SWEET TALKING, SLICK BANKING: FEDERAL RESERVE POLICY

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The rap music group "Wu-Tang Clan" purrs in "C.R.E.A.M.": "Cash, Rules, Everything, Around, Me C.R.E.A.M. Get the money Dollar, dollar bill y'all."

OVERTURE

Europe's sovereign and banking debt drama recently has seized much of the attention of international economic communities and the media. The epic Greek rescue project has written seemingly endless verses. However, financial audiences should not forget the ongoing Herculean efforts by the United States Federal Reserve Board to consummate its statutory mandate. Why not examine the Fed's current lyrical wordplay alongside some of its ardent actions? This unveils nuances of its policies and thereby displays potential implications for trends and levels in assorted marketplaces.

MONEY MORALS

"Things change so fast, you can't use 1971 ethics on someone born in 1971." Grace Slick, lead singer of the Jefferson Airplane

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In love and commerce, taking implies giving. On Valentine's Day and throughout the year, undoubtedly the prudent Federal Reserve remembers the benefits of having and needs of both debtors and creditors. This regulatory chaperone surely would declare that they passionately strive to perform their very best (do what's most reasonable according to their interpretation of their regulatory duties) for all parties concerned. Besides, they must balance competing interests. Besides again, the Fed has a long run horizon. The Fed's recent policies nevertheless imply not only an ethics of inflation, but also manifest somewhat greater affection for debtors than creditors.

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The Federal Reserve vows to its congregation that it firmly commits itself "to fulfilling its statutory mandate from the Congress of promoting maximum employment, stable prices, and moderate long-term interest rates" (1/25/12). Clear communication of its inflation goal "helps keep longer-term inflation expectations firmly anchored, thereby fostering price stability and moderate long-term interest rates and enhancing the Committee's ability to promote maximum employment in the face of significant economic disturbances." The FOMC policy statement that day speaks only of its "dual mandate" of "maximum employment and price stability", making no reference to moderate long term rates.

The Fed reveals details regarding its monetary gospel. Their rhetoric solemnly affirms the faith that two percent inflation, as measured by the annual change in the personal consumption expenditures index (PCE), "is most consistent over the longer run" with their duty.

Since its two percent rule is appropriate (dutiful, reasonable, good, meritorious), the financial guiding light implicitly believes more than this. Its morality reaches further. Anything less than that two percent rate is less good, indifferent, or even bad. Certainly its various easing efforts (such as rock-bottom policy rates and money printing festivals) in recent years display unbridled faith that "deflation is bad". Presumably, sustained inflation over two percent is less good (and might even be a little bit bad). Really high inflation surely is something bad (inappropriate), and the Fed has a duty to slay it. Similar regulatory notions relative to sustainable employment prevail. Unemployment can be too high (bad) and so on.

Finally, the Fed policy program probably is fine not only for right now (current era), but also for some undefined but still fairly long term vista. Keep in mind that the vigilant Fed typically qualifies its views by saying that its viewpoints and applications of them depend on circumstances.

Suppose the Fed, as a guardian of goodness, suspects a fall-off in inflation relative to its virtuous two percent target is too severe and will remain so (or that excessive unemployment exists and will persist). It probably will respond enthusiastically. This can involve not just policy preaching; frequently resolute action reflects this. Keeping interest rates very low has been a longstanding Fed strategy during the ongoing global economic crisis. Innovations such as massive money printing (two rounds of quantitative easing) and Operation Twist also come to mind.

SWEET NOTHINGS

The Federal Funds target remains close to the ground floor, at zero to one-quarter of one percent. The Fed stated on 1/25/12 that economic conditions, including a "subdued outlook for inflation over the medium run", probably "warrant exceptionally low levels for the federal funds rate at least through late 2014". The midpoint of its 2012 prediction for the PCE's central tendency is 1.6 percent. This creeps up to 1.7pc in 2013, with 2014 edging to 1.8pc. The indefinite "Longer run" PCE forecast is two percent. "The inflation rate over the longer run is primarily determined by monetary policy, and hence the Committee has the ability to specify a longer-run goal for inflation."

