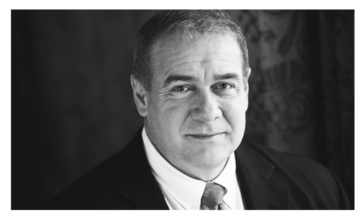
MARKET PERSPECTIVES SEPTEMBER 30, 2010

'Deciphering the Fed's Next Move'



BY SCOTT MINERD

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The trail of bread crumbs is getting easier to follow. The telegraphing is getting easier to read. The clues are more obvious – at least in retrospect. For months now the Federal Reserve has been posturing, hinting, and planting the seeds for its upcoming decision about whether or not to implement another round of monetary stimulus. While some think the debate is far from over, I believe the path is clearly paved for what has already become known as "QE2," or a second round of quantitative easing.

It was almost exactly two months ago that James Bullard, the president of the St. Louis Fed and voting member of the Federal Open Market Committee, first announced his view that the central bank should resume purchases of Treasury securities if the economy slows and prices fall. Since that time, a lively debate about the likelihood of QE2 has grown out of the summer's economic "soft patch." I've been saying for some time that the Fed will institute another round of asset purchases and that the rising tide of liquidity will inflate asset prices across the board – especially equities and commodities – while eventually driving down long-term interest rates to 2 percent or lower.

In recent weeks, however, as I've expressed my conviction on the certainty of QE2 at various speaking engagements, I was surprised to find that the trail of bread crumbs I'd been following wasn't quite as obvious to everyone else. In response to this, I had one of my researchers dig up a time line of what I call the Fed's "QE2 clues" from the past two months. Here is a brief summary of all the subtle (and not so subtle) clues the central bank has been signaling to the market about its intentions to take further action.

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JULY 29: St. Louis Fed President James Bullard publishes a report titled "Seven Faces of the Peril" about the specter of deflation in the U.S. economy. The piece is widely picked up in the financial press. Bullard warns that "the U.S. is closer to a Japanese-style outcome today than at any time in recent history." He goes on to recommend that the Fed should not allow its balance sheet to shrink and proposes it stand ready to address a potential negative shock to the economy by expanding "the quantitative easing program through the purchase of Treasury securities."

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AUGUST 10, FEDERAL OPEN MARKET COMMITTEE (FOMC) MEETING: The Fed's outlook on the economy in general and inflation in particular continues to deteriorate. The Committee – which is composed of the Fed's seven governors and five reserve Bank presidents – observes that "measures of underlying inflation have trended lower in recent quarters...with substantial resource slack continuing to restrain cost pressures..." True to Bullard's public prediction on July 29, the Fed announces that it will not let its balance sheet shrink, but will instead reinvest principal payments from Treasuries and mortgage-backed securities (MBS) in order to "help support the economic recovery in a context of price stability." Not letting the balance sheet shrink is the first step toward expansion, according to some.

AUGUST 17: Bullard, the self-described "inflation hawk," tells The Wall Street Journal: "There is no getting around the fact that the outlook is weaker...there has been disinflation. It has been at the low end of where I'd like to see it. For that reason I think we should supplement our quantitative easing program if we get further developments on that front." He pegs the probability of QE2 at "50-50."

AUGUST 27, THE ANNUAL FEDERAL RESERVE BANK OF KANSAS CITY ECONOMIC SYMPOSIUM IN JACKSON HOLE, WYOMING: Ben Bernanke takes center stage. His 5,000 word speech might be best summarized in three points: 1) The Fed is very concerned about deflation; 2) The Fed is not out of bullets and believes quantitative easing is the most effective tool at this juncture; and 3) The Fed stands ready to take action, make no doubt about it.

Also in Jackson Hole, James Bullard again goes on record with the national press. In a CNBC interview he says outright that the FOMC is "contemplating more in the direction of quantitative easing," citing that the economy looks softer than what the Fed expected just 90 days prior and that the Board of Governors was definitely "concerned."

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Bullard also made a point of saying, "I think the chairman has a lot of support," before alluding to not just rolling over assets to keep the balance sheet constant, but growing it through QE2. "Going forward," said Bullard, "if we try to do more than just keep the balance sheet constant, I think it should be a disciplined program where we tell the market what we intend to do. We make moves, but as we do with interest rates, we tell the market as to what the path might be."

