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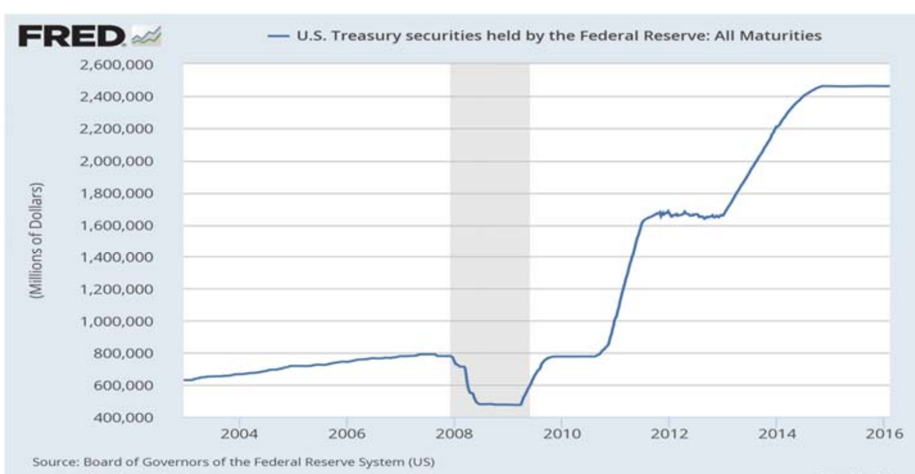
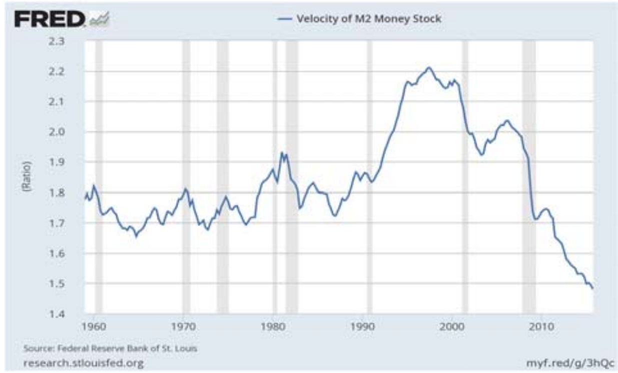
Fed Policy (Or The Lack Thereof) Exposed

The divergent monetary policy of the Fed became that much more apparent [and disconcerting] after the lone voting hawk at the Bank of England joined ranks with the doves last week to unanimously vote to keep rates unchanged in the face of declining inflation and a lowered growth forecast. It wasn't too long ago that many observers thought it would be a race between the Fed and the BoE to see who would be the first to raise interest rates. **Now even more doubt is cast upon whether the Fed will hike rates when it meets next month.**

Fed Chair Janet Yellen's Congressional testimony today and tomorrow is unlikely to provide much comfort as she keeps her cards close to her chest before she plays her hand. Questioning is likely to be more contentious and acrimonious than her prior appearance given the deteriorating global environment and unsettled political backdrop. Unless backed into a corner, it's doubtful that she'll offer much clarity to Fed policy and is more likely to throw the ball back into Congress's court by faulting them for a lack of cohesive fiscal policy. Other voting members of the FOMC have been ratcheting up the recrimination over Congress's inaction to enact stimulative fiscal policy. (It's a dilemma faced by other central bankers such as Mario Draghi, who has become voracious in his criticism over inaction by European politicians.) **The sight of Washington politicians and the Fed openly trading jabs in a blame game will only contribute to greater investor unease in an already unsettled investment climate, made that much worse in an election year.**

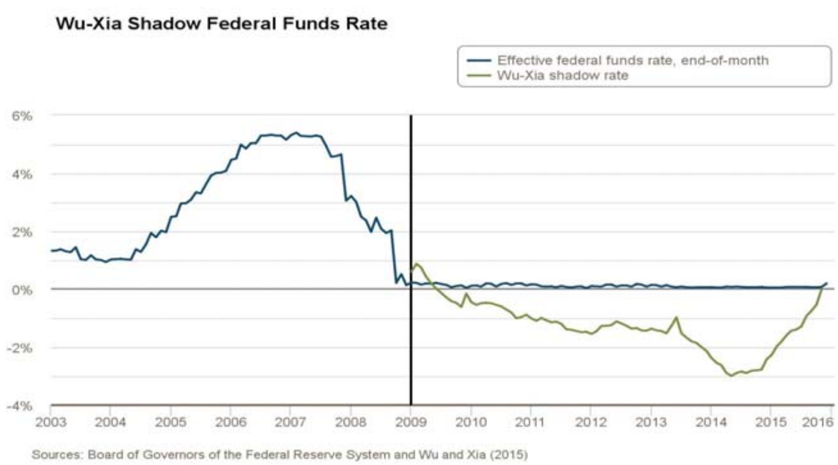
The Federal Reserve has gone to great lengths to assure the public that the contemplated rise in interest rates will be gradual while the overall tenor of monetary policy remains accommodative. As proof, the Fed points to its balance sheet that hasn't shrunk in size by continually rolling over maturing debt on its books. But if that's so, why has the market been in such disarray since December's rate hike? After all, liquidity is the lifeblood of the market and if liquidity is not being constrained shouldn't risk assets continue to levitate higher? We believe that they would if that last statement was true. **In reality, de facto tightening has been underway as liquidity is being drained from the system.**