Supply and demand for US Treasuries obviously influences yield levels and trends. However, the Federal Reserve's power in this marketplace realm is crucial and substantial, especially over the shorter end of the yield curve. Thus by keeping the Federal Funds rate at or around current depressed levels, the Fed expresses and implements its policy program of maintaining short and medium term US Treasury yields at very low heights. Its doctrine aims at making longer term yields low as well. From the standpoint of 2012 inflation at 1.6 percent, there's no real return to those handing the government money (savers, creditors) unless yields exceed this.

Buried in the International Monetary Fund's recent update of its "Fiscal Monitor" (1/24/12, Figure 2) is a portrait of negative returns from holding US debt (implicitly Treasury debt). The picture indicates the US in January 2012 has a negative real marginal interest rate of approximately half of one percent (based upon its analysis of the yield curve and maturity profile; deflated versus inflation projections).

Short term Treasury obligations currently yield little above zero. As of the end of last week, six month T-Bills yield just over .10 percent, and two year notes slightly over .25pc. The five year note yield is about .80pc (still under one percent). The seven year UST note yield at about 1.40pc still falls under the anticipated 2012 rate. The 10 year UST around 2.00pc offers a slight positive return, with the 30 year bond's 3.15pc providing some. Thus for at least seven years out on the UST curve, owners receive a negative return versus (lose money relative to) current inflation.

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The Fed does not hate or dislike creditors. The Fed's obviously knows that both debt and credit are inseparable and that creditors perform necessary and sometimes praiseworthy deeds. Some debt helps to build productive businesses. Borrowing enables consumers to enjoy "a better life" or "the good life". The Fed surely aims to do right by both debtors (and borrowers) as well as creditors (and savers).

As a rough rule, and admittedly only "up to some point" and "all else equal", debtors generally love inflation, creditors generally adore deflation. The Fed admittedly faces challenges in easily reconciling both parts of its dual mandate. Yet why, as a matter of principle, over the long run, is two percent inflation better than zero inflation? Inflation (including low inflation) tends to benefit debtors confronting their fixed obligation to repay. Inflation reduces the weight of their existing debt burden. It reduces the cost of paying off that existing debt because the "real" value of that debt is less. Thus the Fed's policy decision promoting around two percent inflation, no matter how much its propaganda sugarcoats it, prefers debtors to creditors.

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Moreover, that the Fed favors debtors is shown by more than its having an inflation target greater than zero. Its current interest rate policy pins down Treasury yields across much of the yield curve beneath its own PCE inflation forecast. This underscores its bias in favor of debt and borrowing.

By keeping the yield curve depressed (low) relative to current and anticipated inflation, the Fed deliberately cheats savers (at least those willing to put their money into Treasuries). Why not give lenders at least a minimal return relative to inflation? Should one have to march almost 10 years out on the yield curve to unearth that? Its embrace of "exceptionally low levels for the federal funds rate at least through late 2014" alongside its inflation outlook emphasizes its relative hostility to (or lesser love for) saving (creditors), and thereby its affection for debtors (borrowers).

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Is the Fed's preference for debtors mirrored elsewhere in economic culture? US federal government and household debt levels ballooned relative to GDP in recent years. And over the past fifty years, the federal government has run an annual deficit the great majority of the time.

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The Fed offers more pillow talk in its "Appropriate Pace of Policy Firming", "Target Federal Fund Rate" (Figure 2, 1/25/12). This Figure depicts the distribution, as regards the individual judgments of FOMC participants, regarding "the appropriate level of the target federal funds rate at the end of the specified calendar year or over the longer run". At year end 2012, the average of the distributed viewpoints is around a quarter of one percent. The high judgment by a participant is one percent. At year end 2013, the distribution (average) is around three-quarters of one pc (the loftiest viewpoint is two pc). End 2014's average looks to be around one to one and a half percent or so (the high 2.75pc). However, the average for FOMC participants over the "Longer run" jumps up 4.25pc or so, with the lowest individual judgment at 3.75pc.

