Third Party Research **September 22, 2017**

FOMC's Cautious and Correct Plan to Unwind QE

***e*Research Corporation** is pleased to provide an article by Scott Grannis for his Blog, "Calafia Beach Pundit".

In this article, Mr. Grannis comments on the health of the U.S. economy and why the Fed's Quantitative Tightening plans are sound.

The article is reproduced below, beginning on the next page, or you can go to this specific Blog at the following link: **FOMC's cautious and correct plan to unwind QE**

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Thursday, September 21, 2017

FOMC's Cautious and Correct Plan to Unwind QE

The bond market was a little rattled yesterday after the FOMC announced that, despite the trauma of two major hurricanes, despite the absence of news suggesting the economy has strengthened, and despite the fact that inflation remains somewhat below their 2% target, they would proceed, starting next month, with the long-awaited unwinding of their Quantitative Easing efforts.

This moderate surprise was somewhat offset by the FOMC's decision to hold off on hiking short-term interest rates, presumably until December. Now that the dust has settled, short-term interest rates are a handful of basis points higher, gold is down a bit, and the dollar is up a bit—all of which suggest a slight improvement in the market's outlook for the economy.

People feel better knowing the Fed is finally on track to "normalize" its balance sheet, even though it will likely take several years to accomplish. (Their plan to start selling $6 billion per month of Treasuries and $4 billion per month of MBS, to be ramped up slowly, is very cautious and conservative and will take a long time.)

A review of some key market-based indicators shows that the market's outlook for economic growth has only improved marginally from sub-par levels. More importantly, however, there are few, if any, signs in the market that the Fed's plans to raise short-term rates modestly, while slowly paring down the size of its monster bond portfolio, pose any threat to growth. This tells me that the Fed is moving in the right direction, and its caution is warranted.

The Fed is proposing to move slowly and cautiously to take steps to bolster the demand for money (by raising the interest rate it pays on excess reserves), now that there are increasing signs that money demand is beginning to ebb.

I reviewed this in detail in a post last month, "Something to worry about." As long as the Fed keeps the supply of money in line with the demand for money, we won't have to worry about inflation. So far, it looks like they have been doing their job, since inflation has been relatively low and stable for quite a few years, and forward-looking inflation expectations have not increased.

The first chart, on the next page, is one of the most important.

Although neither the press nor the Fed normally talk about the inflation-adjusted Fed funds rate, that is the monetary variable which is the most important for the economy, since it sets the floor for the true cost of borrowing and the true benefit to saving.

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Today, the real rate of interest on overnight money is slightly negative (the funds rate is 1.25% and the inflation rate is about 1.5%). It is a lot less negative now than it has been for most of the current recovery, but it is still the case that real borrowing costs are negative and real savings rates are very low or negative. This has been the case for years, and we have yet to see any unpleasant consequences.

It cannot go on forever, however. If the Fed holds the real funds rate to an unreasonably low level, that would inevitably result in an imbalance between the supply and demand for money, and that, in turn, would result in rising inflation, a weaker dollar, and rising gold and commodity prices.

The real yield on 5-yr TIPS is best thought of as the market's expectation for what the real Fed funds rate will average over the next 5 years. 5-yr TIPS today carry a real yield of only 0.1%, while the current real yield on the Fed funds rate is about -0.15% to -0.25%. That means the market expects only *very modest* "tightening" from the Fed over the next 5 years. This squares with implied forward rates which show the Fed raising rates only 2 or maybe 3 times over the next several years. Both the market and the Fed believe that interest rates need rise only modestly, and that, in turn, implies a belief that the economy will not pick up significantly from its 2% trend rate of growth that has prevailed since 2009.

As I have said many times before, one thing to watch for and worry about would be the nominal funds rate exceeding the 5-yr real TIPS yield. That would be the market's way of saying that the Fed is entering "tight" territory and, thus, threatening real economic growth.

