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When the Fed Can't Walk the Walk

By Andy Nybo, Principal

Today the Federal Reserve announced it was pushing back the timing of an interest rate hike until 2014 at the earliest, extending its original guidance released in August 2011 by more than a year. Rumors of the policy shift have been circulating for weeks but the extension of the low rate policy has been welcomed by the markets with glee, with equity prices jumping on the news and Treasury bonds (at least initially) seeing significant inflows.

That's great, but is there more here than meets the eye?

The Fed has an extremely powerful voice in the global financial markets, having long ago replaced EF Hutton as the force to be reckoned with in terms of market-moving messages.

But is the Fed getting a little out over its skis? Policy statements by the Fed are successful since they carry the weight of its wisdom and ultimately, the heft of its balance sheet.

However, in its fervor to become more transparent, the Fed has severely weakened the power of its verbal arsenal. By prognosticating far into the near future, the Fed has opened up a can of worms. It’s acceptable for the Fed to be wrong for short periods as policy adjustments can be made relatively quickly to address any mistakes. But long term forecasting carries with it the potential for large margins of error. And the Fed will bear the full responsibility for any forecasting errors and, more importantly, the damage to its credibility.

The Fed’s announcement raised at least a number of questions:

1. Most obviously, what do they know that we don’t know? The crisis in Europe seems to be contained; at least that’s what the global equity markets are telling us, with gains of 5 to 10 percent in developed and emerging markets since the beginning of the year.

   And Iran’s efforts to threaten the world’s oil supply seem to be falling on deaf ears, despite dire predictions from the IMF that shutting off Iran’s spigot could result in a 20 to 30 percent increase in the price of crude. Is there some other structural deficit that is hiding under the surface that us mere mortals have yet to identify? Makes you wonder…..

2. How can they be so sure they will not need to raise rates sooner, say in 2013 or even 2012? The Fed's record on predicting inflation and related economic events has been abysmal.

   Perhaps it has refined its model through cloud deployments of Cray, K and Tianhe super computers using all of the data that it is so good at collecting. But I reserve judgment until Bernanke and gang can prove its acumen through a proven track record. Inflation in my neck of the woods is on the rise.

3. Gas costs more, the amount of food in boxes keeps shrinking even though prices are going up, and repair men are raising prices just to come give me an estimate on that nagging roof leak (Oh and by the way, did you know the cost of shingles relates directly to the price of oil? So if I lock in the price of shingles now I won't get hit with a price increase….). The only prices that seem to be falling are for LCD TVs, computers and all sorts of electronic gadgets. But these are discretionary items and at the end of the day you still have to serve food to your guests when they come over to watch the Giants-Patriots Superbowl on your new 70 inch LCD TV (btw, Giants by 13).

4. What if the Fed is wrong? A lot can happen in two years. I for one believe the economy will begin to gather steam as consumer confidence begins to rebound. Asset prices are rising, optimism seems to be on the rise and people are beginning to shop again.

   The average car on the road is 11 years old and pretty soon a lot of these cars will have to be replaced. As consumer demand recovers inflation will increase and the Fed will have to act, especially with its (benign) 2 percent inflation forecast.

5. What happens when they reverse course on the direction of rates? The market likes hearing a forecast for a longer period of lower rates but when the Fed makes an official announcement that interest rates are going up the knee-jerk reaction will be swift and damaging, especially for fixed income investors. But maybe that's the plan, raise rates and the resulting decline in value in all those foreign holdings of U.S. Treasuries becomes a powerful economic weapon policy tool.

6. What happens to the Fed's credibility if it is wrong? One of the Fed's most powerful weapons (especially with rates at or close to zero) is to communicate and effect policy through public statements that are digested by the market in microscopic detail. The Fed's credibility—and ability to influence market sentiment—will be indelibly damaged if it is wrong on the timing of rates. The Fed's statements to-date have been reassuring for the market but if the market

senses any failing in the Fed's prognostications then the power of policy statements will be significantly diluted.

Just a few of my thoughts. How about it TabbFORUM users, is the new Fed policy of super-transparency a good thing or a bad thing?

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