The Fed is not forever married to a particular policy or its application. The UST yield curve can have a wide range of shapes. And many factors influence ownership choices of a given interest rate instrument class and its maturity. But all else equal, suppose Federal Funds venture up to around 4.25pc or so in 2015, or even a few years after this. Suppose someone continues to hold a given long term UST, such as the 10 year note with the current two percent yield. After the passage of time, since rising Fed Funds almost certainly means increasing UST yields, will many still find owning that particular instrument attractive? What about sustaining current ownership of an even longer maturity UST, such as a 30 year bond?

CUPIDITY

"'A Ti-tan iv Fi-nance,' said Mr. Dooley, 'is a man that's got more money thin he can carry without bein' disordherly. They'se no intoxicant in th' wurruld, Hinnissy, like money. It goes to th' head quicker thin th' whisky th' dhruggist makes in his back room.'" From the "Mr. Dooley" essays, by Finley Peter Dunne (spelling as in the original)

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The Fed's spectacular money printing satisfied some of the ravenous US fiscal deficit. US quantitative easing (QE2) essentially ceased at end June 2011. Since gaping US fiscal deficits continue to be financed, isn't ownership of UST a lovely proposition despite unattractive yields? There are limits to this romantic notion.

"Flight to quality" fears encourage some people to buy and hold US government debt. Some avid fortune-seekers these days probably buy UST directly, rather than placing their funds on deposit in the banking system. In the ongoing worldwide economic crisis, various banks suffered nasty shocks from the unruly behavior of their assets. Recall what ensued when real estate assets (especially in the subprime parlor) and shaky sovereign debt reared their heads. Insurance will not sufficiently protect huge deposits in banks if asset values collapse and several big banks go under, will they?

The fears regarding banks and other corners of the financial system eventually may diminish significantly. Yet in any event, how long will many people stay enamored with negative US Treasury returns (or unflattering ones, as for the current 10 year note)?

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Savers (potential creditors) of course can put their money elsewhere, if not in UST. The Federal Reserve's slick interest rate policy prods some fortune hunters lusting for greater returns than offered via US government debt to venture into other seemingly more promising avenues.

Some elect to visit other sovereign and corporate debt securities offering greater yields. Although recent and ancient experience underlines that such debt varies significantly in quality, the Fed probably welcomes public ownership of decent (satisfactory; suitably graded) debt offerings.

What about stocks? Take the S+P 500 as a stock benchmark. The Fed's recent proclamations have not explicitly recommended buying American (or related) equities. However, its fertile inventiveness has generated an environment of negative returns relative to inflation from US government debt (in general, according to the IMF; certainly across much of the yield curve). Thus the Fed's bedside manner has helped to provoke many to trot into stocks.

In regard to the stock topic, keep in mind the Fed's own 2012 PCE inflation forecast at 1.6pc as a guide for evaluating how generous Federal Reserve policy is toward savers in US government interest rate obligations. In this context, stress also that for the fairly past few years, the Fed established its beloved target rate for Fed Funds at zero to one-quarter percent on 12/16/08. What was the Federal Funds rate relative to observed PCE inflation during 2009-11? Though PCE inflation was only .2pc in 2009, it was 1.8pc in 2010 and 2.4pc in 2011 (Bureau of Economic Analysis, GDP Report, Table 4, 1/27/12; the GDP implicit price deflator rose 1.1pc in 2009, 1.2pc in 2010, and 2.1pc in 2011). Relative to 2010 and 2011 inflation in particular, the Fed policy offered little reward along a wide portion of the yield curve. The six month T-Bill yield averaged .28pc in 2009, .20pc in 2010, and merely .10pc in 2011. As for the two year note, it yielded only .96pc in 2009, .70pc in 2010, and .45pc in 2011. The five year offered some real return in 2009 via its 2.20pc level, and probably a little bit in 2010 with its 1.93pc average. But what's the story for 2011's 1.52pc average in the five year? (See the Fed's H.15 data.)

