

Economics Group

Special Commentary

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Capital Markets and Monetary Policy: Comments at the GIC/National University Conference*

He had “no clear idea of when to stop”
Niall Ferguson on John Law in *The Ascent of Money*¹

For decision makers, there should be a clear framework to evaluate the current status of capital markets and monetary policy. Choices for wealth managers, such as the sovereign wealth fund Abu Dhabi Investment Authority, large SWFs, or our own, much simpler, pension and retirement funds, reflect our assessment of this framework. Here, we focus on a framework of macroeconomics that incorporate our expectations on growth, inflation, interest rates and the dollar exchange rate, as those factors are clearly linked to current capital markets and monetary policy choices.

Growth

For the past three years, and we expect for this year as well, real GDP (gross domestic product) in the United States has grown at a two percent pace (Figure 1), and this should give us pause. The economy appears to have tracked a steady pace of growth, yet policymakers and some commentators are searching, and promoting, the case for an acceleration of growth in the face of evidence that the economy has settled in at a two percent pace—given the current condition of the credit market. This is important to emphasize. The real economy and the credit markets are not independent entities and the higher degree of regulation, capital requirements and credit standards post the Great Recession should signal to observers that the sustainable pace of economic growth may be more modest than some estimate. Finally, basing today’s policy on a model of an economy that may be outdated reflects an anchoring bias in decision making that will lead to poor decisions.²

The real economy and the credit markets are not independent entities.

Moreover, when we split the growth in the economy between public and private spending (Figure 2) we note that the real issue with slow economic growth is actually a story about public sector restructuring as the overpromises in prior decades meets the inability of the economy today to pay for those promises. There appears to be no clear tie to further monetary policy easing that would address the fundamental fiscal policy restructuring needed for adjusting fiscal imbalances as we have already witnessed in Greece, Spain, Portugal and Ireland.

* Presentation at the 25th Anniversary Higher College of Technology Conference and the Global Interdependence Center, Dubai, March 26, 2013. Special thanks for help on this presentation to Kaylyn Swankoski, Sarah Watt, Azhar Iqbal and Michael Brown.

¹ Ferguson, Niall. (2008). *The Ascent of Money: A Financial History of the World*. Penguin Books. P. 143

² For more on decision making biases see Silvia, John. E. (2011). *Dynamic Economic Decision Making*. Hoboken, N.J.: Wiley. Chapter 5 in particular.



Figure 1

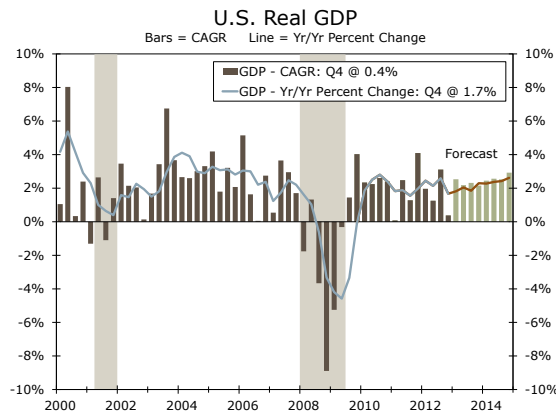
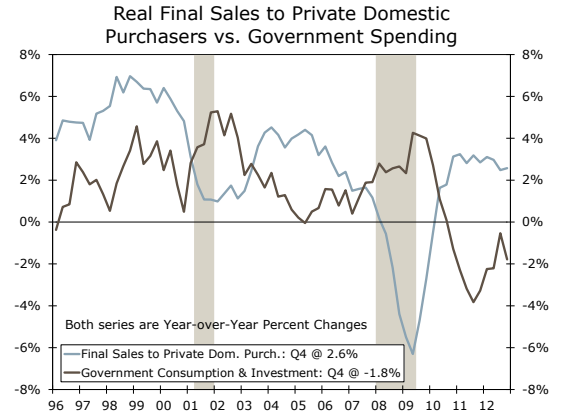


Figure 2



Source: U.S. Department of Commerce and Wells Fargo Securities, LLC

The revenues associated with the long-run growth rate will not be enough to meet the entitlement promises.