Growth has slowed in the US money supply, which is an effective tightening of liquidity. More restrictive lending standards have resulted in tightened bank credit. Banks continue to park excess reserves at the Fed and collect interest. Rather than raise the Fed funds rate, perhaps it's time for the Fed to follow the lead of the ECB and BoJ to implement negative interest rates on reserve deposits as an incentive for banks to put those excess funds to work. Prior to this past year, such a view at the Fed would doubtless be considered heresy with the possibility of such a course of action openly ridiculed. **We suspect that Fed Vice Chairman Stanly Fischer's comments last week about his growing appreciation of the effectiveness of negative interest rates in Europe was really a trial balloon regarding the possibility of the Fed exploring a similar path and speaks to the growing quite desperation at the Fed.**

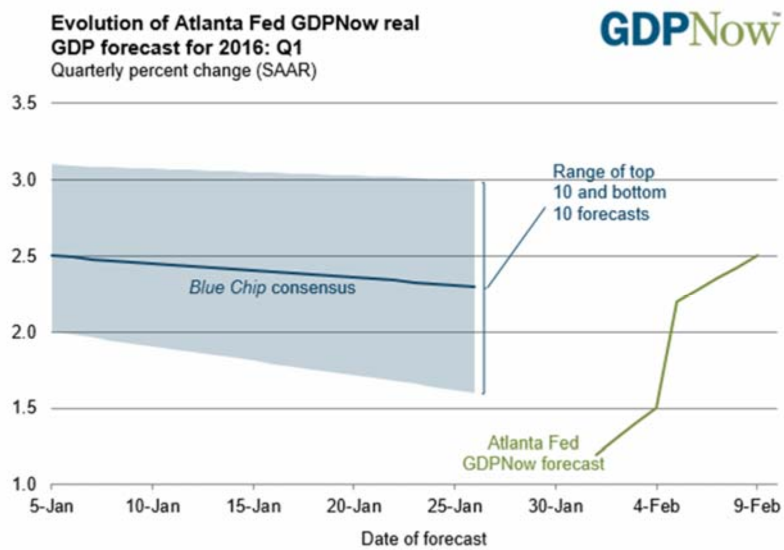
The financial repression practiced by the Fed since 2009 has already kept real rates below zero for an extended period courtesy of quantitative easing. The adjacent work by the Atlanta Fed clearly demonstrates the impact of quantitative easing and only shows a return to a positive rate coincident with the December increase in the Fed funds rate. **But what should be readily apparent is that since the end of QE3, a stealth tightening has already been underway.**



If monetary conditions are actually tighter than generally believed, the Fed has greater latitude to postpone interest rate hikes as liquidity has been drained elsewhere. The US dollar would therefore be more likely to surprise speculators who are overwhelmingly long the dollar. The resultant boost to positive relative US economic growth versus most of the developed world would prevent the dollar from going into free-fall and initially serve to keep it more anchored and range bound to the ongoing frustration of currency speculators. **However, the negative interest rate policy that many other central banks such as the ECB and BoJ are embracing will prove less effective in this scenario and could cause them to go to even more extreme negative rates in**

a renewed race to the bottom for currencies. Once investors recognize this, the upward pressure on the dollar probably reasserts itself due to higher real yields and the steadying influence of the relatively insular US economy.

The Fed now faces a dilemma (when hasn't it over the past few years?) since it has portrayed itself as hardwired to data dependency to determine the direction and pace of rate changes. Global macro headwinds have not receded. To the contrary, flagging overseas economies and escalating deflationary pressure raise the risk of global contagion should tightening by the Fed inadvertently contribute to greater financial distress, particularly among the emerging world economies that have grown to account for more than a third of the world's economic output since the Asian debt crisis almost two decades ago. Meanwhile, the Atlanta Fed introduced its first quarter GDP forecast at the start of the month and has already (yesterday) raised it significantly to 2.5% based upon the past week's released economic data, which puts the economy on track for its best quarterly start to the year since 2012 and on the surface dispels the risk of imminent recession. However, as conflicting and volatile as the various data series have become, we are reluctant to assign a high level of probability that this forecast will be sustained in subsequent months. **What is the Fed to do? We fear that the probable message of "we need to see more data" is unlikely to sit well with investors struggling to make sense of the market's sell off.**



Sources: *Blue Chip Economic Indicators* and *Blue Chip Financial Forecasts*

Chair Yellen will try to walk a tightrope during her Humphrey-Hawkins testimony. Markets have now almost fully discounted the probability of another Fed funds rate increase in 2016. One could readily presume that the Fed could (and should) wait given the stubborn lack of inflationary pressure and conflicting economic signals. However, those market participants looking for a departure from the typical obfuscation by the Fed Chair are destined to be disappointed. Equity markets are deeply oversold and many market participants believe Chair Yellen's appearance will be the catalyst for markets to rally. The Chair's written comments won't provide the answers that investors are looking for. The Q&A will be more insightful but expect palpable frustration from the committee members because the insight gleaned will be that answers are not forthcoming. Investors hate uncertainty and this testimony is unlikely to provide the answers that they yearn for. Subsequent speeches and comments by other Fed speakers over the next week will be highly scrutinized and assume greater market moving potential. **Any positive reaction to Chair Yellen's testimony could prove fleeting.**

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