chinese, like the Fed, may be more fearful of the potential combination of higher interest rates and falling stock marketplace prices than they publicly acknowledge. They also may be much more worried about current and near term growth prospects than they admit.

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Audiences should not overlook the Fed's recent Summary of Economic Projections (6/19/13). Figure 2 reveals the distribution of the nineteen FOMC participants' assessments of appropriate monetary policy. The average "longer run" level for the appropriate target Federal Funds rate at year end is about 4.0pc (the lowest one stands at 3.25pc), far above the rate under .25pc (monthly average) that has persisted since December 2008.

Observers should ask if the Fed really has a coherent exit plan. Besides the relative lack of detail, note that "a strong majority" of Fed FOMC participants expect Fed "will not sell agency mortgage-backed securities during the process of normalizing monetary policy" (Bernanke Press Conference, 6/19/13). Why not? These mortgage-backed instruments comprise a large part of the Fed's money printing portfolio.

Anyway, although the UST 10 year yield dropped to 2.41pc on 7/3/13 from the high it reached at 2.66pc on 6/24/13, it then nevertheless quickly ascended over the 6/24/13 height to reach 2.75pc on 7/8/13. In addition, not only rising rates at the long end of the Treasury yield curve, but also the widening of the UST 10 year less two year spread displays the Fed's fading powers and

cracks in its credibility. The 10 year government yield exceeded (made lows against) the two year note by 117 basis points on 7/24/12 and 134bp on 11/16/12 (closing basis). After making another bottom on 5/1/13 at 143 basis points, it soared to 234bp on 7/5/13.

After all, why hold onto interest rate instruments for little or no real return? How long will savers permit themselves to be cheated of a fair return relative to inflation? When will foreign institutional holders of UST, including central banks, run for the exits, or at least reduce their net buying? Note recent foreign net selling of UST. And how well-anchored are inflation expectations despite the Fed's repetitious sunny rhetoric?

Government securities are not the only debt ballpark. Despite the Fed's smooth talk and loose money programs, the nerve-wracking bear advance of higher yields, so dismaying to interest rate "investors", extends beyond governments. In recent months, the rising rate trend has included corporate bonds, municipal debt, and mortgages. Scan the American horizon. Yields for a 10 year US corporate ("industrial") benchmark of BBB grade rose from 2.95 percent on 5/2/13 (11/8/12 floor 2.82pc) to 4.14pc on 7/5/13 (closing basis, Bloomberg data). A 10 year BBB municipal general obligation note saw yields climb from 2.97pc on 5/3/13 (12/5/12 bottom 2.80pc) to its recent plateau of 3.98pc on 6/26/13 (closing basis, Bloomberg data). The rate for 30 year fixed rate home mortgages (national average; from Bankrate.com) flew from 3.40pc on 5/1/13 (12/6/12 bottom 3.36pc) to 4.64pc on 7/5/13.

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The European Central Bank, despite having pinned interest rates low for quite some time, despite having the OMT and LTRO arrows at hand, recently offered a seemingly significant innovation to its policy panorama. The ECB stated (7/4/13): "The Governing Council expects the key ECB interest rates to remain at present or lower rates for an extended period of time." This forward guidance represents a change from the prior policy of not pre-committing to future interest rate decisions. The Bank of England, like the Federal Reserve Bank a determined devotee of money printing also proposed on US Independence Day an alteration in its program. The Bank of England declared: "the implied rise in the expected future path of Bank Rate was not warranted by the recent developments in the domestic economy." The BoE also spoke of potential for "adopting some form of forward guidance" (7/4/13).

These European actions indeed surprised and excited many marketplace players and the media. "Radical moves from BoE and ECB" headlines the Financial Times (7/5/13, p1). Maybe the ECB and BoE will eventually offer more specifics on their guidance plans (think of inflation signs and unemployment levels), thus bringing their monetary tactics even closer to that of the Fed. These sentinels, like other central banks, cannot repair or improve everything by themselves. Yet central banks want audiences to believe they are doing their very best to satisfy their legislative mandates and to help generate economic growth.