SEPTEMBER 9: Bullard, now somewhat of a household name among financial circles, once again goes on national television to tell reporters that the Fed will take additional steps to boost the U.S. economy should conditions warrant. At this point it seems like Bullard is either on a personal campaign trail or he has been intentionally unleashed by the Fed as a talking head with a script to read. His messaging is consistent with Bernanke's comments in Jackson Hole, only with a little more detail: "We will take more action [i.e., implement QE2] if things do get worse," says Bullard, "And we will take action in a disciplined way. As the news comes in, we will be able to make moves to keep us closer to our inflation target."

SEPTEMBER 21, FOMC MEETING: The FOMC issues a further deteriorating outlook, saying that since its August meeting, "the pace of recovery in output and employment has slowed." The central bank reiterates that it is "prepared to provide additional accommodation if needed to support the economic recovery." Most importantly, the Fed makes the following carefully crafted and explicit statement about deflation: "Measures of underlying inflation are currently at levels somewhat below those the Committee judges most consistent, over the longer run, with its mandate to promote maximum employment and price stability. With substantial resource slack continuing to restrain cost pressures and longer-term inflation expectations stable, inflation is likely to remain subdued for some time before rising to levels the Committee considers consistent with its mandate." I will return to the importance of this language in a moment.

SEPTEMBER 25: Speaking at a conference at Princeton University, Bernanke answers a softball question about whether or not the Fed is pushing on a string. He states his unequivocal belief that quantitative easing has proven to be an effective tool for stimulating the economy. This ends any debate about where Bernanke stands on whether or not the Fed is out of bullets.

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SEPTEMBER 29: A new voice joins the public posturing about QE2. The Boston Fed's Eric Rosengren, a member of the Fed's Board of Governors and voting member of the FOMC, gives a speech to The Forecasters Club of New York. The text is posted online and repurposed in The Wall Street Journal. His talk is called "How Should Monetary Policy Respond to a Slow Recovery?" In his speech, he advocates vigorous and persistent (his words) additional action on the part of the Fed. Using the Taylor Rule to show that additional quantitative easing is warranted, he proposes the purchase of additional long-term Treasuries. He concludes by saying that "it is important to keep firmly in mind the goal of such purchases: to stimulate the economy by reducing long-term interest rates to a level that is more consistent with where they would be, were we able to further reduce the federal funds rate."

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'Putting the Pieces Together'

These are just the highlights of the "QE2 Clues" the Fed has been dropping over the past two months. At first I wondered if James Bullard's campaigning was intentionally planned by Bernanke; he seemed too active and aligned with Bernanke for it to be a coincidence. When I revisited an interview he did from Jackson Hole, I found the answer. Bullard specifically says, "This is a time of unusual monetary policy and we have to do all that we can to get out there and explain what we're doing. If we don't get out there and explain, then others will do the explaining for us and that will only create more confusion. The Chairman does a fantastic job, but he only has certain moments when he can do this. He cannot be out there every day talking, so we try to provide a little bit of help on that."

That statement from Bullard confirmed my suspicion that he was indeed a mouth piece for the Chairman of the Fed, but not many people seem to have picked up on this. On July 29, Bullard said the Fed should maintain the size of its balance sheet. On August 10, the Fed announced that it would do exactly that. Since that time what has Bullard been saying? He's been advocating another round of quantitative easing – not whether or not the Fed should conduct QE2, but rather *how* it should conduct QE2 (which he says should be announced clearly to the market and then implemented incrementally and transparently).

'The Catalyst'

If the Fed is indeed resolved to implement another round of monetary stimulus, the next question is what catalyst will be required for it to actually pull the