These impressions are given statistical weight in our recent paper in which we find that the pace of real economic growth in the post-inflation era tends to show reversion to the mean at 2.75 percent.³ This pace of growth should serve as a benchmark for good decision making. Unfortunately, this pace of growth reinforces the fundamental problem that the revenues associated with such growth will not be enough to meet the entitlement promises for Social Security, Medicare and state/local pensions made by earlier public policymakers. This reflects the time inconsistency character of these promises where one generation of policymakers can make a promise that another generation of policymakers must deliver.

While the evidence suggests the economy has moved into a mid-cycle trend growth of two percent, attempts by policymakers to achieve a return to faster growth and lower unemployment may not be successful and may create distortions in credit markets that would lead to mispricing risk. As suggested by David Romer, monetary policy operates best at minimizing variability in inflation due to demand shocks and that policy has no impact on average unemployment.⁴ This brings into question the advisability of a central bank aiming for a specific unemployment rate target.

Robert Lucas, in his 1987 paper, reinforces this message by finding that the welfare gain from stabilization policy is small.⁵ While the benefits from stabilization may be greater than what Lucas suggests (see Clark, Laxton and Rose, 1996) there does not appear to be a clear case for a stabilization policy that seeks growth above a trend pace of 2.75 percent and also does not account for the distortions created in the credit markets at the same time.⁶

For investors and decision makers, we would suggest a high degree of skepticism on the claim that there is no evidence that central bank purchases have impaired the functioning of financial markets (and the real economy as well). In fact, we see similar distortions developing in the housing market that gave rise to the housing boom of 2004-2007. As evidenced in Figure 3, the current pace of home price inflation exceeds the going rate on home mortgages—as was the case during the 2004-2006 period. In effect, the home-buyer is witnessing home price inflation faster than the rise in the burden of home finance, which is exactly the problem that gave rise to the prior housing excesses. For us, this suggests that housing decisions are in fact being distorted and is a case for everyone to be cautious. For policymakers, this is a cautionary note to suggest greater thought be given to tempering purchases of mortgage-backed securities as the level of housing starts are not part of the dual mandate of a central bank.

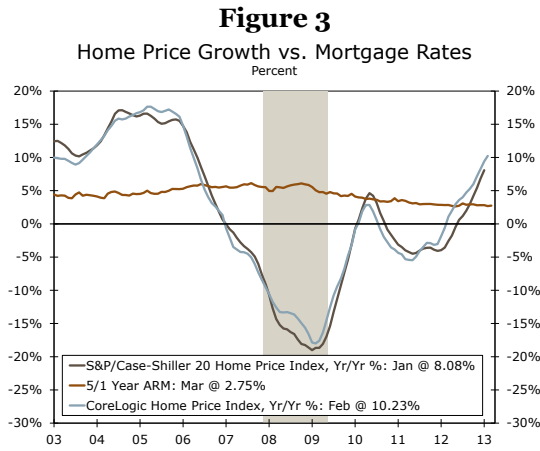
³ Silvia, John. E., Iqbal, Azhar and Swankoski, Kaylyn. (March 20, 2013). *How Stationary Is My Economic North Star?* Wells Fargo Economics, Wells Fargo Securities, LLC.

⁴ Romer, David. (2006). *Advanced Macroeconomics*, Third edition. McGraw-Hill. Pp. 520-522.

⁵ Lucas, Robert E. (1987). *Models of Business Cycles*. Oxford: Basil Blackwell.

⁶ Clark, Peter, Laxton, Douglas and Rose, David. (1996). *Asymmetry in the U.S. Output-Inflation Nexus*. IMF Staff Papers 43(March):216-251.

Whereas the role of a central bank is to provide liquidity when needed, and we surely have a storehouse of liquidity today, the specific targeting of housing and how that liquidity is employed will create pricing distortions for investors and decision makers alike.