In any event, it nevertheless stretches credibility to claim that these recent ECB and BoE statements represent a change of genuine significance. They appear to be clever ploys to boost confidence in the ability of the central banks to help guide and sustain recovery. How likely was (is) it that the ECB or the BoE were (are) going to raise rates anytime soon? Not only is much of Europe in recession, but Europe's economic crisis (including sovereign and banking debt and related bailout issues) persists. Noteworthy troubles still loom in Greece, Ireland, Portugal, Cyprus, as well as in Spain and arguably in Italy. Moreover, recall the ECB President's inspiring "whatever it takes" talk about a year ago (7/26/12); people gave substantial credence to that open-ended proclamation.

Consequently, these recent ECB and BoE remarks, like the cheerleading comments by Federal Reserve and Chinese officials after the June 2013 stock marketplace lows, look like a sign of weakness. Are the ECB and BoE losing some of their hold on the distant section of the yield curve? Yes. Again underscore the steady creep higher in longer run government rates in the United States (and many other arenas) despite keeping Federal Funds near the ground. The 10 year German government note yield reached valleys at 1.13pc (6/1/12 and 7/23/12) and 1.15pc on 5/2/13, rising to 1.85pc on 6/24/13. Compare this yield pattern with that of the 10 year UST. Though the 10 year German note yield fell to 1.60pc on 7/4/13, it rose to 1.74pc 7/5/13. What about the United Kingdom 10 year note's movement recently? Its yield swung up from 1.61pc on 5/2/13 to 2.59pc on 6/24/13. Although it dipped to 2.30pc on 7/3/13, it hiked up to 2.51pc on 7/5/13.

The courageous Fed and other heroic central banks have played the easing game with incredible skill. But their game has run on for several years, and notable risks (warning signs) for the global economy still exist. And how much remains in the central banking bag of tricks (toolkit)? It arguably has become increasingly difficult for the ongoing easy money games of central bankers to promote further national or worldwide economic growth.

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The Fed and other central bankers cannot save the world by themselves. Of course these bankers do not believe they can do so. Deficit spending has helped the global recovery to get and stay on track. Yet now in the United States (despite some near term optimism) deficits are a substantial current and big long term problem. The International Monetary Fund states that US "public finances remain on an unsustainable path over the longer term" (Concluding Statement of the 2013 Article IV Mission to the US, paragraph 6, 6/14/13). And fiscal problems persist in Japan, much of Europe, and elsewhere. Will the US debt ceiling be raised without substantial political and economic turmoil?

To get their economies to race forward at a decent speed, many nations want their currency to be feeble, relatively weak, or weakening. However, in the foreign exchange ring, sometimes devaluation becomes competitive, which tends to place some boundaries on the depreciation of a given currency. However, the Fed's adamant long run refusal to lift short rates tends to weaken the US dollar. And America has had some (although modest) inflation (around 1.5pc or so nowadays), so much of the US government yield curve for quite some time has offered no real return. The broad real trade weighted US dollar remains relatively weak. Its June 2013 level is only 84.8 (monthly average), up slightly from May's 84.3 (record low July 2011 at 80.5). What will the Fed do with the Federal Funds rate if the US dollar depreciates significantly? Note that longer term US rates have ascended partly due to reduced net foreign buying (and even recent net selling) of UST.

The Bank for International Settlements makes ominous warnings in its recent Annual Report (6/23/13). "What central bank accommodation has done during the recovery is to borrow time-time for balance sheet repair, time for fiscal consolidation, and time for reforms to restore productivity growth. But that time has not been well used, as continued low interest rates and unconventional policies have made it easy for the private sector to postpone deleveraging, easy for the government to finance deficits, and easy for the authorities to delay needed reforms in the real economy and in the financial system. After all, cheap money makes it easier to borrow than to save, easier to spend than to tax, easier to remain the same than to change." (p5). "Indeed, the debt of households, non-financial corporations and government increased as a share of GDP in most large advanced and emerging market economies from 2007 to 2012 (Graph 1.2). For the

countries in Graph 1.2 taken together, this debt has risen by $33 trillion, or by about 20 percentage points of GDP." (p7).

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