By cheating ("under-compensating") many savers, the Fed helps to propel equities higher. Of course variables such as strong US corporate earnings, productivity gains, foreign demand for US goods and services inflame and sustain rises in the S+P 500. The Fed's very low rate policy has existed for an extended period alongside a little but not negligible amount of inflation. And this policy has persisted alongside the S+P 500's majestic advance to heights around double its March 2009 depths.

Moreover, the Fed wants to repair the heartbreaking destruction of household net worth suffered in the economic crisis. By helping to spark and sustain an equity rally, Fed missionaries mend consumer balance sheets (thus inspiring many consumers to spend more).

Stocks may seem like a modern-day promised land, at least as long as they do not slump in price. Many US equity promoters have long educated audiences that pilgrims should buy and hold American stocks for the long run, right? In today's times, quite a few stocks in the equity garden offer beautiful dividends, even greater than some UST obligations.

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The Fed may await specific information regarding the PCE and employment prior to altering its policy stance. However, it may not always do so. Hints from other entrancing venues may provoke Fed liveliness. Over the past couple of years, rather rapid declines of about 20 percent in the S+P 500 from a notable prior summit arguably motivated accommodative Fed behavior. Many wizards define a twenty percent decline as a bear market. So the Fed's motto may be "Don't wait, anticipate!" Since equity declines tie into consumer net worth and morale (and spending) and influence business action and confidence (and thus GDP growth/recovery, inflation, and unemployment), the Fed peers closely at stocks.

Wasn't there a recovery underway in 2010? Anyway, the 4/26/10 S+P 500 high was 1220. Note the S+P 500's subsequent not-too-graceful tumble. It touched a low on 7/1/10 at 1011 (a 17.1pc drop from the high). Yet after a fitful rally, it glumly faded to a final low on 8/27/10. In regard to the August bottom, note that the Fed revealed its QE2 extravaganza in late August to November 2010.

What about 2011? The S+P 500 attained a happy new pinnacle on 5/2/11 at 1371. It then slipped slightly, making a lower peak on 7/17/11 at 1357. It flirted with that May high again with 7/21/11's 1347. A low at 1258 on 6/16/11 stretched modestly above the April 2010 top. However, the S+P then fell out of bed from 7/21/11's level. It hit 1101 on 8/9/11 (19.7pc fall from the May 2011 peak). It rallied to 1231 on 8/31/11 before sinking to its final low at 1075 (not far from the August 2010 trough) on 10/4/11 (21.6pc drop from high). The Fed's Operation Twist announcement on 9/21/11 occurred only a few weeks after the S+P 500's August 2011 low and not long before its October one. The Fed's policy dance then- as well as its stance now- strongly suggests it does not want summer 2010's S+P 500 lows to be penetrated.

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All else equal, long run inflation of two percent of “everything” eventually fixes household net worth- although only in nominal terms. However, despite its mantra of liking price stability, Fed attitudes toward stability (and inflation) sometimes depend on context. So although the Fed usually likes rising stock prices to rise, and though it now desires ascending house prices, their wordplay is much less fond of commodity inflation.

Major trends in commodity benchmarks such as the broad Goldman Sachs Commodity Index and US stock weathervanes such the S+P 500 have tracked each other in recent years. Commodities (with the occasional exception of cash-and-carry spread positions) do not have anything akin to interest rate payouts or stock dividends. Commodity instruments nevertheless have been dressed up by being deemed “alternative investments” (“asset classes”) which can offer “returns” and “portfolio diversification” benefits. The investment label in particular helps many suave salespersons to woo audiences to buy commodities. To the extent returns (yields) in US government debt (or elsewhere) seem inadequate, incremental money may elect to walk into the commodities pasture. Commodities obviously have their own supply/demand picture involving numerous diverse variables. Yet substantial net money flows into the commodity space on the buy side are a bullish factor for commodity prices, though gurus debate how much.

