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Macro Perspectives

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Just Give Me a Framework

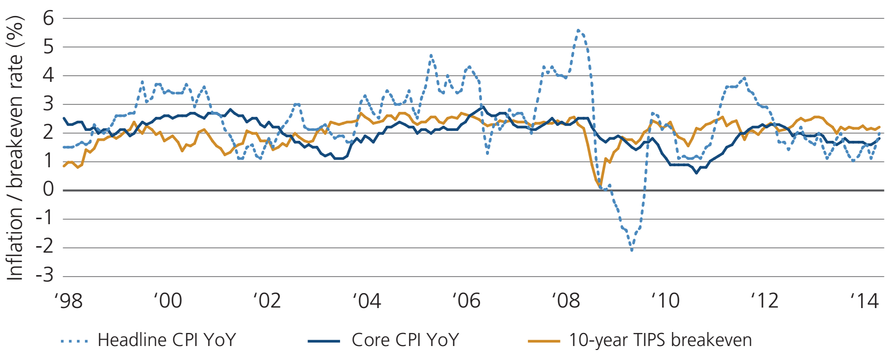
Last weekend, after the whirlwind of the first week in my new job at PIMCO, I reread all my essays written during my previous incarnation here – some 120 of them. Yes, I have masochistic tendencies, which I will explore with my therapist, in hope those tendencies haven't advanced to a disorder.

Don't think so, as I was simultaneously listening to Pink: Just Give Me a Reason!

It was a very useful exercise, in part to remind myself of what I said and when I said it, so as to faithfully own my priors going forward. Not that I don't have the right to change my mind. I am a devout believer of Keynes' dictum that when presented with new information, a person has not just the right but the duty to change one's mind. Or in the famous words of Ralph Waldo Emerson, a foolish consistency is the hobgoblin of little minds.

PIMCO is not a little-minds place, but rather a right-answer-wins place. And getting the right answer is often about being willing to openly recast one's view of how the world works, in the context of one's prior view, rather than passively dismissing it. There is no shame in recognizing new realities, only in refusing to do so.

WELL-ANCHORED INFLATION EXPECTATIONS: THE NEW REALITY



Source: Bureau of Labor Statistics, Barclays. Data as of 30 April 2014.

War remembrances

In rereading my work of the first decade of this century, what struck me most was one unifying theme for the economy, policymakers and the markets: declaring victory in the War Against Inflation launched by Federal Reserve Chairman Paul Volcker in October 1979. Many of my new colleagues weren't even born when that War started!

I could – but won't! – go through the gory (wonky!) details of that War's campaign. Suffice it to say that for two decades after Volcker's initial assault, the Fed fought a **secular** campaign against inflation with a **cyclical** strategy called **"opportunistic disinflation."**

This strategy rejected the notion that the Fed should deliberately induce recessions to reduce inflation, but rather called for the Fed to "opportunistically" welcome recessions when they inevitably happened, bringing cyclical disinflationary dividends.

A corollary of this thesis was that the Fed should **pre-emptively** tighten in recoveries, on leading indicators of rising inflation, rather than rising inflation itself, so as to "lock in" the cyclical disinflationary gains wrought by the preceding recession.

Former Philadelphia Fed President Edward Boehne elegantly described the approach at a Federal Open Market Committee (FOMC) meeting in late 1989:

> *"Now, sooner or later, we will have a recession. I don't think anybody around the table wants a recession or is seeking one, but sooner or later we will have one. If in that recession we took advantage of the anti-inflation (impetus) and we got inflation down from 4 1/2 percent to 3 percent, and then in the next expansion we were able to keep inflation from accelerating, sooner or later there will be another recession out there. And so, if we could bring inflation down from cycle to cycle just as we let it build up from cycle to cycle, that would be considerable progress over what we've done in other periods in history."*

Victory, and feeding Minsky

Opportunistic **cyclical** victories in the War Against Inflation became **secular** victory in the recession that marked the end of the century. The anti-inflation dog finally caught the price-stability bus. Indeed, a favorite day in history for me is 6 May 2003, when the FOMC, struggling to fuel faster recovery from the preceding "opportunistic" recession, formally declared victory (my emphasis):

> *"[T]he probability of an unwelcome substantial fall in inflation, though minor, exceeds that of a pickup in inflation from its already low level. The Committee believes that, taken together, the balance of risks to achieving its goals is weighted toward weakness over the foreseeable future."*

Unwelcome. Yes, the FOMC declared, for the record, that any further fall in inflation would be unwelcome. There was no place lower for inflation the Fed wanted to go, and was worried that if the **cyclical** economic recovery didn't get faster traction, deflationary pressures would emerge. At the time, the core CPI was running at a 1.5% year-over-year rate; it troughed a few months later that year at 1.3%.

