January 24th, 2017 | Scott Carmack (Portfolio Manager)

COMBATTING THE CONUNDRUM

GREENSPAN'S FAMOUS CONUNDRUM

In 2005, Alan Greenspan, chairman of the Federal Reserve, used the term "conundrum" to describe the flattening of the yield curve in response to Fed tightening. At the time, the Federal Reserve had already raised the Fed Funds rate 150 bps, while ten and thirty-year yields remained stubbornly stable. History has shown that short and longer-term rates have rarely moved in a parallel fashion, and it is difficult to accept that Greenspan believed they would. A more likely motivation for Greenspan's explanation is that he did not want to admit publicly what was truly happening—that rate hikes were curbing future growth and inflation. And although coincident indicators supported tightening monetary policy, the treasury market was well-aware of the future implications. Admitting this scenario would have undermined the efficacy of Fed policy. The key point is that the Federal Reserve has a difficult time justifying policy actions based on what "might" happen while the market is fixated on just that. Basing policy action on both coincident macro-economic indicators and the economic response to such action would likely lead to Fed paralysis. Greenspan was notorious for his vagueness and ambiguity, and "Greenspeak" was designed to jawbone the market when its reaction was contradictory to policy goals.

THE ERA OF TRANSPARENCY POSES A PROBLEM

Current Fed communication has replaced ambiguity with transparency through its frequent press conferences, speeches, and the publication of its macro-forecasts and expected Fed response ("dot-plots"). The dilemma of executing Fed policy in a transparent manner where the market can quickly price-in resultant growth and inflation repercussions has already been illuminated. Until recently, expected rate hikes exacerbated dollar strength, lowered long-term yields, and resulted in significant capital outflow from emerging economies. In 2015, China depleted significant dollar reserves to strengthen their currency (or prevent rapid devaluation) in the face of capital outflows. Global volatility ensued, and the Fed was forced to delay rate increases—eventually raising in December for the first time in nearly a decade. In 2016, dollar strength and market volatility forced the Federal Reserve to ratchet back from an expected four rate hikes at the beginning of the year to only one (December 2016). In both cases, the mere prospect of higher short-term rates sent global markets reeling, tightened monetary conditions, and sent longer-term treasury yields lower. Historically, market front-running might have been prevented by Fed ambiguity and vagueness. How can the Fed, in a transparent manner, communicate Fed policy without working against themselves?

THE FEDERAL RESERVE SHOULD STOP INCORPORATING MARKET REACTION IN DECISION MAKING

I don't envy the Federal Reserve. Balancing full-employment and an inflation target is a difficult mandate. At times, there is a clear-cut policy that can be pursued to achieve these goals. Post-recession, dovish monetary policy was the appropriate course of action given that disinflationary forces and slow economic growth were concomitant concerns. However, there will come a time when the duel mandate of the Federal Reserve will be inherently contradictory. It has happened before. During the 1970's the U.S. economy was stricken with low growth and high inflation. "Stagflation" forced the Fed to choose between fighting inflation and maintaining full employment. They ultimately, after years of discord, opted to punitively raise rates and squash inflation. The short-term pain that ensued came in the form of high cyclical unemployment and a series of recessions followed. Paul Volcker, at the time, would *not* have won any popularity contests, and admittedly, the decision was a difficult one. It would not be surprising if, over the next decade, the Fed finds itself at a similar crossroad.

In any case, history views Paul Volcker in a much more positive light. Ultimately, his difficult decision helped issue in a long-period of strong growth and disinflation. In retrospect, Volcker's decision seems straightforward, but only with the hindsight afforded by time and prosperity. In the moment, he had to ignore the public reaction, the market drawdowns, and the short-term economic consequences that ensued. It is a lesson that the Federal Reserve should hold in high esteem, and it speaks to the apolitical nature of the Federal Reserve that should be preserved at all costs.