Source: S&P/Case-Shiller, Bloomberg LP, CoreLogic and Wells Fargo Securities, LLC

Unemployment as a Mixed Signal

For investors and decision makers, the focus on an explicit unemployment rate as a benchmark for policy decisions appears to some as misplaced given the dynamic nature of the labor market, and that the character of the labor market seems different today than in the past. Moreover, recall that the unemployment rate is a lagging economic indicator—not a leading indicator. While the U-3 unemployment rate of 6.5 percent may not be a trigger to change policy, it still may be misleading given evidence of structural change in the labor market, as well as a long history of research that suggests that the long-term trend of unemployment remains independent of the influence of monetary policy.

The unemployment rate may be misleading given the structural change in the labor market.

As discussed in an earlier paper, surprisingly, the unemployment rate, measured by the U-3 definition that is commonly reported in the media as well as serving as a benchmark for stress testing suggested by the Federal Reserve, is indeed mean reverting around the value of 6.37 percent which is just below the threshold—not trigger—that could signal a move to withdraw easing policy. Even more intriguing is that the unemployment series of U-3 is stationary and thereby does not exhibit any drift in values over time despite the perception that the long-term level of unemployment may have shifted upward after the Great Recession. So far, there is no evidence of a fundamental shift in this series.⁷

Yet, the labor market of the 21st century is behaving in a way that is different from prior years. This differential behavior reflects the ways in which the actual behavior in the labor market may deviate from the perfectly competitive marketplace that forms the basis for models that may frame the decision making in both the public and private marketplace.⁸

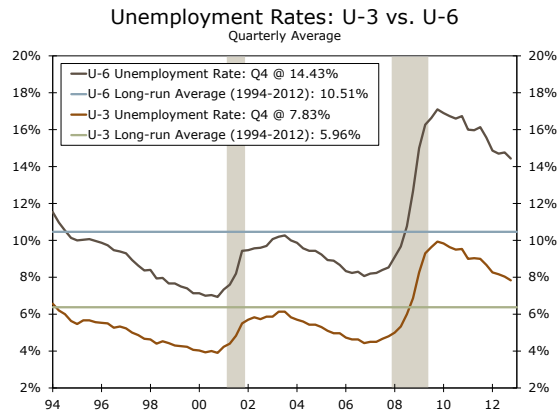
The labor market is behaving differently from prior years.

The evidence reported in the paper cited above suggests that the U-6 series (Figure 4) is not stationary. The mean value of the U-6 unemployment rate appears to be rising over time. This is consistent with the sentiment that there appears to be a developing gray labor market that does not fit our historical view of the operation of the labor market. There is a growing part-time/turnover character to the labor market that suggests less attachment to the model of the full-time job.

⁷ Silvia, John, E., Iqbal, Azhar and Swankoski, Kaylyn. (March 20, 2013). *How Stationary Is My Economic North Star? The Study of Drift in Economic Benchmarks*. Wells Fargo Economics, Wells Fargo Securities, LLC.

⁸ See Romer, David. *Advanced Macroeconomics*. Boston: McGraw-Hill Irwin. Chapter 9 in particular.

Figure 4



Source: U.S. Department of Labor and Wells Fargo Securities, LLC

The Beveridge Curve: Yet to Shift Inward

The unemployment rate remains high relative to the rate of job openings.

While some have argued that the structural shift in labor markets, as evidenced by the Beveridge Curve, is temporary, we should note that after four years of economic expansion this shift is taking on the character of a more fundamental change than simply a temporary cyclical phenomenon. Even as the headline U-3 unemployment rate has improved in the typical, albeit slow, cyclical fashion, other indicators on the labor market continue to suggest that today's labor market environment has changed. Job vacancies have become more plentiful as the economy has recovered. However, in Figure 5, the unemployment rate remains high relative to the rate of job openings in previous cycles and suggests more frictions in matching the unemployed with available jobs.

It has been argued that the outward swing in the Beveridge curve is typical during the early stages of a labor market recovery. While some skills mismatch is to be expected as the economy undergoes significant periods of restructuring following a recession, more than four years into the recovery the Beveridge curve remains above its path during the last economic expansion. The depth of the previous recession posts a challenge to structural frictions beyond the typical pattern. The share of unemployed workers out of a job for more than 27 weeks remains historically high, and the longer these workers are out of a job, the higher the risk that the slow cyclical recovery results in longer-lasting structural mismatch as these workers' skills become increasingly out of date.

