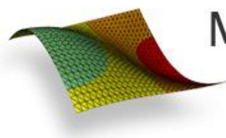

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Macro Notes

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The Binary Fed – to Normalize or Not?

During a presentation last Thursday I faced a question: "Do you have an opinion on the Fed raising rates in June?" I was shocked – what kind of a question was that? Unsure how to respond, I answered with a question of my own:

"Why would they?"

"Well, rates have been at zero for so long they must go up, otherwise we will have inflation" he recited the Street's view on the economy, job growth, earnings, etc.

"But," I answered, "'good numbers have not brought inflationary pressure. On the contrary, with a strong U.S. dollar and fear of deflation, the US is importing 'worries' about disinflation (and maybe outright deflation). This is what one should expect in a global deleveraging environment."

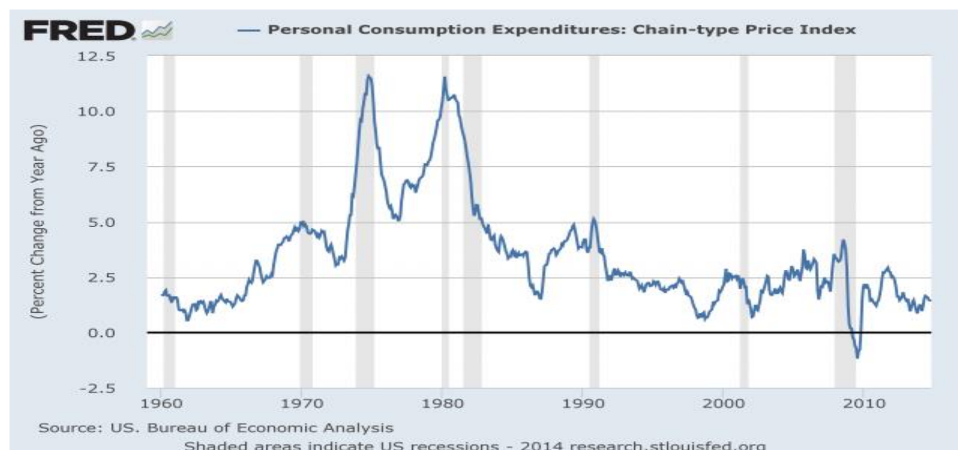
He was annoyed; at me and at his lack of swift comeback, but his face broadened into a smile: "Sir, don't rates need to normalize?"

Got you! *I thought. "The question is not will the Fed raise rates by a smidge in June, but will they start to normalize rates and initiate the long predicted and much anticipated liftoff?"*

"Yes," he answered with joy, "that's what I meant." He was winning again, and I thought: the customer is always right.

Forgive my faux Michael Lewis, but this is getting silly: everyone is guessing whether the Fed will raise rates in June or September but no one carries the analysis out to what that might *mean*. All eyes are on this week's FOMC meeting, in particular whether the word "patience" will be deleted. Janet Yellen did tell Congress that the policy implication of removing the word "patience" was that rates would go up in the following two months. So: April, May…June!

The real question is: what is the objective? The Fed cannot hide behind inflation; notwithstanding what the press says, we are still far from the 2% Fed target:



There are only two scenarios – hence, the **binary Federal Reserve:**

1. If the Feds use the "behind the curve" argument, or the "buying insurance" excuse, the increase will be small and accompanied by strongly worded forward guidance: "will raise 25 now and possibly 25 later, and then will stop and stay put for the foreseeable future in order to assess the impact on the economy and the market". In that case we will get a little jolt (less than the Taper tantrum – 50 bps will only affect the prop desks, not the public at large), the search for dividend will continue, and volatility will remain at current level – not a dramatic change.

2. If, on the other hand, they raise rates while invoking "normalization", the wrath of the market will be upon us: <u>based on the Fed Funds Futures table below and the implied yield quoted, there is no sign of normalization being priced in</u>. In this case, volatility will definitely pick up and the market will collapse.

FF1 99.8650 -.0050 ic99.8600 / 99.8650 8667 x 1855 Prev 99.8700
At 15:48 d Vol 4829 Op 99.8700 Hi 99.8700 Lo 99.8650 OpenInt 78131

FF1 COMB Comdty | 1) Settings | 2) Actions | Futures Contract Table

4) Futures | Sort By Expiration | As of 03/16/15
Generic 1st 'FF' F 7) CBT (CEM) | Display Rate | Session COMB | First Leg All
Delayed Pricing Contracts 35/36 | Aggr Vol 55,651 | Aggr Open Int 664,450 | Length 0