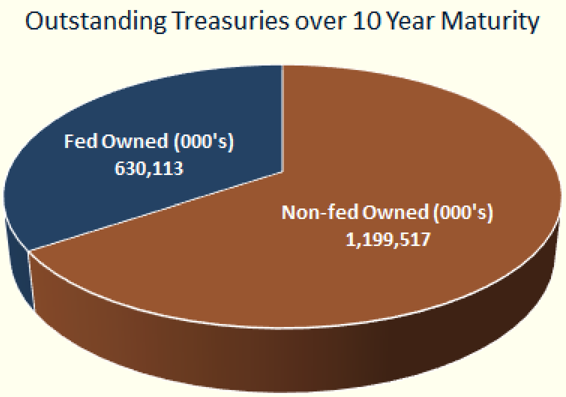
The modern-day Federal Reserve does not find itself in a similar quandary, at least not yet. Currently, both mandates are close to being met—core inflation is running at a 2.1% rate, and the U.S. economy is close to (if not at) full employment. But given the fact that both mandates are effectively being fulfilled, it begs the question, "why are rates still so low?" The Fed is increasingly aware that the environment for dovish monetary policy has very likely passed, and it is for this reason, they are intent on normalization. Had they ignored the market reaction during the past two years to their transparent normalization plans, they may very well be further along in this process. As it stands, they risk falling further behind the curve if they continue to bend policy to accommodate short-term fluctuations in the market. Globalization and the interconnected nature of markets means that economic activity abroad affects the domestic economy—the severity of such affects is hotly debated. I am not advocating that these effects be ignored, but they certainly should take a back seat to tangible coincident labor and price data that has been consistently improving. Transparency and efficacious policy implementation are not mutually exclusive *if* the Federal Reserve can ignore short-term market fluctuations. Conviction, confidence and steadfast resolve will ultimately be better for the economy long-term. In this respect, the Fed should take a page from the Volcker playbook.

THE BULLET NOBODY TALKS ABOUT

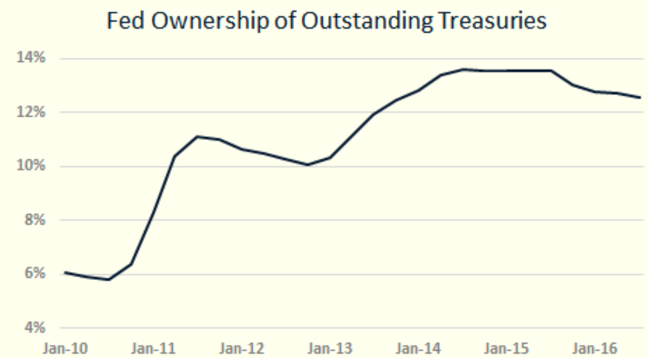
Policy normalization is fragile. Unwinding the monetary stimulus of the past decade is an experiment, and there is no playbook since its scope is without precedent. One might expect that the Federal Reserve would pursue a normalization program that mirrored its stimulus program. Curiously, that has not happened. During the credit crisis, the Federal Reserve first lowered short-term rates to zero. It was only after they had exhausted conventional policy tools, that they pursued their open-market QE programs. A reasonable expectation for unwinding stimulus would have been shrinking their balance sheet (and thus removing excess reserves) and *then* raising the Fed Funds rate. Such action would have ensured that money markets would operate like they did pre-crisis. Ultimately, the Fed was concerned that shrinking their balance sheet might have unintended consequences and allow for less control over the normalization process. They opted, instead, to raise short-term interest rates through the interest paid on excess reserves (IOER) and a reverse-repo program. Banking jargon aside, the Fed's election to maintain the size of their balance sheet has important consequences for the treasury market, and the yield curve.

