MORNING BRIEFING
October 12, 2016

A Star Is Born

See the collection of the individual charts linked below.

(1) Get a dog. (2) Barking at the mirror. (3) Fed officials perplexed that real rate is zero. (4) Gloria Swanson and r*. (5) Is there such a thing as the equilibrium, neutral, or natural interest rate? (6) What if it changes all the time? (7) Dudley tells Yellen and Brainard that the headwinds may not be transient. (8) Williams says low real rates here to stay. (9) Round up the usual suspects: Weak productivity, too much saving, old people, shortage of innovations, the financial crisis of 2008. (10) Maybe it's just too much government and policy meddling. (11) Who's afraid of the big bad woof?

Bonds I: Mirror, Mirror on the Wall. "If you want a friend in Washington, buy a dog," is a quote falsely attributed to the President Harry S. Truman. More and more Republican leaders may need to get dogs as they turn on Donald Trump and as he barks right back at them. At my home on Long Island, we have two wonderful Cavalier King Charles Spaniels, Chloe and Max. They keep me company in my office at home while I am writing. They are truly great friends. You can see a picture of me holding Chloe in my 2/6 interview with *Barron's* titled "Yardeni: No U.S. Recession in Sight."

Chloe is two years old, and Max is almost one. When Chloe was only a few months old, she would growl and bark at herself in front of a long dressing mirror in my daughter's bedroom. Fed officials may be doing the same now. They are perplexed that inflation-adjusted ("real") interest rates are so low. They've come up with lots of explanations suggesting that this may be a secular rather than a cyclical phenomenon. In any event, in their opinion, near-zero real bond yields reflect these forces of secular stagnation rather than reflect their near-zero interest-rate policy since the financial crisis of 2008. They seem to be concluding that there's not much that they can do other than keep their nominal official rates abnormally low for the foreseeable future.

Maybe Fed officials are doing what Chloe did when she was a puppy, i.e., barking at themselves. They are the ones who spent the past few years providing us with their forward guidance about interest rates remaining a lot lower than in the past. They are the ones who adopted so-called "unconventional" monetary policies (which have become all too conventional) to flatten out the yield curve closer to zero. Their ultra-easy policies have depressed interest income, reducing spendable income and also forcing people to save more. Cheap credit enabled zombie companies to stay in business, contributing to global deflationary pressures and eroding the profitability of healthy companies. Corporate managers have had a great incentive to borrow money in the bond market to buy back shares as a quick way to boost earnings per share rather than invest the proceeds in their operations.

Bonds II: An Old Star Reborn. In "Sunset Boulevard" (1950), Gloria Swanson plays Norma Desmond, a has-been movie star. When Joe Gillis, an unsuccessful screenwriter played by William Holden, meets her for the first time, he says, "You're Norma Desmond. You used to be in silent pictures. You used to be big." She responds tartly, "I am big. It's the pictures that got small."

The big star at the Fed these days is r-star (r*). The star made its debut in last year's October FOMC minutes, which began with a very dense section titled: "Equilibrium Real Interest Rates." The fixation with r* was evident, as it was mentioned for the first time (maybe ever) in the October minutes and appeared 11 times. The concept has been around for a very long time and is sometimes called the "neutral" or "natural" real interest rate. In the minutes, it is defined as "the level of the real short-term interest rate that, if obtained currently, would result in the economy operating at full employment or, in some simple models of the economy, at full employment and price stability."

The minutes reported that a number of FOMC participants believe that "the longer-run downward trend in real interest rates suggested that short-run r* would likely remain below levels that were normal during previous business cycle expansions, and that the longer-run normal level to which the nominal federal funds rate might be … consistent … with maximum employment and 2 percent inflation … would likely be lower than was the case in previous decades." Now let's put together a chronology of how Fed thinking about r* evolved since last October:

(1) *Yellen was guardedly optimistic.* Increasingly, Fed officials have been using the concept as an excuse for why their policies haven't worked. Last year, in a 12/2 speech, Federal Reserve Chair Janet Yellen explained: "Had the neutral rate been running closer to the levels that are thought to have prevailed prior to the financial crisis, current monetary policy settings would have been expected to foster a very rapid economic expansion, with inflation likely rising significantly above our 2 percent objective."

