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Eye on the Market, January 23, 2013

Topics: market and economic update, and the latest televised confession

Market update. We released our 2013 Outlook on January 2nd; please contact your J.P. Morgan team for an electronic or printed copy. Since that time, more of the same:

- *Reflation.* Equity volatility has fallen to pre-crisis lows as central banks drive up financial markets via ultra-low interest rates, hoping for whatever trickle-down effect they can get in the economy. Piles of cash held by pensions, endowments, central banks, individuals, etc, are looking for return, and on the march. While earnings growth is slowing, equity valuations are not stretched in an historical context. Expect another year of markets outperforming what growth alone would imply.
- *US growth* is running at ~2%. Income, consumption, housing and capital spending were improving at year-end. Higher income tax rates and the end of the payroll tax holiday will probably slow growth for a quarter or two before a modest rebound later in the year. Q4 S&P profits are coming in better than lowered expectations, and 2013 estimates are stabilizing at 10% y/y.
- *China's economy* has been improving (production, demand, trade, housing, capital spending), reinforcing consensus growth expectations of 8%. In the rest of emerging Asia, exports and production are rising gradually after last year's slowdown
- *In a schizophrenic Europe,* economic data is still weak while capital markets keep improving. German growth stalled, the % of employed Italian men hit a new all-time low of 66%, and Spain's unemployment rate is about to pass Greece. Employment is usually a lagging indicator, but forward-looking surveys for Italy and Spain don't look good either. However, deposit outflows have stabilized, Spanish bond yields keep declining and European HY spreads are back to pre-crisis levels, all based on the view that the ECB (firmly in Italian hands) will print money and bail everyone out. France passed legislation to introduce more flexibility into labor markets, but they've got a long way to go to close the unemployment and export gap with Germany.
- *Japan* edges closer to a formal money-printing exercise of its own as the global currency wars continue. This week's announcement fell short of the Big Bang, but was made by lame duck members of the BoJ who are on their way out; expect to hear more in April. Something tells me Europe may be the export loser as the Euro appreciates against the Yen.

True Confessions. Televised confessions make for fascinating viewing. Below is a transcript of Federal Reserve Chairman Ben Bernanke ("Chairman") on *The Zeppo Show[a]*. This imagined exchange is our way of surfacing the debates and risks around the Fed's balance sheet and possible exit strategies, a universal question that we get from most of our clients.

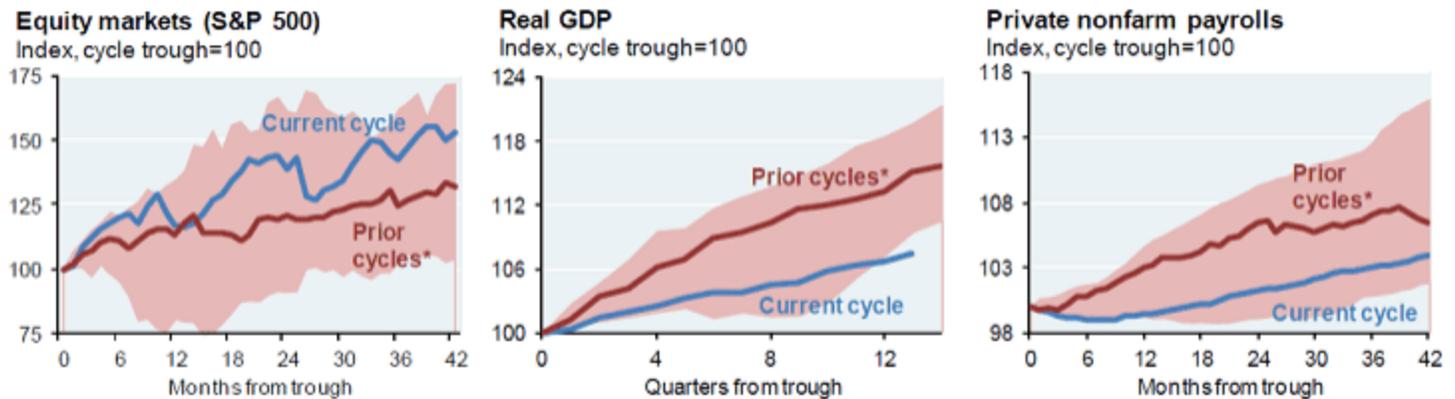
Zeppo: "Thank you for coming on the program. What brings you on the show today?"