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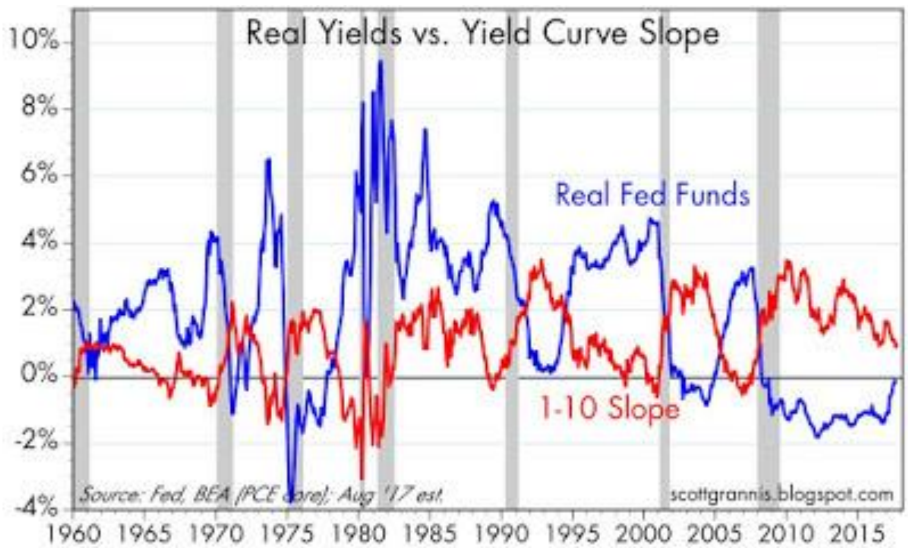
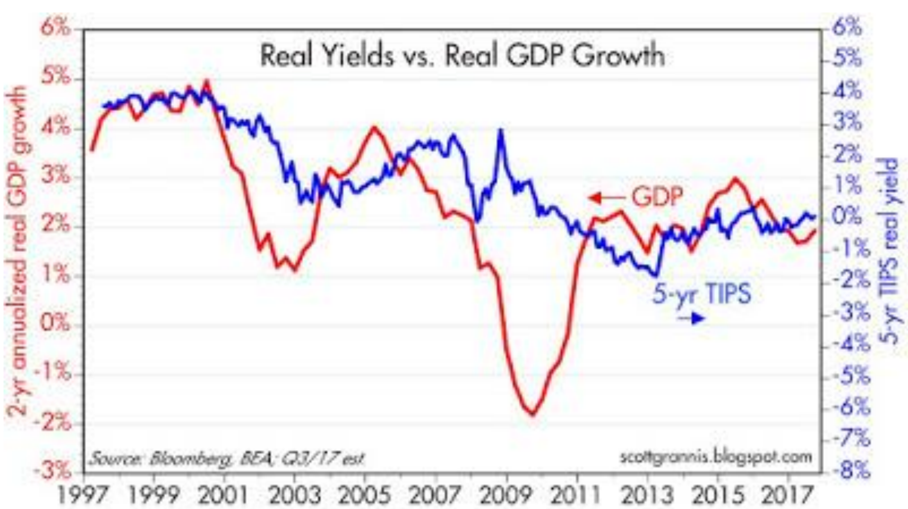
The next chart is also very important. It shows that every recession in the past 60 years has been preceded by a substantial tightening of monetary policy. Monetary policy is tight when the real Fed funds rate (blue line) is at least 3-4%, and when the Treasury yield curve (red line) is flat or inverted. We are likely years away from seeing those conditions.



As the next chart suggests, today's very low level of real interest rates is consistent with real GDP growth of about 2%. If the market today were convinced that major tax reform is going to happen in the foreseeable future, I have to believe that real interest rates would be significantly higher, because true tax reform could unleash a lot of the economy's untapped potential. So, despite rumblings of progress on tax reform, the market has not priced it in yet. The market remains cautious, just as the Fed remains cautious.