Figure 5

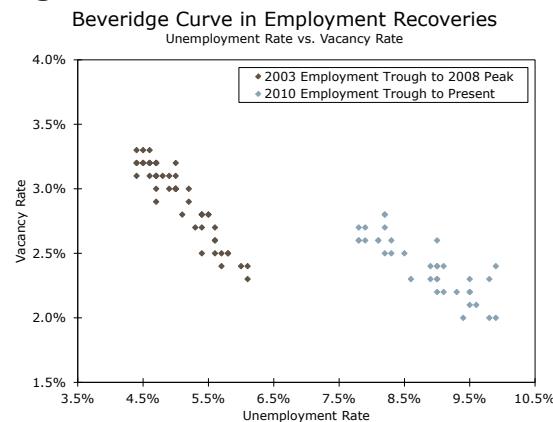
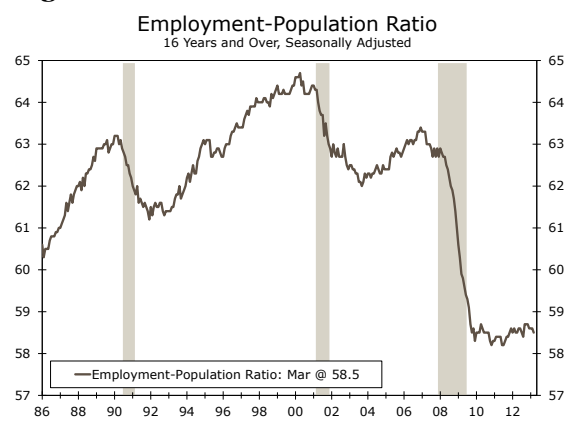


Figure 6



Source: U.S. Department of Labor and Wells Fargo Securities, LLC

Two final points also illustrate the suggestion of structural change in the labor market that is not captured by the U-3 unemployment rate. First, there has been a sharp downdraft in the employment-population ratio (Figure 6). According to this measure there are far less workers as a share of the working-age population than in the past. This creates two problems. First, to achieve any given pace of economic output, productivity must improve significantly for the fewer current workers. Second, when inverted, this employment/population ratio suggests a far smaller share of the population is supporting entitlement programs, which relates back to the budget issues both here and abroad.⁹

There are less workers as a share of the working-age population than in the past.

The other indication of structural change in the labor market not captured by the U-3 unemployment measure is the drop in labor force participation. In recent years, we have witnessed a decline in labor force participation for both male and female workers, which reinforces the view that the future pace of GDP growth may downshift from current perceptions.

This downshift should be taken in the context of changes in credit policy and financial regulation. As regulation has emphasized diminished risk taking, we should expect a slower pace of aggregate demand, housing and personal consumption. Yet, we continue to hear policymakers clamor for stronger aggregate demand, while labor and credit market fundamentals do not support a return to prior demand benchmarks. This reinforces concerns that policy attempts to restore the prior pace of aggregate demand will lead to credit market distortions.

Regulation has emphasized diminished risk taking.

Another line of argument that may mislead investors is that the credit/bond markets will take their signals of a rise in interest rates from the Federal Reserve when they may react to a decline in the unemployment rate. Yet, as we have seen in history, John Law for one, market rates tend to rise before the Fed has reacted and we suspect that will happen again. Moreover, changes in the economy occur that are often not captured in Fed forecasts. Recall that in January 2008, Fed policymakers declared they saw no case for recession even though the recession began just a month earlier. On March 29, 2007, Chairman Bernanke declared that the subprime problem would be contained. These examples should be enough for investors and decision makers to conduct their own due diligence on the risk of rising interest rates independent of any Fed judgment based on the unemployment rate.

