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The Fed's Great Taper Caper

If every good story needs a beginning, this one starts in May of this year. It was then that Federal Reserve Board Chairman Ben Bernanke warned the financial markets that the Fed may scale back its bond-buying program in late-2013, with a goal of exiting the program in 2014. The bond buying program is better known as Quantitative Easing, version three; but everyone calls it by its street name, 'QE 3'. Likewise, the reduction of this program, presumably in measured steps, goes by the moniker 'taper'. Such colorful characters they have in central banking.

The response to Chairman Bernanke's warnings were predictable. Long-term Treasury rates rose in anticipation of a future supply-demand re-balancing. This is what happens when the Fed all but corners the market on long-term government securities, then determines that its hoarding program has nearly run its course. Mortgage rates followed Treasury yields higher for two reasons. First, mortgage rates are tightly linked to Treasury rates, and when the latter benchmark moves higher, mortgage rates naturally follow; second, the Fed is also a major buyer in the mortgage securities market, and is just as likely to pare its buying of mortgage paper as Treasurys.

So it was all teed up for a September announcement that the Fed was beginning its tapering initiative. Then, as with all good stories, a plot twist developed out of nowhere. When the Fed concluded its September meeting and announced its policy changes... well, there were no changes to announce. Just when you were settled in for a run-of-the-mill drama, a slap-stick comedy appears out of nowhere.

Markets roared, and what else do you do at such a time?

Yields on 10-year Treasurys, recently touching three percent, fell below 2.50 percent. Stocks rose to new all-time highs, consolidated the gain, then moved higher still.

The Fed's explanation added to the comic tone. Bernanke and company repeatedly remind investors that policy decisions are always data-dependent, and that the future is uncertain. Presumably we are supposed to imagine an alternative script, where the future is known and the Fed acts, not based on data, but on a whim. Perhaps they have a Ouija Board or Tarot Cards in the back room.

Adding some spin, the Fed claimed that financial conditions had tightened since it first broached the subject of tapering. This one sets off the BS-meter. As noted by economists at Deutsche Bank, the only meaningful tightening of financial conditions since May was the rise in long-term rates, a rise precipitated by the Federal Reserve.

So here is the script in a nutshell: The Fed talks up interest rates, and rates rise. The Fed then pulls a fast one, improvises new lines, and blames it on higher rates. Markets roar. After all, who's complaining? QE 3 is the Fed's blessing of stock and bond markets; the gift that keeps on giving; you know... free money.

Behind the scenes, here is what happened. The Fed has been on a long campaign to improve its communication with financial market players. It now holds televised press conferences and releases detailed minutes of its meetings. It also provides economic projections that are always wrong, and always wrong in the same direction. This adds levity to an otherwise dry subject. Nevertheless, it is all done in the name of transparency. Chairman Bernanke's warning in May was more of the same… more transparency, fewer surprises.

But since that first mention of tapering, numerous Fed officials have gone off script. Between May and September, at least three Federal Reserve Bank Presidents pushed back on the timing of Fed tapering. To their thinking, the labor market was too weak, and inflation too benign, for the Fed to ease off the gas pedal. So the Fed as a whole was never fully committed to tapering this year. If this posed a credibility problem, Chairman Bernanke could always blame inaction on weak data, uncertainty, and tightening markets... the usual suspects.

And here is one more plot twist: taken in context, those Fed Bank Presidents were right. If the QE 3 bond-buying program made sense in January or April of this year, it made sense in September and October. The economy is not accelerating, the job market is not strengthening, and inflation is not a threat. Moreover, the mess that Congress and the White House created over the budget and debt ceiling could only add to the near-term malaise in the US economy. So the Fed may have it right on the taper issue; they just blew the delivery.

In an uncertain world, there is never an optimal time to tighten monetary policy. Yet, eventually the Fed must exit its Quantitative Easing program. It needs to stop enabling a spend-thrift Congress. It should allow markets to set long-term interest rates and allocate capital. But that is for another day. For the Fed, tapering is like going on a diet: the best part is, you can always start tomorrow.

Boys Behaving Badly

What if the government shut down and nobody cared? For the first time in 17 years this question arose, but alas the people still want their Department of Education, ethanol subsidies, and failed investments in solar-energy plays. Silly folks.