The chart below shows how the bond market reveals its inflation expectations. The difference between the nominal yield on 5-yr Treasuries and the real yield on 5-yr TIPS gives us the market's expectations for what the CPI is going to average over the next 5 years. That is currently about 1.75%, which is very much in line with the current level of inflation (the CPI is up 1.9% in the past 12 months, and the Core CPI is up 1.7%). That tells me the market is reasonably confident that the Fed is going to be doing a good job for the foreseeable future. If the market were worried that the Fed was being too aggressive, inflation expectations would be declining.

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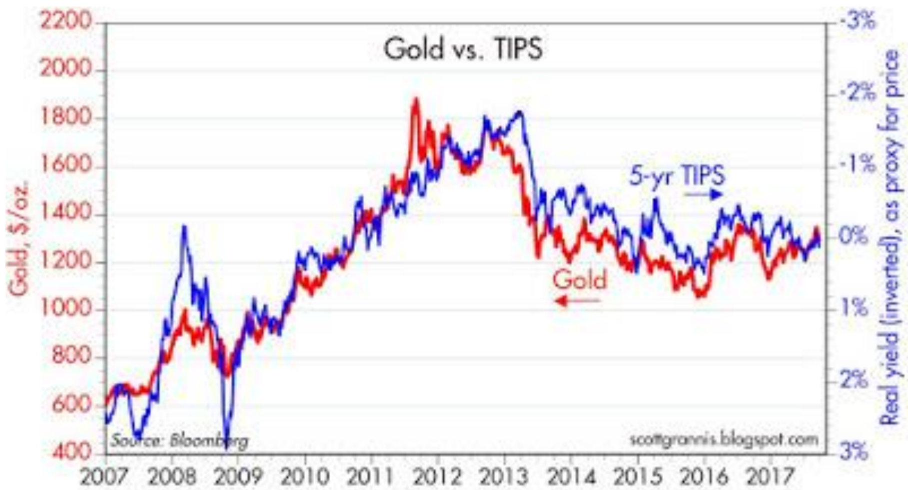
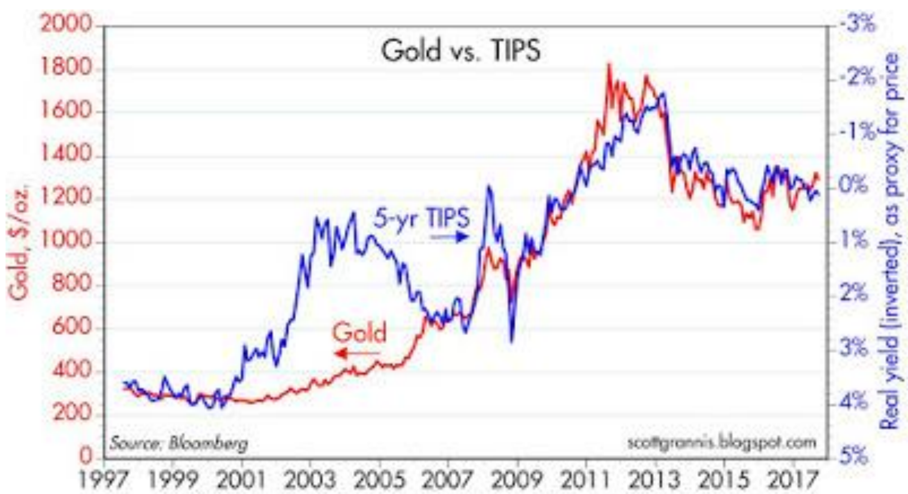
The two charts below compare the price of gold to the price of 5-yr TIPS over different time frames.





I find it fascinating that these two completely different assets should behave so similarly. If anything, it means that strong economic growth (which typically coincides with high real yields such as we had in the late 1990s) depresses demand for gold, and weak growth increases the demand for gold. That, in turn, suggests that buying gold today is a hedge against a weaker economy.