Inflation and Inflation Expectations

For investors, the argument that inflation expectations are well-anchored should be examined more closely than simply taken as *prime facie* evidence to be incorporated into investment decision making. Instead, we suggest that investors follow the observation of David Romer that monetary policy has an inherent inflationary bias.¹⁰

One measure of inflation expectations is the 5-year implied inflation expectations from the TIPS yield, illustrated in Figure 7. This figure suggests that since 2010 there has been a steady, but very modest, rise in inflation expectations. The 5-year measure of inflation expectations is at 2.17 percent, and the five-year forward rate is 2.79 percent. As suggested earlier, inflation expectations are rising but not at the pace that would likely prompt any change in monetary policy soon. Whether these patterns suggest that inflation expectations are well-anchored is another issue. More important for decision makers, the recent pattern of rising inflation expectations, although modest, intimate that nominal yields may not cover the actual inflation experience over time and that must be brought into the investment calculus.

Inflation expectations are rising, but not at the pace likely to prompt change.

⁹ John E. Silvia's Economic Outlook presentation to the CFA Society of Jacksonville, FL on Jan. 16, 2013.

¹⁰ Romer, David. *Advanced Macroeconomics*. McGraw-Hill Irwin. Chapter 10. P. 496

Figure 7

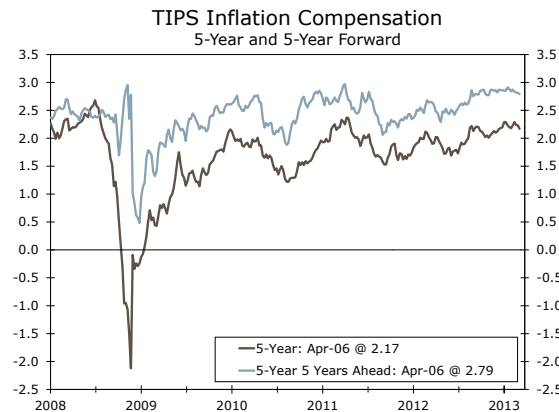
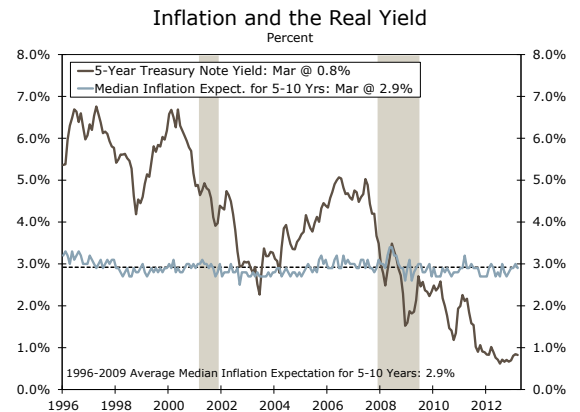


Figure 8



Source: Federal Reserve Board, University of Michigan and Wells Fargo Securities, LLC

One final point on inflation expectations is represented in Figure 8. Here, inflation expectations, as measured from a survey conducted by the University of Michigan, appear to be well-anchored—unfortunately too well anchored. The series appears to stay remarkably close to three percent such that there would be little reason for policy tightening or easing over the past 16 years. Certainly, there is no case for Fed actions to fight deflation fears neither in 2002-2004 nor in 2007-2008. Yet, we did see aggressive Fed action. If this series is indeed the benchmark for inflation expectations, then such a benchmark should work on both the upside and the downside. The median inflation expectations remain at 3 percent—if you interpret that as well-anchored, the problem is that the series hardly deviates from 3 percent and would not justify any Fed moves for the past 16 years and certainly not aggressive easing to fight deflation fears in both of the last recessions/early expansion periods. Complacency today may face a rude shock when inflation makes an unscripted return.

Interest Rates

We often reason by analogies, but as illustrated by Neustadt and May, choosing the correct analogy for the particular problem is the trick.¹¹ This leads us to question how relevant is the Japanese experience of the 1990s and the Great Recession of the 2007-2008 period. Are policy makers fighting the last war and thereby creating further financial market distortions than might be necessary?