Chairman: "I have a confession to make. For the last few years, I have been injecting the US economy with steroids in the form of Central Bank asset purchases. While at times FOMC members obscure it, the primary goal of this exercise is to drive up financial asset prices, make holders of such assets feel wealthier, more confident, and spend more money than their current income affords. Increased spending should lead to higher incomes and profits that, in a virtuous circle, will further support economic expansion. Lower corporate bond rates also encourage investment, and eventually, hiring." [b]

Zeppo: "Thank you for being so frank with us, I know it must be hard. I have to ask, how is that different from the much-derided supply side arguments of the 1980s, referred to as trickle-down economics?"

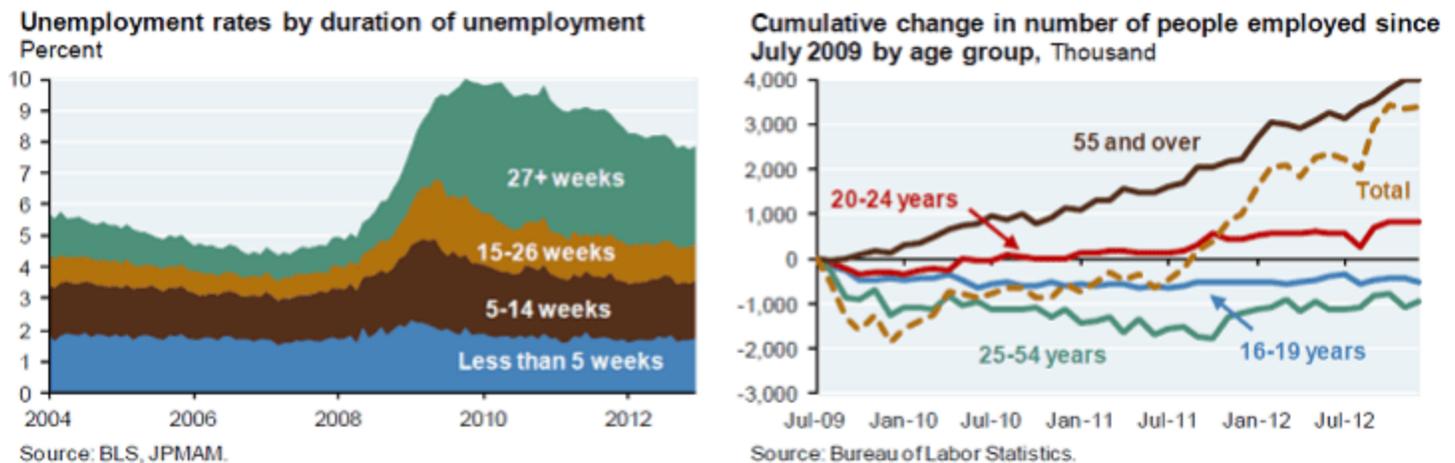
Chairman: "No comment on that. The FOMC is doing what it thinks is best for the US economy using the tools at its disposal which as our mandate states, is to make progress toward maximum employment and price stability."

Zeppo: “Let’s look at the asset purchases. The Fed has undoubtedly been successful in driving up equity markets compared to prior cycles. The pass-through to growth and employment is not showing that much progress yet; is it too early to judge?”



Source: BEA, BLS, Haver Analytics, NBER. *Solid line denotes median and band denotes range.

Chairman: “I think so. Without asset purchases, employment would probably be worse. Data suggests that cyclical rather than structural factors are the primary source of increased unemployment. If that is correct, accommodative monetary policy to support the recovery should help. We must watch long-term unemployment: even if the primary cause is insufficient demand, if progress in reducing unemployment is too slow, the long-term unemployed will see their skills and labor force attachment atrophy further, possibly converting a cyclical problem into a structural one. Another concern is generational. Over three million jobs have been created since 2009. However, jobs for those over age 55 have risen by 4 million, while workers from 16-54 have been net losers of 0.6mm jobs. A couple of other statistics on labor markets to show why the Fed is addressing this component of its mandate with so much vigor: the unemployment rate when including discouraged workers and people working part-time for economic reasons is over 14%.”