Thus even though the Federal Reserve may not be wild about commodity price inflation, its accommodative inflationary policies (particularly its low interest rate posture; but do not overlook its money printing) help to create and preserve it. Think of many workers and retirees in the US (and elsewhere). By raising commodity cost burdens in arenas such as petroleum and food, the Fed’s sustained easy money policies are especially hurtful to individuals and households with low and even moderate incomes and little or merely modest wealth.

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Let’s peek briefly a bit more at housing. Moderate (and especially low) interest rates tend to spur housing activity. Falling rates help to encourage mortgage refinancing. For a sense of how the Fed would like to encourage real estate inflation, see the white paper it sent to Congress, “The U.S. Housing Market: Current Conditions and Policy Considerations” (1/4/12). “Looking forward, continued weakness in the housing market poses a significant barrier to a more vigorous economic recovery.”

The President of the New York Fed offered his related views (Remarks at the New Jersey Bankers Association Economic Forum, 1/6/12). “I will make the case for further housing-related policy interventions that would help stabilize home prices, improve the housing outlook and generate an earlier recovery in housing activity.” His pronouncements on balance look rather favorable to real estate debtors. He adds: “Monetary policy and housing policy are much more complements than substitutes.”

JAPAN

Billy Ray Valentine says in the film “Trading Places”: “Oh, see, I made Louis a bet here. See, Louis bet me that we couldn’t both get rich and put y’all in the poor house at the same time. He didn’t think we could do it. I won.” (John Landis, director)

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The IMF’s World Economic Outlook Update (1/2411) comments: “Another downside risk arises from insufficient progress in developing medium-term consolidation plans in the United States and Japan." Yet what lessons does Japan seem to murmur in regard to some of America's debt and inflation issues?

Japan's general government gross debt as a percent of its GDP is gigantic, at 241.0 percent for 2012 (IMF, Fiscal Monitor Update, Table 1, 1/24/12). This dwarfs America's 107.6pc and the Euro area's 91.1pc. Japan's general government debt has been huge for several years. How does it keep financing this massive total? And if Japan can keep doing it, doesn't America really have a lot of room to go (and time to wait)?

Japan may have more domestic savings than America, or be more of a nation of savers from an overall cultural perspective. Japan has run a current account surplus for quite some time, in direct contrast to the bulging United States current account deficit. (See the September 2011 World Economic Outlook, Statistical Appendix, Table A10.)

However, Japan's ability to accumulate and finance its big general government deficit also may be due to its more favorable treatment of creditors. And despite low interest rates! Creditors of the Japanese government have earned, and have earned for quite some time, a net positive return due to deflation alongside low government interest rates.

What's the current Japanese situation? The IMF (see its Fiscal Monitor Update, Figure 2, 1/24/12) judges that Japan in January 2012 provides a slightly positive real marginal interest rate. The US did not.

Now look under the covers of the IMF's September 2011 World Economic Outlook (Statistical Appendix, Table A5). Even though Japanese yields have been very low along its yield curve, they have not fallen below zero. A tiny nominal yield in a deflationary environment is a real return. Even zero is higher than deflation. For the years 1993-2002, Japan's GDP deflator averaged a decline of-.6percent. It also was negative every single year from 2003 to 2010, ranging from a deflationary low of -.4pc (2009) to a high of -2.1pc (2010). The IMF estimated -1.5pc for 2011 and predicts deflation via this indicator at -.5pc for 2012. Consumer price measures for Japan were slightly positive from 1993 to 2002 (.2pc average). However, they were about flat on average from 2003-07. Moreover, this inflation measure has been negative thereafter: -1.4pc in 2009, -.7pc in 2010, and -.4pc in 2011. The IMF forecasts it at -.5pc for 2012. Thus the Japanese example suggest that some deflation (even if the government would prefer not to have it persist) occasionally may have benefits.

So how long will the Fed and US Treasury get away with offering negative (or very low) real returns on US government debt?