Our concern for investors, decision makers and even more so for savers is that nominal returns may not reflect the true underlying fundamentals in the marketplace. Moreover, the claim by some that there is no current evidence of financial distortions would also be exactly the same claim that could have been made for housing in 2004-2006 as well as for European sovereign debt before the Great Recession. The evidence appears when interest rates rise or growth slows in the future. Subprime lending made sense as long as home prices continued to rise. European sovereign debt appeared fine—until the recession hit.

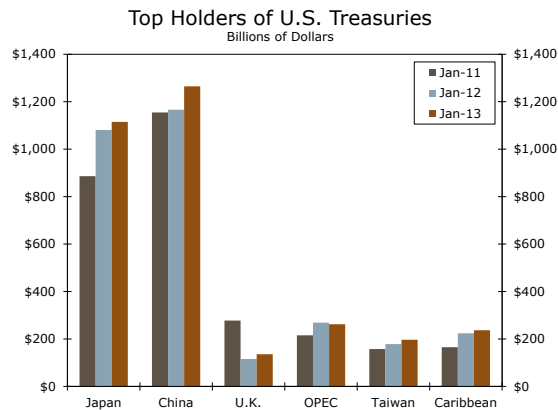
For savers and investors in money market funds and short-term Treasury bills/notes, the real returns are already negative, before taxes, as current inflation, still exceeds the nominal return. For pension fund investors, continued low nominal rates effectively lowers the net present value of the portfolio and thereby incentivizes pension fund managers to take on risk to achieve higher yields, while the same policymakers who pursue the low interest rate policy are also warning investors about taking on more risk. These contradictory messages indeed create distortions in both suppressed interest rates as well as greater risk taking. For many private investors, the market incentive is to increase average maturity and increased risk.

The market incentive is to increase average maturity and risk.

¹¹ Neustadt, Richard E. and May, Ernest R. (1986). *Thinking in Time: The Uses of History for Decision Makers*. New York: The Free Press.

As for benchmark Treasury issues, the question is whether there is a private market for Treasury debt. As indicated by Federal Reserve Chairman Bernanke, foreign holdings are one-half of Treasury debt outstanding.¹² China and Japan, as illustrated in Figure 9, dominate foreign holdings. Meanwhile, Federal Reserve purchases constitute the majority of new purchases. All three major purchases do not mark to market and do not report returns to shareholders or investors. As a result, there is no real benchmark or risk-free market rate set by private investors that would allow private investors to price other financial market assets.

Figure 9



Source: U.S. Department of the Treasury and Wells Fargo Securities, LLC

For perspective, decision makers should consider the comment made by Chairman Bernanke in his San Francisco presentation cited above on the topic of the possible future trend in the 10-year Treasury interest rate. His conclusion is that these forecasts intimate a 3 percent yield at the end of 2014. For today's investor, buying the 10-year today at a 1.91 percent yield would deliver a negative 6 percent total return at the end of 2014. This would clearly not be acceptable to any investment committee in the United States as well as at the Abu Dhabi Investment Authority. This potential loss suggests that market pricing is being distorted today by public policy actions that differ so sharply from private market assessments.

Another signal of the unusual circumstances in today's capital markets is the inversion in the ratio between Baa corporate bond yields and S&P earnings, as illustrated in Figure 10. Bond yields appear low relative to equity earnings even though general equities have historically yielded more (1990-2007) and are considered riskier investments.

Finally, one sign of financial imbalances in the economy is the extent to which inflation expectations are not reflected in current 5-year Treasury yields (Figure 11). In the early years of an economic recovery, it is not surprising for Treasury yields to decline in line with monetary policy easing as evidenced in 2002-2004. However, the current period indicates that yields are far below inflation expectations and have been there for some time. This suggests that the extent of Fed buying of Treasury debt, along with that of the Japanese and Chinese central banks, has distorted pricing in the Treasury market. The central banks are now the demand side of the market.

Treasury yields are far below inflation expectations.