Zeppo: “Even so, there is some controversy about the long-term impact of central banks influencing markets. I remember an article that Jeremy Grantham wrote a couple of years ago around Halloween entitled, ‘*Night of the Living Fed: The Ruinous Cost of Fed Manipulation of Asset Prices*’. He referred to the negative consequences of misallocation of capital, unproductive speculation, the risk of currency-related conflicts, and the corrosive impact of repeated boom-bust cycles over time. The housing boom-bust, partially fueled by a 1% Fed Funds rate in the early 2000’s, is just one example.”

Chairman: “I can’t say that I’ve read it. No question, the Fed did not cover itself with glory in assessing the risks of the housing and subprime problems during the prior credit cycle. However, there are costs to every policy decision; the question one has to answer is whether the benefits outweigh the risks in the long run.”

Zeppo: “Let’s talk about those risks for a minute. Why are you not worried about the inflationary consequences of easy monetary policy and the size of the Fed’s balance sheet?”

Chairman: “Current inflation measures are benign, and more importantly, there is a large negative output gap. By this I am referring to estimates by the Congressional Budget Office that effectively measure the amount of spare capacity in the US economy, and how much the economy could grow before generating inflationary pressure. As you can see, the negative output gap is large, unlike periods in the mid 1970’s when there was a *positive* output gap and easy monetary policy, which

when combined with an oil price shock and protectionist labor markets, led to inflation. Circumstances are quite different today.”

US inflation

Percent change, YoY



Source: Bureau of Labor Statistics.

US output gap

Percent of potential GDP



Source: Congressional Budget Office.

Zeppo: “I hear you, but James Bullard, an FOMC member from the St. Louis Fed, is a critic of output gaps and thinks the US version might not be that negative. He cites unresolved gap measurement issues and shaky empirical relationships. He also believes that positive output gaps outside the US are important to look at as contributors to US inflation dynamics.”

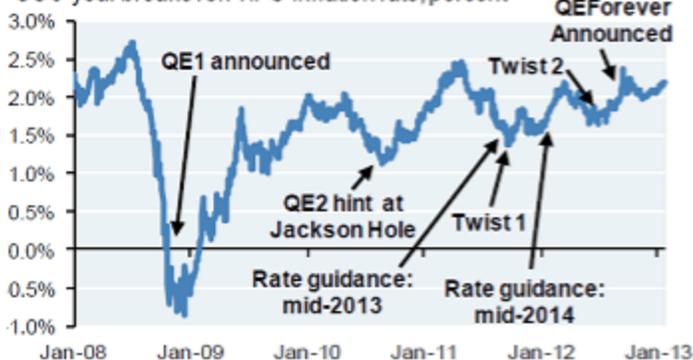
Chairman: “The FOMC is not relying just on output gap estimates. There is a healthy debate at the FOMC about these issues, which we continue to monitor. By the way, are you sure that your viewers are really interested in stuff like this?”

Zeppo: “I sure hope so, since we cancelled Otis the Sky-Diving Dog to book you. Let’s get back to it. Some Fed watchers also note that while QE1 and QE2 were adopted when inflation expectations were falling, the more recent Fed actions have taken place when they were stable. In other words, despite the disappearance of deflation risk when looking at what is priced into TIPS markets. That’s what the chart below shows.”

Chairman: “To reiterate, the employment situation is taking a front seat for a while given Fed concerns about structural unemployment risks. At the current time, our thinking is that Fed asset purchases would stop if core inflation rose persistently above 2.5%, or if unemployment fell below 6.5%. Or if Texas Governor Rick Perry says its OK (just kidding).”

Fed policies and inflation expectations

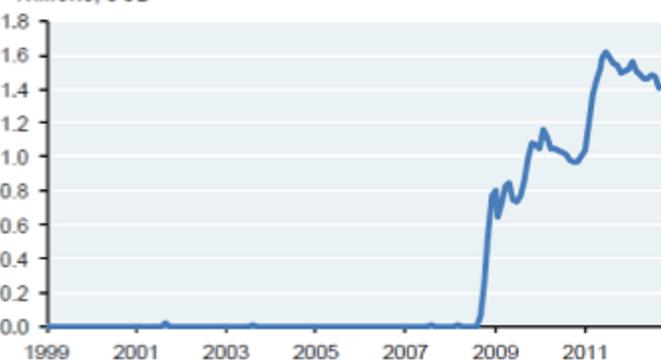
US 5-year breakeven TIPS inflation rate, percent



Source: Bloomberg, GaveKal.