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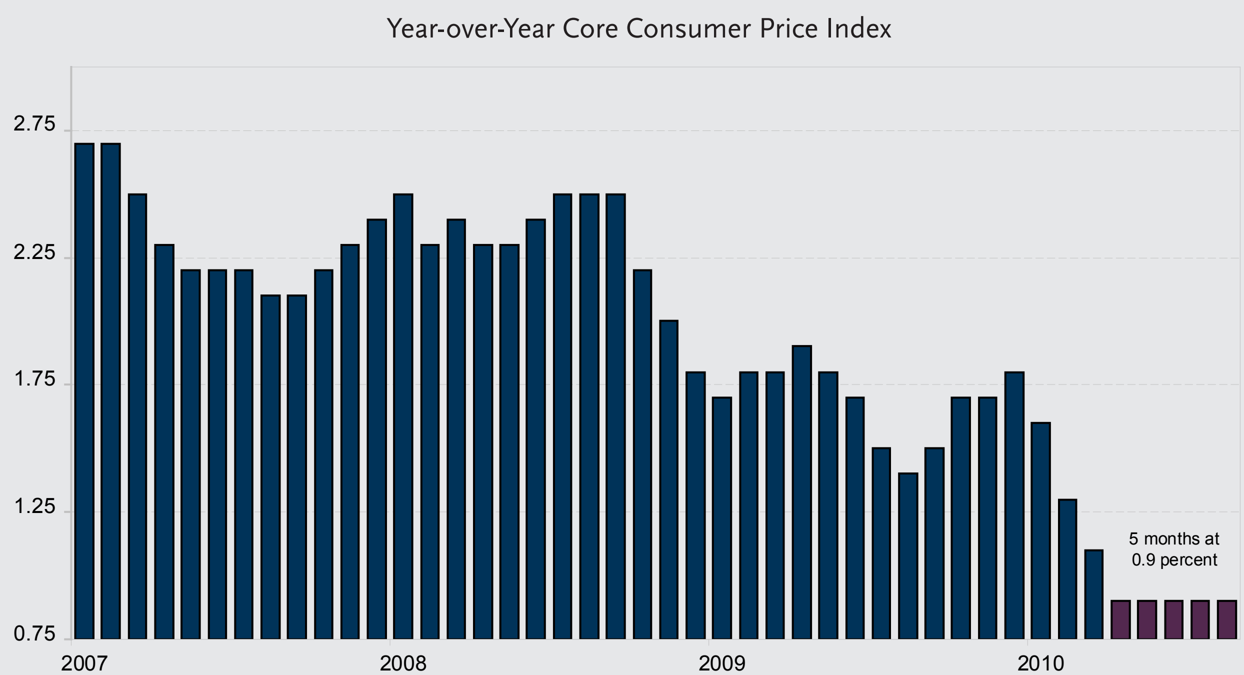
trigger on QE2. In this regard, people seem to be mistakenly looking for the catalyst to be some event in the future – weaker than expected third quarter GDP, a poor jobs report, etc. Once again, in the Fed's many calculated remarks leading up to this point, I believe it has already identified the catalyst for us. It is not an event in the future; it is something already in place today.

If you read the language of the FOMC statement from September 21, it was very carefully worded with particular regard to inflation. To reiterate this important language, the Fed said, "Measures of underlying inflation are *currently at levels somewhat below* those the Committee judges most consistent, over the longer run, with its mandate to promote maximum employment and price stability. With substantial resource slack continuing to restrain cost pressures and longer-term inflation expectations stable, inflation is likely to remain subdued for some time before rising to levels the Committee considers consistent with its mandate." (emphasis added)

'STUBBORNLY LOW' – CORE INFLATION REMAINS JUST OFF THE RECORD LOW

The current core rate of inflation of 0.9 percent has persisted for five consecutive months. This is the lowest reading since 1961 when only two consecutive months notched 0.7 percent.



Source: Bureau of Labor Statistics; Bloomberg

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Bernanke has essentially told the market outright that where inflation is today is reason enough for the Fed to institute another round of quantitative easing. Keep in mind that for the past five months core CPI has been 0.9 percent – the lowest level since 1961. The current disinflationary environment is an established trend, not a trend in the making. At the start of the recession core CPI was 2.4 percent and it has steadily fallen ever since. In April 2010, core inflation reached a nadir of 0.9 percent. It has stubbornly remained at 0.9 percent ever since.

> "All inflation needs to do is stay at its current level for the next month and that alone would be sufficient reason for the Fed to announce additional quantitative easing...it would appear the trigger for QE2 has already been pulled."

The Fed's implicit target for core inflation is around 2 to 3 percent. It has been crystal clear about its desire for a higher level of inflation, especially in a deleveraging environment like the current one. In the September 21 FOMC statement the Fed did not say that inflation is heading too low and that it will continue to monitor the data. It said inflation is already too low and it does not expect inflation to improve without intervention. So all inflation needs to do is stay at its current level for the next month and that alone would be sufficient reason for the Fed to announce additional quantitative easing. Given the data on inflation, from the Fed's point of view it would appear the trigger for QE2 has already been pulled.