¹² Ben Bernanke. (March 1, 2013). *Long-Term Interest Rates. Remarks at the Annual Monetary/Macroeconomics Conference: The Past and Future of Monetary Policy. Federal Reserve Bank of San Francisco, San Francisco.*

Figure 10

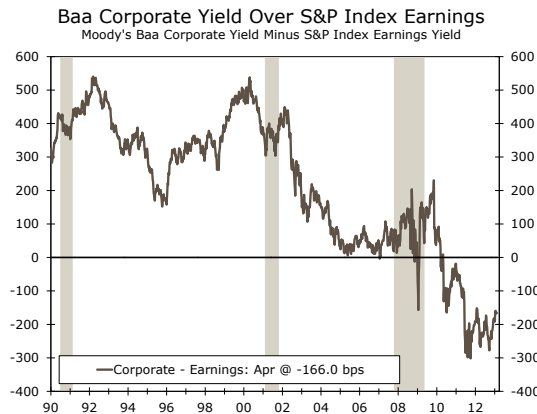
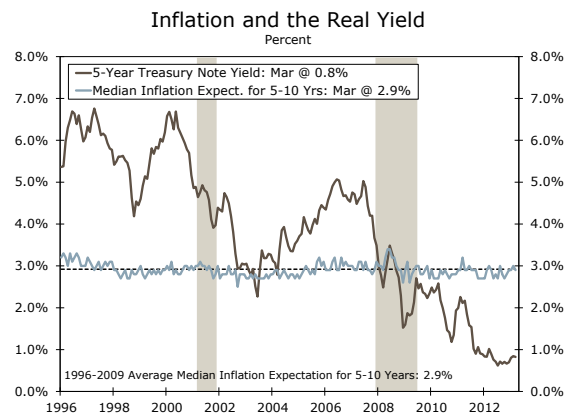


Figure 11



Source: Moody's Analytics, S&P, University of Michigan and Wells Fargo Securities, LLC

Measures of risk perceptions have fallen.

Meanwhile, measures of risk perceptions have fallen, as measured by the VIX (Figure 12) and the CDS index for investment grade bonds (Figure 13). Both appear to have settled into a comfortable zone, suggesting an equilibrium in these asset markets that gives pause to the case for further policy ease. The markets appear comfortable with the current benchmarks for risk.

Figure 12

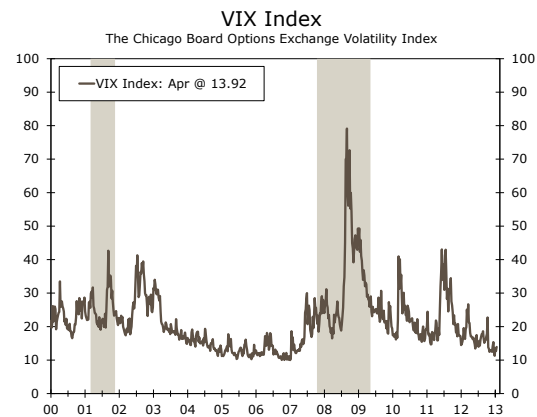
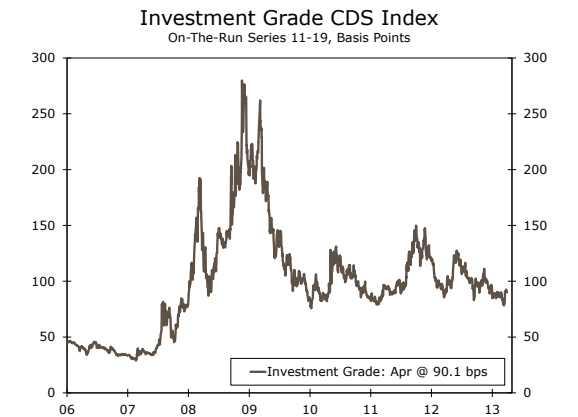


Figure 13



Source: Bloomberg LP, Mark-It Partners and Wells Fargo Securities, LLC

Corporate debt issuance has been very strong (Figures 14 and 15) for both high grade and high yield debt. This issuance indicates a healthy marketplace, and whether this represents too much risk taking depends on the future patterns for real economic growth, inflation and interest rates.