Excess reserves held by banks at the Fed

Trillions, USD



Source: Federal Reserve Board.

Zeppo: “Even if we assume that inflation stays low, assuming that the US is not Japan, *eventually* the output gap chart will close, and it will be time to withdraw some of the liquidity that has been created. How complicated do you think that will be? Here’s a chart on excess reserves in the US banking system. As you know, these balances are not a result of ‘bank hoarding’ or ‘miserly bank lending standards’, but a direct byproduct of the excess reserves created by the Fed to pay for Treasury and Agency bonds it purchased during its balance sheet operations. By next summer, excess reserves could top \$2 trillion.”

Chairman: “There are a variety of mechanisms the FOMC can use when the time comes. One approach that the Fed has written about conducts monetary policy through the rate paid on these excess reserves, such that this rate becomes a proxy for the cost of money which the Fed can raise or lower as it sees fit. We would raise it in the scenario you mention.”

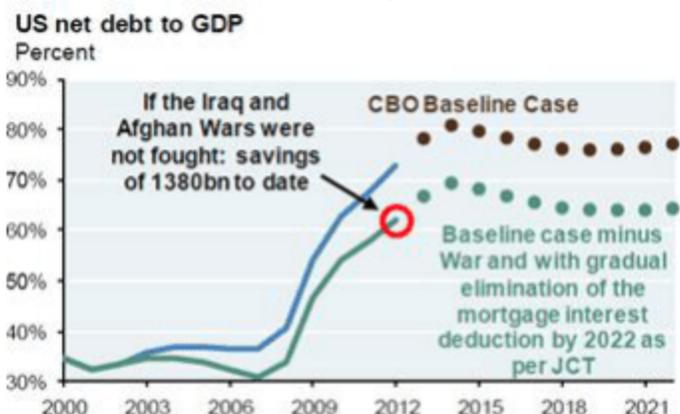
Zeppo: “That sounds plausible, but what happens when/if interest rates have to be raised to a level above the Fed’s income on the Treasury and Agency securities that it holds? The first consequence would be a reduction in the positive carry subsidy that the Fed has been paying to the US Treasury, and as interest rates rise further, eventually the Fed would be in a negative carry situation. What then? Would the Fed sell gold so as not to have to go to Congress to be recapitalized?”

Chairman: “You are talking about a string of hypotheticals that are a long way away from today, at which time the FOMC will evaluate its range of options, including asset sales and repo operations. That is a bridge we can cross when we get there.”

Zeppo: “Ok, I don’t want to get too exercised about this...maybe I should stop reading Charles Plosser, president of the Federal Reserve Bank of Philadelphia. He has been giving interviews in which he wonders about the speed by which interest rates would have to be raised on excess reserves to prevent undesired lending to an overheating economy, the limited experience that the Fed has with this approach, and what the next steps would be if it did not work as expected. Some of his comments verge on the hysterical, and by that I mean ‘concerned’ rather than ‘funny’.”

Chairman: “There are a wide range of opinions on this issue, and Charlie’s views are part of that spectrum. I have said in the past that we will continue to reevaluate the costs and benefits of these activities, and adjust them as necessary. I should also point out that there is a large consensus on the Federal Open Market Committee for the steps the Fed is taking, and for exploring the concept of paying interest on excess reserves as an exit strategy.”

Zeppo: “Let me ask about the independence of the Fed. There is some speculation that another reason for ultra-low interest rates is that the Fed has been co-opted into helping the Treasury deal with its deficit. In the last chart, we plot the CBO’s Baseline debt/GDP scenario, the one that assumes that the budget sequester *will* go through as planned. And in response to one of our viewer questions, we also show what the debt/gdp outlook would look under two assumptions: what if the US had not fought wars in Iraq or Afghanistan, *and* what if the mortgage interest deduction were completely eliminated by 2022? In other words, let’s examine a scenario in which the US focuses its balance sheet on those most in need, rather than on military adventurism or middle class entitlements. As you can see, the debt problem remains pretty high by any historical standard. Is financing the deficit a third mandate for the Fed now, and why it is forcing down interest rates?”



Source: Congressional Budget Office, Joint Committee on Taxation, Congressional Research Service, JPMAM.