And with that **secular** victory in the long War Against Inflation, not only did the doctrine of "opportunistic disinflation" die, but also its companion **cyclical** implementation strategy of "pre-emptive tightening." What's more, policy errors "on the side of tightness" would no longer carry welcome disinflationary silver linings. They would be mistakes!

Glowing with victory, the Fed celebrated the notion that it had fostered a Great Moderation, with long expansions and short recessions, a nirvana land of low **cyclical** economic volatility in the context of **secular** price stability. Concurrently, the Fed moved into a world of **forward guidance**, initiated with the FOMC telling the world explicitly, on 12 August 2003, that it would remain accommodative for a *"considerable period"* into recovery.

Without saying so explicitly, because it would have been politically incorrect to do so, the FOMC, by its subsequent actions, endorsed the notion that it would be acceptable for inflation to pick up somewhat in the unfolding expansion, in part simply to cut off the fat tail of deflation risk that had become all too real in the preceding recession.

And, to be fair to the FOMC, the next recession, now known as the Great Recession, was **not** the result of excessive Fed zeal in cyclically fighting inflation. Where the Fed sinned, and indeed the whole mosaic of financial policymakers sinned, was failure to recognize that the whole concept of the Great Moderation would feed into Hyman Minsky's **Financial Instability Hypothesis!**

As both private sector players **and** policy players believed and acted on the Great Moderation thesis, their very acts of doing so destroyed its viability, on the back of ever-more-risky **private** sector debt arrangements – from Hedge to Speculative to Ponzi debt units, incubated in the explosively growing, barely regulated Shadow Banking System. And then the Minsky Moment hit in 2007–2008, ushering in a Liquidity Trap.

Liquidity trap exigencies

For the last half decade, the Fed – in weakly coordinated tandem with other policy authorities – has been using all available tools to escape the Liquidity Trap, following Paul Krugman's doctrine of acting irresponsibly **relative** to orthodoxy.

Yet, it is hugely important to stress that **at no time since entering the Liquidity Trap over five years ago has the Fed had to give a moment's worry about inflation.** To be sure, the FOMC has had to rhetorically beat back nattering nabobs of antiquated monetarism, who see the Fed's "bloated" balance sheet as inherently evil, the moral equivalent of a very fat man in Speedos: wrong, just wrong!

But, as a **practical matter,** the Fed has not had to worry about accelerating **cyclical** inflation, but rather about the risk of unrelenting "unwelcome" (to borrow a word from 2003) disinflationary pressures. There is absolutely nowhere lower the Fed wants inflation to go, period. The FOMC actually wants it to go higher!

Yes, I hear some of you retorting: But what about asset price inflation? Answer: That's a good thing!

The decisive dynamic behind the Fed's story of success has, in my view, actually been soaring equity prices and valuations, both publicly traded and private. How so? Equity capital gains are the **only** asset that does **not** have a corresponding liability. Thus, soaring equity prices and valuations **endogenously** heal private sector balance sheets that have too much debt and too little equity.

Simple example: If a homeowner has negative equity on his house, there are two ways to fix it. The bank can haircut the mortgage to "restore" equity, or the market value of the house can go up – "recover" would be the polite word – above the value of the mortgage.

Moralists would argue for the former; enlightened macro policymakers try to engineer the latter.

I use this example as but an example, as it is easy to understand. But the principle applies on an economy-wide basis. Capital gains – whether realized or not! – work to delever over-indebted private sector balance sheets, the fundamental cancer of a Liquidity Trap.

But are those gains sustainable?

The New Neutral!