'Dealing with Dissension'

What about all the hype about dissension in the ranks among the 12 FOMC voting members? Once again, James Bullard went on record with the press to dispel any rumors that Ben Bernanke wasn't indeed ruling the roost. In Jackson Hole he was asked about internal conflicts within the FOMC. He confidently told reporters that "the Chairman definitely has complete support of the Committee, or certainly a huge majority on the Committee."

True, there are Fed presidents and Fed governors who are skeptical of the effectiveness of another round of quantitative easing. Nonetheless, Bernanke has made no bones about his stance that quantitative easing is an effective monetary policy tool. At the end of the day the FOMC will follow its leader, a man who's very DNA seems to be hardwired to battle deflation.

'When Will QE2 Happen?'

There are two more Federal Open Market Committee (FOMC) meetings this year – November 3 and December 14. After that, the next meeting is January 26,

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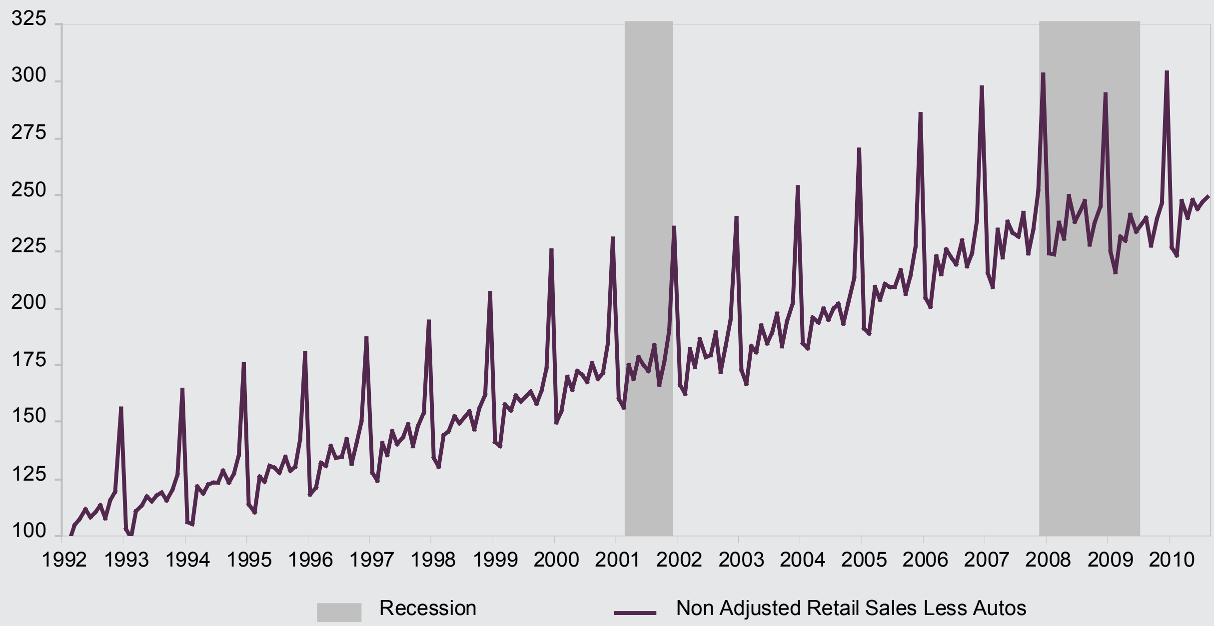
2011. The reason the November 3 meeting is particularly important is because it allows the Fed to send a confidence-boosting signal through the economy just prior to the most important two months of consumer spending in the entire year. In addition, November 3 just happens to be the day after the midterm Congressional elections, which reduces the possibility that any announcement from the Fed could be perceived as being politically associated.

Getting back to the importance of an announcement prior to the Christmas shopping season, if you look at the data over the past 20 years, retail sales (excluding autos) are 36.2 percent higher in December than the average of all other months. November is the second most active month for retail sales and December has still never failed to spike 20 to 30 percent on a month-over-month basis in the past 20 years. After December's spike in retail sales, activity falls off a cliff in January and typically troughs in February before posting modest gains in March.

'NOTICE A TREND?' – RETAIL SALES EX AUTOS SPIKE IN DECEMBER

Over the past 20 years, retail sales (ex autos) rise in November and then spike dramatically December. This well-established pattern could influence the timing of the Fed's announcement for QE2.



