Yellen signals next bubble

What's the point of guidelines if they are said to be meaningless?

The above headline is an exaggeration. But it is not as exaggerated as one would perhaps wish. The base scenario for the US economy for this year and next seem to be one of below-trend but still positive growth, with unemployment gradually falling, to some extent countered by the return of people to the labour force. The Fed will cease its QE by the end of the year and will begin to raise interest rates in 2015. As readers of these comments are aware, I disagree. In my opinion – supported not least by monetary data but also by some hard data such as foreign trade and car sales, as well as the improving housing market – growth this year and next is likely to be faster than consensus expects. In turn, this means that unemployment will reach the Fed's 6½% target early, prompting a first interest rate increase in 2014 – earlier than the 2015 expected. This is good news for equities and bad news for fixed income.

However, yesterday's speech by Janet Yellen, the Fed Vice Chair, raises another possibility. Ms Yellen was a dove when she was President of the San Francisco Fed and has carried those tendencies with her to the FOMC, where she is generally perceived to be the most dovish member. She is previously on the record as saying that interest rates should remain near zero into 2016. She has now said that "It deserves emphasis that a 6-1/2 percent unemployment rate and inflation one to two years ahead that is 1/2 percentage point above the Committee's 2 percent objective are thresholds for *possible* action, not triggers that will necessarily prompt an immediate increase in the FOMC's target rate. In practical terms, it means that the Committee does not expect to raise the federal funds rate as long as unemployment remains above 6-1/2 percent *and* inflation one to two years ahead is projected to be less than 1/2 percentage point above its 2 percent objective. When one of these thresholds is crossed, action is possible but not assured."

This raises a number of disturbing possibilities. Obviously, Ms Yellen is only one among her colleagues on the FOMC, where there are both hawks and doves. But she is a – the? – frontrunner to succeed Ben Bernanke when his mandate expires in less than a year (31st January 2014). The history of the Fed, as well as that of other central banks, shows that the person of the chairman/governor/president can matter substantially, even in the most collegial environment.

A Yellen Fed could well become a repeat of the Greenspan Fed – always willing to see interest rates cut or low, rarely willing to see them raised or high. This is perhaps more serious now, when we could reasonably ask if US government bonds are not perhaps already in a bubble. Certainly, if interest rates would not remain as low as they are without the Fed's intervention (clearly the case), that is one bubbly indication. It may not qualify for a bubble now; but if the Fed persists in depressing bond yields even when the economy is growing at trend (probably around 2½%) as could well be the case by next year, then it does begin to look suspiciously bubble-like.

One must also ask to what purpose. At the end of last year, the Fed told us that interest rates would remain low as long as unemployment remained above 6½% and future inflation is not expected to go

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above 2½%. Now, bear in mind that the Fed's inflation objective is 2%. Yet it – and certainly Ms Yellen – is willing to see inflation rise above this number provided it means lower unemployment. Does that mean that the Fed has resurrected faith in the Phillips Curve, the idea that there is a trade-off between inflation and unemployment? If so, that would be even more worrying. Because there is no such trade-off; in the long run, unemployment will revert to its 'natural' rate, NAIRU. The only way to avoid that would be to engineer constantly accelerating inflation. But this would eventually distort the economy and lead to NAIRU rising as we have ample historical evidence of in the 1970s and 1980s (depending on the country). Ultimately, the bond market would crash anyway, but the effect would be much more severe than an earlier exit would mean.

This may all be too alarmist. But it certainly should be worrying when the Fed one month announces guidelines for how long policy will remain ultra-loose; and a leading contender for the next chairmanship two months later says that these guidelines mean next to nothing. Short term this might benefit treasuries, but it cannot do so in the medium to longer term.

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