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OPERATION TWIST Déjà vu: If at first you don't succeed, try again

Quarter on quarter economic forecasting is a mug's game. It may be the stock and trade of sell side analysts trying to impress their clients that their "bank" is on top of the situation, but frankly, no one should have real confidence that economists can look back at past data and discern what is likely to prevail in this current (growth) recession. Traders are well advised not to base too much of their risk posture on the very negative views of GS (a la Jan Hatzius) or the hopefulness of MS (Richard Berner)¹ Why? Either view is at best an educated guess. Frankly, we lack econometric models that are appropriate evaluating this credit bust and the jerky recovery we are experiencing. Further, economists that are making longer run forecasts for Q42010 and 2011/2012 have to assume something about fiscal and monetary policy and there is great uncertainty as to what policy to assume for those periods.

Economic common sense suggests that the extension of unemployment benefits out to 99 weeks has to have some impact on the willingness of unemployed workers to be active searchers for new jobs---and if there is an impact (which we intuitively believe), it has to be a restraint on both job search and the willingness to accept a lower than-previous-pay job and get off the unemployment rolls. Furthermore, undoubtedly some labor has gone underground to the "green" market and is able to collect UE benefits as well as earn some unreported income. But we have no stats on this either just conjecture. If anything, we should characterize what we have seen in currency, bond and equity markets as mass confusion. Fear of deflation has pushed the 10 year government bond rate down and has led to a widespread conjecture that business spending is about ready to drop off the cliff. Rumor trumps fact when fear is abundant.

Who really knows what might be coming out of Washington? I have speculated that this latest downtick in the employment situation---first time claims at 500,000---and the quite negative Philly Fed report would tempt the Fed into action. Reactions from various, respected economists ranged from total disagreement to speculation that the Fed won't sit tight at this point, but let me provide some justification for the conjecture.

Bernanke is giving the opening speech at the Jackson Hole Conference (sponsored by the KC Fed) on August 27. Either what he says or what he doesn't say will generate more market confusion. If he had some of that old Greenspan éclat, he might shoot the moon and announce a Fed intervention at the long end, but he is a consensus builder, and that implies touching base rather solidly with the FOMC aviary.

While we think it is unlikely that the FOMC would create a conference-call change in monetary policy before the Jackson Hole speech, we think it is possible---even likely---that the Fed will be induced to do something before the next FOMC meeting.² Why? There will be huge pressure on the Fed to attempt to reverse the growing fear of a pronounced downward trend while changes in fiscal policy in the period prior to the next FOMC meeting to be held September 21 are essentially off the table. Further, given the extremely activist nature of the Fed's interventions in 2007-2009, would a sitting Chairman not try to pull another rabbit out of his hat and secure the efficacy of his now-doubted past moves?

I am not suggesting that the Fed needs to or ought to act, but clearly the Fed since September 2007 has become more and more sensitive to political pressure. Having gone as far as the Fed has gone in the past

¹ See Richard Berner, "Deleveraging the American Consumer: Faster than Expected," Morgan Stanley, U.S. Economics, August 20, 2010

² See Bruce Kasman, "Global Data Watch: When the Facts Change," J.P. Morgan August 20, 2010



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three years, why would it not respond to growing job restlessness, a waning inflation threat (the hint of deflation) and the obvious fear of a double dip recession? In addition, this Fed Chairman has an intellectual history of thinking about exchange rate effects in a Bust.

One possibility is for the Fed to try to bend the yield curve by moving out on the curve for Fed monetary policy actions.³ Presumptively, that could lower longer term rates, put further downward pressure on mortgage markets and probably weaken the dollar against other major currencies. It will also put pressure on large commercial banks to seek more C&I loans. The “deflation” Bears will certainly provide all sorts of justification for stronger Fed actions NOW rather than waiting while more pessimism sets in, and the Fed is more than likely to ignore the expressed fears of the Gold Bugs—namely that inflation is our next great national disaster.

This would not be a riskless strategy for the Fed because it could well turn out that Q4 consumer behavior will be better than currently evident. Why? If the Morgan Stanley “deleveraging hypothesis” holds up, consumers can service their current debt levels more easily and still manage to increase their spending in Q4.⁴ Prices of many desirable goods are cheaper, and while the unemployment rate seems stuck on the ceiling, there is reason to believe that reported labor income is not accurately reflecting what consumers may actually be earning. It wouldn't be the first time that the Fed has gone too far in one direction when the underlying currents maybe changing.

All of this hints of considerable confusion among policy makers, but why should they be immune from the current epidemic? If we are correct, we have to expect more volatility in equities...and a case could be made that if a modern version of “Operation Twist” (1962) were tried, lower long term rates could induce better high yield prices, an expansion of C&I loans and an equity market that “gets it” with a lag, giving some support to higher consumption expenditures down the road.⁵ Not being on firm ground with an unequivocal assessment of current conditions has never stopped an activist Central Banker. Why should current circumstances be different?

³ Or twist it by intervening at both ends, selling short term and buying long term securities. That it didn't work in 1962 doesn't mean that it couldn't be tried again, this time with more ‘vigor.’

⁴ See Berner op.cit.

⁵ Since this conjecture was first drafted, we have come across a nice theoretical piece in the Kansas City Economic Review for Q2 2010, “The Efficacy of Large-Scale Asset Purchases at the Zero Lower Bound,” by Taeyoung Doh which actually provides a theoretical framework for a Fed action of this type. Surely, someone on the Board's Staff in Washington has read this piece, probably in an earlier draft form and has opined on the policy implications to various Board members.