Historically, the Federal Reserve has been quite effective at controlling short-term rates. Through open-market operations they can control the supply of money and the overnight rate. However, the longer the duration, the less control the Fed has over the prevailing rate—which is determined by a multitude of factors. Hence, the Greenspan "conundrum." Rising short-term rates are not always accompanied by similar increases on the long-end of the yield curve. Right now, the Federal Reserve is actively trying to "normalize" rates. And given their transparency and tightening bias, there is a scenario whereby the market interprets rate hikes as deleterious to both future growth and inflation. In such a scenario, the yield curve could continue to flatten, and perhaps, invert. For those not familiar with what an inverted yield curve means, write this down: historically it is the most accurate predictor of a U.S. recession. Period. In every case where the yield curve inverted, a recession soon followed. And over the past fifty years no U.S. recession has occurred without an inverted yield curve (although six recessions did between 1935 and 1965). The last thing the Federal Reserve wants is an inverted yield curve while they are still normalizing rates. It leaves them with less monetary ammunition to combat the ensuing recession *and* it will likely detract from their credibility as market participants view the normalization process as a policy mistake.

Fortunately, by choosing to raise short-term rates before shrinking their balance sheet, the Federal Reserve has given themselves a preventative policy bullet—a rubber bullet large enough to halt a conundrum assailant. It is not a forgone conclusion that the Federal Reserve will need to fire its rubber baton round. Budget deficits will likely increase treasury supply on the long-end of the curve, and accelerating inflation is usually an effective antidote for low long-term rates. However, if the Fed finds itself in a situation whereby it feels the need to fight inflation, and the market disagrees, selling their long-term treasuries should buy them some time. Consider this: The Federal Reserve owns more than 34% of outstanding treasuries with maturities greater than ten years.



By contrast, the Federal Reserve only owns 12.5% of total U.S. public debt as shown below

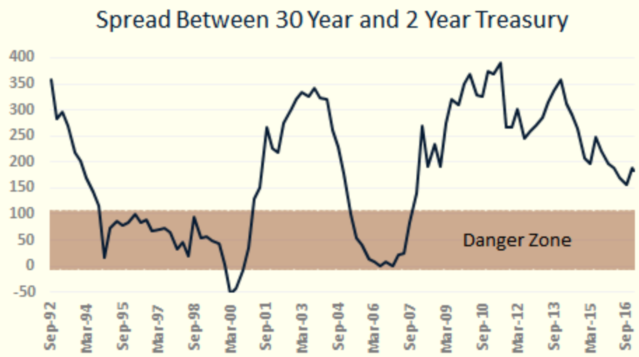


Source: FRED

The Fed's considerable ownership of long-dated treasuries gives them a policy tool that has historically been lacking—the ability to affect longer-term rates, if only for a limited time.

WHEN WILL THE FED EMBARK ON QUANTITATIVE TEASING?

If employment and inflation data weaken, the Fed will likely ratchet back its tightening bias, and shrinking the balance sheet will not be a consideration. If, however, the economy continues to strengthen and the Fed continues to raise short-term rates, two yield-curve scenarios could emerge. First, the market could endorse Fed policy with a parallel yield-curve shift. In this scenario, longer-term yields will increase in tandem with short-term rates suggesting that rate-hikes are interpreted as appropriate normalization and not detrimental to future growth. Alternatively, the yield curve could flatten (Greenspan's conundrum) indicating that the market is at odds with Fed tightening. In this scenario, the Fed can continue what they feel to be appropriate policy normalization through the active selling of longer-dated treasuries. Such action will buy them time, and potentially steepen the yield curve and delay a recession. The size and the make-up of the Fed's balance sheet should enable them to ignore short-term market volatility and pursue their policy goals of normalization. The Federal Reserve is likely to raise Fed Funds three times in 2017. If, over the course of these hikes, the spread between the thirty-year and two-year treasury dips below 100 bps, look for increasing Fed discussion about actively shrinking their balance sheet. Yield curve targeting works both ways—Quantitative Easing sought to bring longer-term yields lower, and Quantitative Teasing will do the opposite.



Source: Bloomberg 1.23.2017

CONCLUSION

The U.S. economy will ultimately dictate the shape of the yield curve. Rates are historically low, and for good reason—the post-recession economy is one that has scarred investor, business, and consumer sentiment. As these wounds heal, normalization is proper Fed policy. The Fed has the rubber bullet to fight a "conundrum" trade and not be held hostage by a disagreeable market. Moreover, they can normalize monetary policy *and* maintain the transparency they have worked so hard to achieve post-Greenspan.