The shutdown played out over the first half of October, with negotiations stuck on budget resolutions, borrowing limits, Obamacare, and scoring political points -- all rolled into one. The greatest drama was over the debt-ceiling, wherein it was plausible the US would miss a debt payment or two and go into default. This would not be the first time, would not be the last time, and calls into question why anyone still considers the US a triple-A rated credit.

Pardon the dismissive tone, but we have seen this movie before, and we know how it ends. Mostly it entails patch-work maneuvering, a promise to do better in the future, and blame falling squarely on the Republican Party. Months or years later, the old script is dusted off, revised, and a sequel is launched. Without going into the sordid details, here are some thoughts on the state of affairs in our nation's capital.

First, what happened to Democrats of a prior generation, leaders such as Tip O'Neill, Bill Bradley, and Daniel Patrick Moynihan? These were men who seemingly knew where the boundaries of party politics were drawn, and where national interests prevailed. They understood there are limits to what government can do, and how much it can spend. Have these men really been replaced by the dynamic duo of Reid and Pelosi?

Second, getting yourself elected by reading a teleprompter is a remarkable achievement, but it is not leadership. A real leader does not live in perpetual campaign mode, making stump speeches to sympathetic audiences while policy flounders. The major contribution to political science from our bloviater-in-chief is to prove that a thin-skinned, megalomaniacal, ideologue does not belong in the White House.

Last, and we really mean last, is the Tea Party branch of the Republican Party. Just a few years old, this was a cause born out of good intentions -- to curtail runaway spending and return fiscal responsibility to Washington. It has already fallen off the rails. It made costly mistakes by picking fights it could not win, and in the process divided its own party. The budget ploy was a huge party over-reach, suggesting its own line-item veto of legislation -- Obamacare -- passed by Congress, signed by the President, and upheld by the Supreme Court. Bad idea or not, Obamacare is the law of the land. Get over it.

Warnings about the shutdown's drag on the economy are mostly exaggerated. In a 17 trillion dollar marketplace, driven more by private enterprise than government, a partial closing of the federal system for half a month is barely worth mention. The economy is still inching forward, just as it was one and two months ago. And if the political brinkmanship damaged our standing in the world, why are stock prices rising and interest rates falling? It simply does not add up to much.

The childish behavior did bring back an old story worth repeating. It goes something like this:

A grade-school Scout Troop was visiting Washington on a year-end trip. Their itinerary included a visit to the Capitol building and greetings by a few members of Congress. Upon meeting the Congressional Chaplain, the Scout leader asked: "Chaplain, do you consider the troubled state of our nation, and pray for Congress?" The Chaplain paused, shook his head and replied: "No, I consider the troubled state of our Congress, and pray for the nation."

Amen.

Sources:
Bloomberg
Wall Street Journal

Tidbits..

Income gap grows to 84-year high as top one-percenters earn 19 percent of US income.
White House rhetoric aside, the rich get richer.

Dow Jones Industrials drop Hewlett-Packard, Alcoa, and Bank of America; replaced by Nike, Visa and Goldman Sachs.
A sign of the times, or silly game-playing by index committee?

Verizon Communications raises 49 billion dollars in largest bond offering in history, to help fund purchase of Vodaphone's stake in Verizon Wireless.

Tablet unit sales expected to exceed PC unit sales in fourth quarter, IDC says.

D.C. mayor Vincent Gray vetoes living wage bill targeting retailers, chooses jobs over populist policy.
Intelligent life finally appears in nation's capital.

Medical cost inflation slows to one percent in past 12 months, slowest pace in 50 years.
But overall medical spending expected to rise six percent in 2014.

US median incomes stabilized in 2012, still down eight percent from 2007 level.
Poverty rate holds steady at 15 percent of population.
In this case, stability is not progress.

JP Morgan to pay five billion dollars to settle US mortgage claims, 920 million dollars to settle London Whale trading fiasco; further claims likely to total billions more.
The nation's best managed bank, other than the huge blunders.

US becomes world's largest oil and gas producer, surpassing Russia's output.
US fuel exports approach four million barrels per day, at record level.
A triumph of capitalism over government impediments.

Case-Shiller Home Price Index rises 13 percent in past year, fastest increase in seven years.
Still down 22 percent from 2006 peak.

Treasury Department report blasts Germany's export-driven economic policy as harmful.
People in glass houses…

US budget deficit falls to 680 billion dollars in 2013, lowest since 2008.
A false sense of security, as big-ticket entitlement issues remain untouched.

Federal Reserve Vice-Chair Janet Yellen is nominated to replace Ben Bernanke as Chairman.