Description	Last	Chg Settle	Time	Bid	Ask	Open Int	Volume	Yest Settle
34) May16	.865	-.025	15:40	.870	.860	6991	318	.890
35) Jun16	.925	-.025	15:46	.930	.920	1150	83	.950
36) Jul16	.995	-.025	15:34	1.000	.990	1011	86	1.020
37) Aug16	1.085	-.025	15:33	1.090	1.075	1246	57	1.110
38) Sep16	1.140	-.030	15:46	1.145	1.135	860	61	1.170
39) Oct16	1.210	-.030	15:41	1.215	1.205	904	13	1.240
40) Nov16	1.280	-.030	15:48	1.285	1.275	280	20	1.310
41) Dec16	1.335	-.030	15:46	1.340	1.330	1999	11	1.365
42) Jan17	1.420s	-.020	15:31	1.415	1.395	169		1.440
43) Feb17	1.490s	-.020	15:31	1.485	1.465	52		1.510
44) Mar17	1.540s	-.020	15:31	1.535	1.515	58		1.560
45) Apr17	1.5900s	-.0200	15:31	1.5850	1.5650	11		1.6100
46) May17	1.6550s	-.0200	15:31	1.6550	1.6350			1.6750
47) Jun17	1.6950s	-.0200	15:31	1.6950	1.6750	16		1.7150
48) Jul17	1.7350s	-.0200	15:31	1.7350	1.7150			1.7550
49) Aug17	1.7850s	-.0200	15:31	1.7800	1.7650			1.8050
50) Sep17	1.8200s	-.0200	15:31	1.8250	1.8050			1.8400
51) Oct17	1.8550s	-.0200	15:31	1.8600	1.8450			1.8750
52) Nov17	1.9000s	-.0200	15:31	1.9050	1.8850			1.9200
53) Dec17	1.9350s	-.0200	15:31	1.9400	1.9200	1		1.9550
54) Jan18	1.9750s	-.0200	15:31	1.9750	1.9550			1.9950
55) Feb18	2.0100s	-.0200	15:31	2.0150	1.9950			2.0300

9) Color Legend | Zoom 100%

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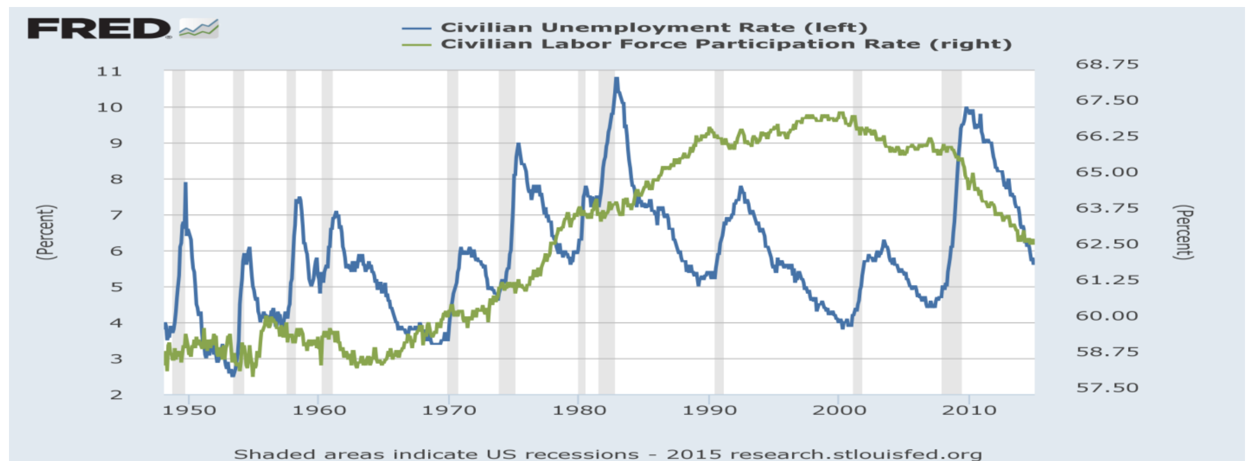
The market will agonize over the definition of "normalized rates". The Fed has rejected a rule-based mechanism such as the Taylor Rules as we are (they admit) in uncharted waters.[1] One definition of normal rates is the Natural Rate of Interest of Irving Fisher, the father of the Quantitative Theory of Money – appropriate, given that we are indeed in a quantitative monetary mode.

[1] In economics, a **Taylor rule** is a monetary-policy rule that stipulates how much the central bank should change the nominal interest rate in response to changes in inflation, output, or other economic conditions. In particular, the rule stipulates that for each one-percent increase in inflation, the central bank should raise the nominal interest rate by more than one percentage point. This aspect of the rule is often called the **Taylor principle**.

According to Fisher, the natural rate of interest is equal to the long-term (LT) trend of GDP, plus the long-term trend in inflation, plus a maturity premium (e.g. 100 bps for the 10-year UST) in condition of full employment. Assuming LT GDP trend for the U. S. economy has declined somewhat, and using the Fed's 2% target for LT inflation, Fed Funds should "normally" be at 4% in condition of full employment and the 10-year UST about 100 bps higher. This is certainly not priced into the market.

Another interesting debate at the Fed is on the level of the NAIRU, Non-Accelerating Rate of Unemployment. The hawks believe it has not changed and it is still at 5 to 5.5%, while the doves believe it has declined to below 5% – how else could they argue that the decline in labor participation has been structural? Assuming the NAIRU is indeed at 4 to 5%, we are already at or close to full employment, so we don't have to shave anything from the Natural Rate of Interest.



Conclusion: I would bet money that the Fed will go with option 1, but I am equally willing to bet another dollar that if they go with option 2 the market will crater. Anyone courageous enough to bet on normalization might make a huge amount of money; it is, after all, not priced into the market. The end conclusion is that the market as we knew it no longer exists, and that once again we are in the hands of the politicians forwardly guiding us… God help us all!

Respectfully submitted,

Simon Nocera
from Brazil, March 15, 2015