Chairman: “Absolutely not. The FOMC remains committed to its dual mandate on inflation and price stability. When the time comes to remove the monetary accommodation, we will do it, and not repeat the mistakes of the 1970’s. Who wants to be remembered like Arthur Burns?”

Zeppo: “One last question. Both you and Bill Dudley have mentioned concerns about mortgage spreads to homebuyers not declining as fast as spreads on mortgage-backed securities issued by Fannie Mae, for example. The Fed presented a paper at a recent conference that stated that mortgage originators were ‘enjoying pricing power on some borrowers looking to refinance’. Have you read a recent note from the American Enterprise Institute on the subject? Fannie and Freddie mispriced credit risk during the housing bubble, and so in 2011, Congress ordered the Federal Housing Finance Agency to ensure that GSE guarantee fees ‘appropriately reflect the risk of loss, as well as the cost of capital allocated to similar assets held by other fully private regulated financial institutions.’ As a result, guarantee fees increased from 22 basis points per year in 2003-2006 to 54 basis points today. The piece also points out that increased regulations add substantial time and expense to the loan origination process (Dodd-Frank is 11,000 pages so far, and only 34% complete), such that of the above-referenced gap, government actions account for about 80% of the increase.”

Chairman: “Was there a question in there? Thank you for the opportunity to participate in this discussion, I have another meeting to attend.”

End of interview.....

To reiterate, this is an entirely fictional exercise. The Fed Chairman’s comments above are a mélange of some of his actual statements and writings, my interpretation and conjecture of what he might say, and pure contrivance. It is my crude way of bringing the policy options to life for clients. The long-term consequences of Fed manipulation of asset prices is an issue that concerns me. We are already seeing extreme levels of optimism in some credit markets (e.g., 100-year Mexican dollar-denominated bond issued in 2010 at a 6% yield that now yields 4.8%, US HY index yield-to-worst below 6%), and valuations on some dividend-paying stocks may have gone past where fundamentals alone would bring them. However, overall S&P 500 equity valuations are fair at 13.5x earnings, and nowhere near the peaks of prior cycles. Household and corporate cash balances, and the surplus of deposits over loan growth in the US banking system, suggest an excess of caution rather than an excess of exuberance, so the overall picture is mixed on this front. If earnings keep rising with an expansion and both household and corporate leverage remain modest, the risks of a private sector disruption appear low.

The key issue is the output gap estimate: if it is anywhere close to correct, the US is at least a couple of years away from a day of reckoning on substantial monetary tightening. While Fed asset purchases may end in 2013, policy rates are unlikely to be raised for a long time; markets currently expect Fed Funds rates to remain below 1% through December 2015 and possibly longer. If that’s the case, financial markets are likely to meet our modest forecasts for 2013, particularly with reduced chances of a disruptive Congressional battle over the debt ceiling. If I am wrong about near-term US inflation risks, then everything changes. Will the Fed’s exit strategy work as planned when the time comes? Given the unorthodoxy of the experiment, there is no way to know in advance. The verdict will only be rendered after policies return to normal one day. **We are in the part of the cycle where the steroids are working, the pain is dulled, and there are few signs of organ damage in sight.**

Michael Cembalest
J.P. Morgan Asset Management

[a] This is of course a completely fictional account of a conversation that never happened. There is no Zeppo Show as far as I know.

[b] Read Bernanke’s Washington Post editorial from November 4, 2010 for an explanation of asset purchases in his own words.

[c] “Global Output Gaps: Wave of the Future?”, James Bullard, President and CEO, FRB-St. Louis, Monetary Policy in a Global Setting: China and the United States, 28 March 2012, Beijing China

[d] “The Rising Gap Between Primary and Secondary Mortgage Rates”; Federal Reserve Banks of New York and Boston, November 2012.

On the Fed Balance Sheet: the mechanics of the Fed balance sheet and its monetary policy operations are quite complicated. You can find a lot of press articles on the subject, but more often than not, they make over-simplifying assumptions that are at times not accurate. My two preferred (and impeccable) sources on the subject are Michael Feroli at J.P. Morgan Securities, and William Denyer at Gavekal Research. To be clear, they are not in any way responsible for the imagined interview shown above, and my guess is that Feroli would have written it differently (e.g., he probably would have expressed less doubt/concern about the long-term cost-benefit of the Fed’s balance sheet expansion).

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