Let's start with the bond market. The Fed's policy rate anchors the yield curve: the yield on cash, which **always trades at par.**

Logically, if you are going to give up the certainty of real-time par, locking up your money for a longer period than tomorrow, you want to earn a higher yield than on cash. That's called a **term risk premium,** as longer-dated bonds don't always trade at par, like cash does.

You also want to be thinking about how the Fed might change the rate on cash in the future; you certainly wouldn't want to blindly lock up your money now at a risk premium over today's yield on cash if you **expected** the Fed to hike cash yields in the future.

Thus, the slope of the yield curve can be summarized as a **forward curve on the Fed's future policy rate, plus a risk premium.** It's that simple (though the math can be very complex, especially in computing risk premiums, which are connected to current and expected volatility).

The bond market is "fairly" valued when the yield curve captures **sensible** expectations on both scores: expected Fed policy and expected volatility.

But what about inflation, you ask; shouldn't the bond market reflect expectations on that score, too?

The fact of the matter is that those expectations have been "well-anchored" ever since the War Against Inflation was won at the turn of the century. Yes, they bounced around **cyclically**, but have **trended** in a sideways pattern, in the neighborhood of Fed's long-term inflation target of 2%.

Thus, in considering the concept of "fair" value for the bond market presently, it is reasonable to start with the assumption that the Fed will achieve its **secular** inflation target of 2%. Note, I said "secular," not "cyclical." As is self-evidently true, the Fed has "missed" on the downside versus its target over the last five years. Stuff happens.

And it may well be the case that going forward, the Fed will have periods when it misses **cyclically** on the upside in the future. Stuff happens. Indeed, I would argue that in the cycle that lies before us, a "miss" on the upside would be a delightful outcome, so long as it doesn't meaningfully unmoor **secular** inflationary expectations.

To be sure, consensus market opinion has yet to fully embrace this thesis, in part because Fed policymakers themselves are still coming to terms with it. But for me, **secular** price stability rationally should imply **cyclical symmetry** around the Fed's long-term inflation target: sometimes below and sometimes above.

Thus, the matter of figuring out "fair" value for the bond market, by Occam's Razor, comes down to this: What is the "neutral" real fed funds rate, that rate which becomes the **secular center of gravity** for the ups and downs of the **cyclical path** of Fed policy?

Taylor redux

I have been writing about this issue for, literally, ten years.[1] There are many ways to come at the analysis – theoretical, empirical and institutional. And all three disciplines offer one robust conclusion: The "neutral" real policy rate is **not** secularly constant.

It **evolves** as a function of changing "real" economic variables – demographics, technological progress, productivity, etc. – as well as changing institutional arrangements, notably changes in the degree of regulation of banking and finance, domestically and internationally. Thus, the notion of a "fixed" center of real policy rate gravity for prudent monetary policy is an oxymoron.

Which is why, for me, it is so befuddling that the Fed, and thus the markets, still clings – even if reluctantly – to one man's estimate of an "equilibrium" real fed funds rate, made in 1993: John Taylor, who **assumed** it to be 2%, which, in his own words, was because it was *"close to the assumed steady state growth rate of 2.2%."*

And that assumption became embedded in his ubiquitous Taylor Rule.

Simply translated, his Rule espoused that **if** inflation was at the Fed's (then presumed, not explicit) 2% target, and **if** the economy was at its full employment potential (that is, the unemployment rate was at NAIRU, or the non-accelerating inflation rate of unemployment), **then** the "right" level for the Fed's policy rate would be 4% – at-target 2% inflation plus his assumed 2% real rate "constant."

Yes, that's the origin of the 4% number that, **to this day**, the FOMC prints as its "**longer-term blue dot**" for where the fed funds rate "should be" (**if** the Fed were, theoretically, pegging the meter on both of its mandates).

I've got to hand it to John, whom I've known and liked for a very long time: Twenty-one years on, and you are still hardwired into the catechism of Fed policy!

But surely, economic life has changed since 1993, about the same time that Al Gore was inventing the Internet.

I believe the FOMC's 4% nominal **longer-term blue dot** – which implicitly embeds John's 2% real rate **assumption** – is wrong, unless we want to say that 2014 is 1993 redux. I don't.