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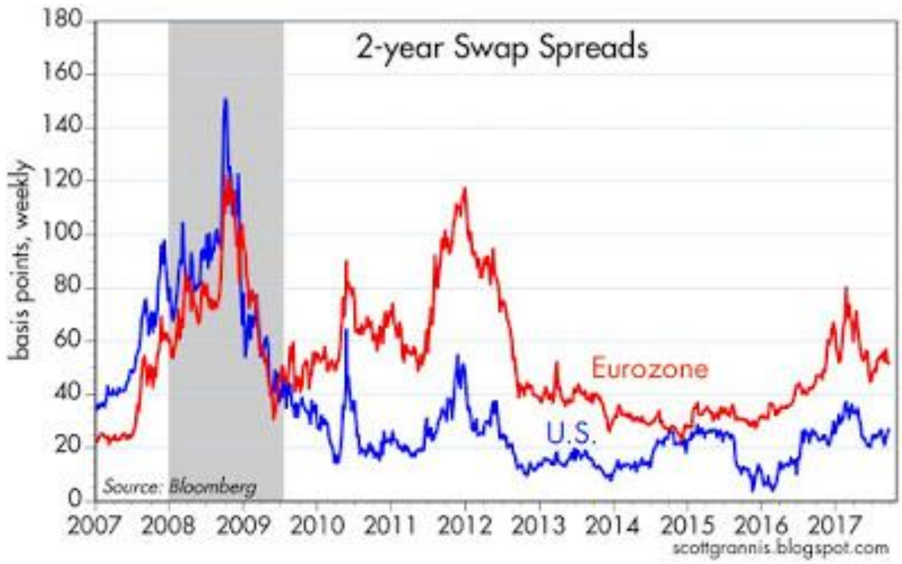
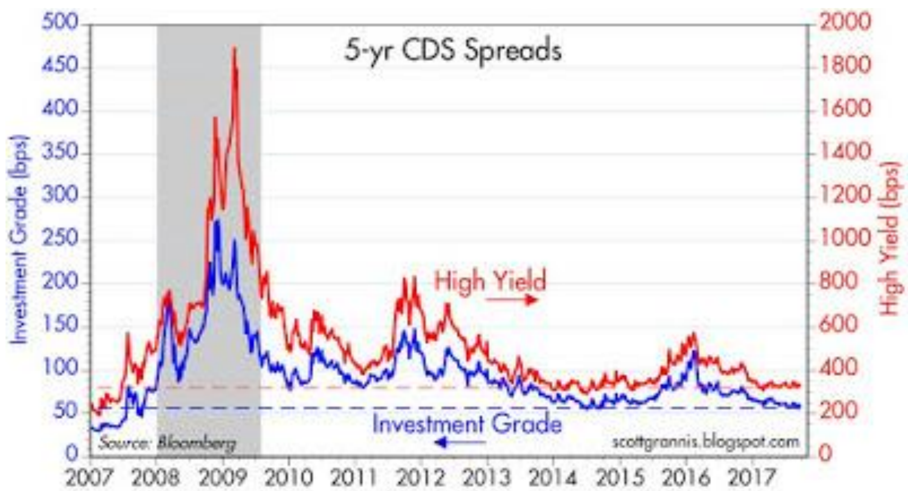
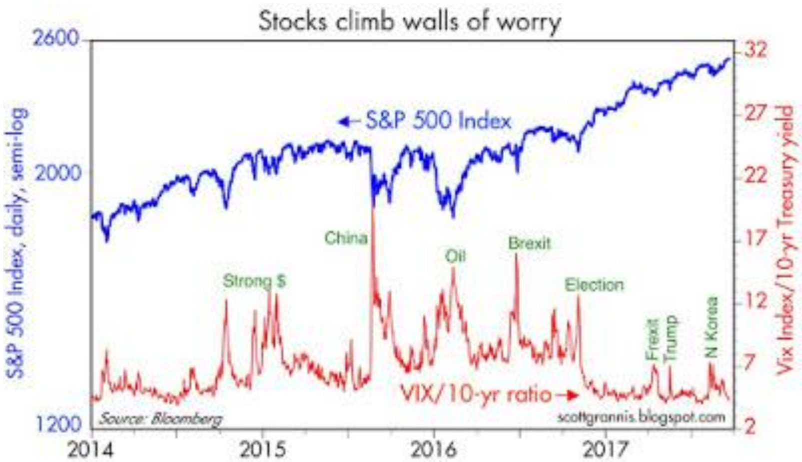