Source: U.S. Census Bureau; Bloomberg

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A bad Christmas season bodes especially poorly for the start of 2011 (which may already be facing the headwinds of a tax increase with the expiration of the Bush tax cuts...but I digress). Bernanke is well aware of the need for the consumer to take the baton from the government in order for the economy to pick up. The same announcement of QE2 on November 3 versus December 14 or next January could have a measurably greater impact on the economy if it spurs consumer confidence during the peak retail months of the year.

Therefore, given the catalyst of low inflation and the fact that the boost to the economy would be maximized prior to the holiday shopping season, I think Bernanke is going to feel the pressure to take action in the November 3 meeting. In addition to these factors, the November 3 meeting is also scheduled to include public revisions to the Fed's outlook on GDP, employment, and inflation. Since the revisions will inevitably be to the downside, what better timing is there for the Fed to make the announcement of QE2 than in tandem with the latest deterioration in outlook?

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'Loading up on Treasuries'

What will be the target of the first purchases of QE2? Basically, I believe the only hand the Fed has left to play is to try and push long-term rates down by buying more Treasury securities (or perhaps even GSE MBS). Both Bullard and Bernanke have openly stated that they think quantitative easing has a stimulative impact on the economy, and both advocate the purchase of Treasuries. As Rosengren stated in his recent speech, "Purchases of long-term Treasury securities are likely to push down long-term interest rates on Treasury bonds, but also are likely to reduce rates on other long-term securities. Some have argued that it would be difficult to reduce Treasury rates further, but U.S. Treasury rates are still well above the zero bound, roughly equivalent to rates in Germany, and well above long-term rates in Japan." The impact of additional Treasury purchases will be to push long-term interest rates lower – down to 2 percent or less, as I've predicted for some time.

When pressed in Jackson Hole on the effectiveness of QE as a monetary tool, Bullard blatantly refuted the suggestion that the Fed is out of bullets, saying, "There are some people who don't think it has an impact, but I don't buy that. I think it has quite a big impact." Whether this is pushing on a string or not has yet to be determined. I believe lower rates will spur incremental residential mortgage refinancing activity that will provide some benefit through increased disposable income and slightly boosted tax revenues.

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'Impact on the Markets'

I am not counting on any resolution to tax policy prior to the November elections. In all likelihood, the Bush tax cuts will experience a temporary lapse and will be dealt with in January. To some degree this strategy makes sense for politicians as there is option value to waiting and seeing how the elections turn out, what the Fed does, and how the economy reacts. Unfortunately, option value for politicians is not counted in GDP, so the headwinds of uncertainty will continue until the Fed makes its intentions known, which I believe will be at the November 3 FOMC meeting.

Once the Fed announces quantitative easing, I believe rates will decline with the 10-year U.S. Treasury eventually trading at 2 percent or lower. But I also remind our clients what Rothschild said about how he became such a successful investor – his secret was to be in the habit of selling early. Similarly, there's the old adage that "no one ever lost money by taking a profit." In the spirit of these statements I think it may be time to lighten up on long duration fixed income.

'BREAKING OUT TO THE UPSIDE' – THE NYSE ADVANCE DECLINE LINE

The NYSE Advance Decline Line has broken out to the upside, which generally means that equities will move meaningfully higher in the six months.

NYSE Advance Decline Line: Cumulative Daily Breadth vs DJIA

Source: Bloomberg; Guggenheim Partners

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I would use a rally in Treasuries to the 2 percent range as an opportunity to reduce some exposure to Treasuries and reallocate to areas offering better prospects for the longer term. For example, based on research on historic returns, I estimate that equities should return somewhere between 6 to 9 percent per annum on average over the next decade. On a slightly shorter horizon, the NYSE Advance Decline Line in the last three weeks has broken out to the high side, so I would anticipate that equity prices will be meaningfully higher in six months as well.

Outside of financial assets, I continue to be bullish on gold and silver, which I believe still have a decade or more remaining in their generational bull markets. I don't see anything stopping gold from moving to $1,400/ounce over the course of the next few months, and then ultimately even higher. With that said, keep in mind that markets that move higher seldom do so in a straight line. Precious metals are currently over-bought. I would expect to see a pullback to around $1,270 on gold and $20 on silver. If this happens it will be a good time to add to positions. In addition to precious metals, I also continue to be bullish on the long-term outlook for industrial metals such as copper, lead, and nickel, as well as for agricultural commodities.