Figure 14

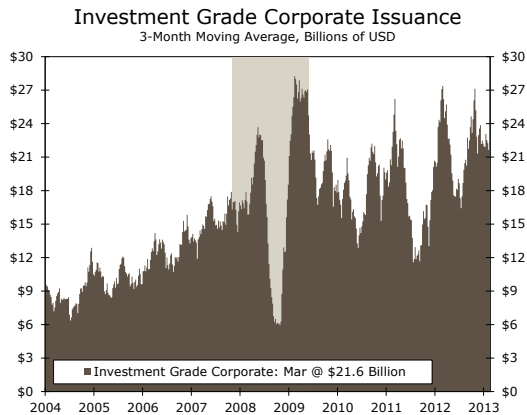
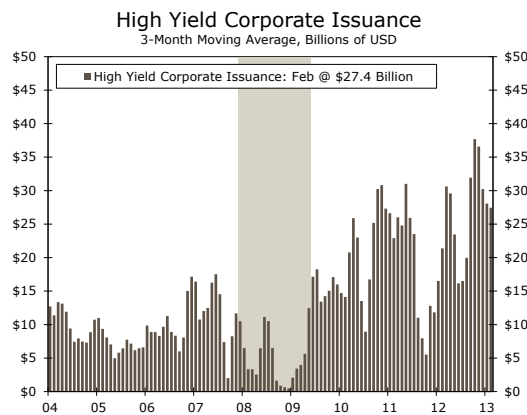


Figure 15



Source: IFR Markets and Wells Fargo Securities, LLC

Finally, the gains in commercial and industrial loans for all three categories of banks (Figure 16) suggest that credit is being made available and reduces the case for some that further aggressive policy ease is needed.

Figure 16

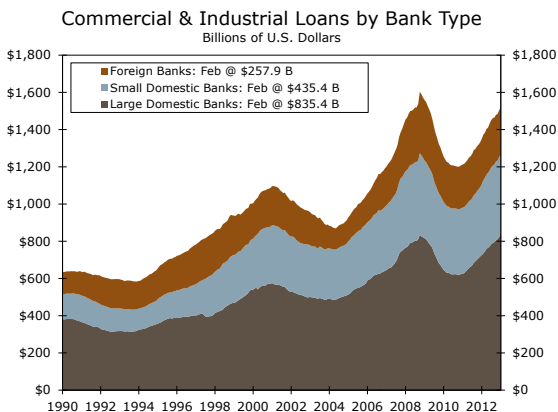
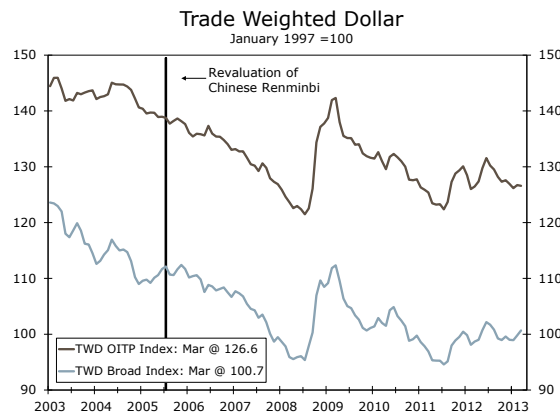


Figure 17



Source: Federal Reserve Board and Wells Fargo Securities, LLC

Dollar Exchange Rate: Continued Exchange Rate Risk for Foreign Investors

As illustrated in Figure 17, the trade weighted dollar value has declined steadily for many years with the 2008-2009 recession period as the only major exception. While the problems in the euro have benefitted the dollar, overall foreign investors face the risk that continued Federal Reserve Bank easing will tend to lower the exchange rate value of the dollar over time if other factors remain in place.

Foreign investors face the risk that easing will lower the exchange rate value of the dollar.

Discussion

What is the message? Current market interest rates do not represent equilibrium rates set in a private marketplace. Policymakers in major economies of the United States, Japan and China have taken on a dominant position in market setting. Unfortunately, attempts by policymakers to achieve what may be a bridge too far in higher economic growth and lower unemployment rates through monetary policy actions increase the risk of higher inflation, higher interest rates and a weaker dollar. For a foreign investor, current pricing and credit market activity represents a case of caution in the calculation of risk and reward.

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