The two charts above show that credit spreads in the USA are at relatively low levels ("normal" swap spreads are 15-30 bps or so). That implies that systemic risk is low, liquidity is plentiful, and the economy is unlikely to throw a wrench into the sales and profits of the U.S. economy's businesses.

Conditions are expected to be good, and profits are expected to rise. The Fed is years away from creating a liquidity squeeze, which could only be precipitated at this point by a massive reduction in bank reserves.



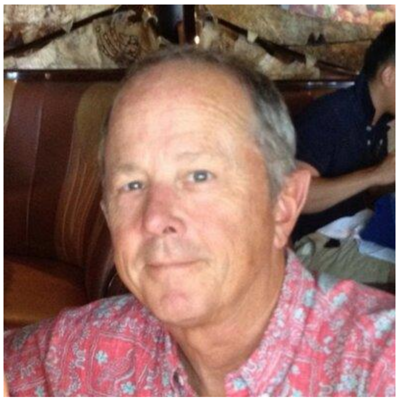
In the absence of obvious or budding threats to the economy, investors find it difficult to resist the stock market, which continues to drift higher. At the current PE ratio of the S&P 500 (21.5), stocks have an earnings yield of almost 4.7% (i.e., if companies paid out all their after tax profits in the form of dividends, the market's average dividend yield would be almost 4.7%). That yield beats the 4.3% yield on the average BAA corporate bond, and it towers over the 1% - 2.8% yields to be found in savings deposits and the Treasury market. Since stocks uniquely can be expected over time to produce capital gains in addition to their yield, the only reason the market would price stocks to yield more than bonds is that the market does not expect earnings to rise, and to more likely fall. Again, this is a sign of market caution.

But, what is slowly happening is that the yield on stocks is declining as their prices rise, and the yield on cash is slowly rising as the price of money declines. This process could continue for some time, as the Fed sets the pace for the yield on cash and the market balances the expected risk-adjusted yield on equities with the risk-free returns on cash. It is a big balancing act that could be disrupted by unforeseen events but, for the time being, it looks like everything is working out OK.

If something about this picture changes, I would bet that it is the outlook for growth, which could improve if and when Congress manages to pass meaningful tax reform and privatize—at least to some extent—the healthcare industry. That would trigger a reduced demand for money (since it would boost confidence and make risky investments more attractive), and that, in turn, would compel the Fed to accelerate rate hikes and the unwinding of QE. But even if all those good things came to pass, I would not expect to see the future returns on equities exceeding the returns we have seen in recent years. Stocks are no longer cheap and are, instead, arguably overvalued; dramatic grains from these levels are thus unlikely.

BW: See ABOUT THE AUTHOR on the following page.

ABOUT THE AUTHOR



Scott Grannis was Chief Economist from 1979-2007 at Western Asset Management, a Pasadena-based, global manager of fixed-income portfolios for institutional clients.

He now enjoys keeping up on economics, markets, and politics from his condo overlooking Calafia Beach on the southern California coast, where he likes to think that he is immune to Wall Street group-think.

Married for 45 years to his Argentine wife, Norma, he has four children and five grandchildren (four boys and one girl).

He is a believer in supply-side economic theory, as practiced by his mentors, the late Jude Wanniski, Art Laffer, and Larry Kudlow. John Rutledge is another of his mentors, from the days that they worked together at Claremont Economics Institute.

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