But that doesn't make the 4% blue dot irrelevant at all: The FOMC **still** prints it, using it as a "benchmark" for neutrality, forecasting that the actual path of its policy rate will remain well below that dot for a long, long time, and **thus**, "accommodative."

And there is some merit to this theater, particularly in the political arena: If 4% is the benchmark, how could Congress complain about lift-off from effectively zero?

But there is a limit to how much markets are willing to suit up for theater: I believe the bull flattening of the yield curve this year has, at its core, been all about the bond market rejecting the 4% dot. PIMCO, as you know, sees The New Neutral real rate likely close to 0% over the next few years.

This brings us to stocks, the valuation of which must start with the bond market.

Rational exuberance

The most basic, and intrinsically most powerful, framework for valuing stocks is, for me anyway, the Gordon Model, which incorporates the "risk-free" long-term real interest rate in discounting profits/dividends. Accordingly, **if** that rate is a function of the central bank's "neutral" real policy rate **plus** a term premium, **then** it should be plainly clear that a structural reduction in the neutral real policy rate should have a profound upward impact on the "fair" valuation of both bonds **and** stocks.

Yes, for stocks, there is the tricky matter of estimating the real growth rate of profits/dividends, and, yes, there is a tail risk scenario, also known as a depression, in which the expected real growth rate for profits could fall more than the neutral real policy rate, which would be a configuration that would reduce "fair" valuation for stocks.

But I start with the notion that the American economy is – and will be! – a going, thriving concern, warts included.

Thus, I don't see current valuations for either bonds or stocks as "**artificial**." They are not cheap, to be sure, because they have been discounting a lower equilibrium fed funds rate for **quite some time**. And, yes, there are some elements of froth in both markets, particularly in specific sectors. But on the whole, I have no problem with prevailing macro valuations of either asset class.

And I think they could get richer still, especially for stocks, in the run-up to the day when the FOMC takes an "official" sharp whack to that 4% dot, which I expect will happen **before** the first policy rate hike. Ironically, that would probably be a good time to take **tactical** chips off the equity table, before the Taper Tantrum is reincarnated into the Hike Heebies. But I digress.

My strategic bottom line

1. The War Against Inflation initiated against inflation by Volcker in 1979 is over, done, finished; we **won** some 15 years ago. Accordingly, the secular Fed strategy known as "opportunistic disinflation" is dead, along with its companion cyclical implementation strategy of "pre-emptive tightening."

2. Winning that War was, ironically, a Pyrrhic victory, to the extent it fostered irrational belief in the staying power of the Great Moderation, setting in motion debt dynamics that gave birth to the Minsky Moment, which ushered in a Liquidity Trap.

3. The Fed has appropriately and mightily fought to escape the Liquidity Trap ever since, employing a mosaic of policies in a "responsibly irresponsible" fashion.

4. These policies have worked. Escape from the Liquidity Trap nears, with the heavy lifting having been done by **endogenous delevering of private sector balance sheets through the alchemy of rising bond and equity prices and valuations**, which are fundamentally grounded in **structural** reduction in the central bank's neutral real policy rate.

   Escape Valuations beget Escape Velocity, not the other way 'round!

5. Both bonds and stocks are presently in **secular** zones of "fair" valuation. Not cheap, but not rich. And definitely not "artificial!"

6. Long live The New Neutral!

[1] *Fed Focus*, "Doctor, My Eyes," April 2004. http://media.pimco.com/Documents/Fed_Focus_McCulley_April2004_GBL.pdf

The "risk-free" rate can be considered the return on an investment that, in theory, carries no risk. Therefore, it is implied that any additional risk should be rewarded with additional return. All investments contain risk and may lose value.

Investing in the **bond market** is subject to risks, including market, interest rate, issuer, credit, inflation risk, and liquidity risk. The value of most bonds and bond strategies are impacted by changes in interest rates. Bonds and bond strategies with longer durations tend to be more sensitive and volatile than those with shorter durations; bond prices generally fall as interest rates rise, and the current low interest rate environment increases this risk. Current reductions in bond counterparty capacity may contribute to decreased market liquidity and increased price volatility. Bond investments may be worth more or less than the original cost when redeemed**. Equities** may decline in value due to both real and perceived general market, economic and industry conditions. Investors should consult their investment professional prior to making an investment decision.

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