Yellen dedicated her closing remarks to r*. She stated: "The marked decline in the neutral federal funds rate after the crisis may be partially attributable to a range of persistent economic headwinds that have weighed on aggregate demand. … As the restraint from these headwinds further abates, I anticipate that the neutral federal funds rate will gradually move higher over time." Yellen did assign a high degree of uncertainty to that expectation. But let's not forget that her speech was the lead-in to signal December's rate hike, so she obviously wasn't too concerned about it.

During a speech in February of this year, Fed Governor Lael Brainard echoed that thought, saying: "The very low levels of the shorter run neutral rate reflect in part headwinds from the crisis that are likely to dissipate over time."

(2) *Dudley was pointedly skeptical.* During the summer and fall of this year, Fed officials started to come around to a view that FRB-NY President Dudley expressed in a July speech: "If the headwinds have not dissipated to a meaningful degree in the seven years since the recession ended, then why should one expect them to necessarily diminish quickly over the next couple of years?" Answering his own rhetorical question, Dudley noted the "growing consensus that the neutral real short-term rate will not return anytime soon to its historical norm of 2 percent." Dudley said that means that "U.S. monetary policy is accommodative, but only moderately so."

(3) *Williams turned outright pessimistic.* The turning point for many Fed officials seemed to come along with the release of an 8/15 *Economic Letter* by FRB-SF President John Williams titled: "Monetary Policy in a Low R-star World." Williams warned: "Economics rarely has the benefit of a crystal ball. But in this case, we are seeing the future now and have the opportunity to prepare for the challenges related to persistently low natural real rates of interest. Thoroughly reviewing the key aspects of inflation targeting is certainly necessary, and could go a long way towards mitigating the obstructions posed by low r-star. But that is where monetary policy meets the boundaries of its influence." By the way, Williams' research on r* has made him into a bit of a star himself among Fed officials. Lots of them have referred to his research in their speeches on this subject.

(4) *Brainard called for an intermission.* The fact that "the neutral rate is likely to remain low for some time" was one of five key reasons that the Fed should hold off on raising rates, according to Fed Governor Lael Brainard in a 9/12 speech, which seemed to have heavily influenced the decision to do

nothing at the September FOMC meeting. She stated: "Several econometric models and estimates from market participants suggest the current real neutral rate is at or close to zero, and any increase is likely to be shallow and slow. These estimates imply that it may require a relatively more modest adjustment in the policy rate to return to neutral over time than previously anticipated."

(5) *Yellen is in no rush.* About a week later, Yellen focused on r* at her 9/21 monetary policy press conference: "With the federal funds rate modestly below the neutral rate, the current stance of monetary policy should be viewed as modestly accommodative, which is appropriate to foster further progress toward our objectives. But since monetary policy is only modestly accommodative, there appears little risk of falling behind the curve in the near future, and gradual increases in the federal funds rate will likely be sufficient to get to a neutral policy stance over the next few years."

(6) *Fischer is anxiety ridden.* Just last week, FRB Vice Chairman Stanley Fischer dedicated his entire 10/5 speech, titled "Low Interest Rates," to r* and shared his anxieties on the subject. First on his worry list is that with low r*, "the economy is more likely to fall into the liquidity trap" and "becomes more vulnerable to adverse shocks that might render conventional monetary policy ineffective." Second, "it may hurt financial stability by causing investors to reach for yield, and some financial institutions will find it harder to be profitable." Third, "a decline in longer-run equilibrium real rates … could be yet another indication that the economy's growth potential may have dimmed considerably."

By the way, in his speech, Fischer gave a brief history of the origin of r*. He lectured: "Knut Wicksell, the great Swedish economist, emphasized the concept of an equilibrium level of interest rates in his influential work. In his 1898 book, *Interest and Prices*, he wrote that 'there is a certain level of the average rate of interest which is such that the general level of prices has no tendency to move either upwards or downwards.' In modern language, this level of the interest rate is usually referred to as the natural rate of interest. Applying Wicksell's insights to the circumstances we face today, the fact that both inflation and interest rates have remained very low over the past several years suggests that our current interest rate environment may well reflect, at least in part, a very low level of the natural rate of interest."

Bonds III: Lots of Excuses. Not surprisingly, Fed officials, other central bankers, and academic macroeconomists have been coming up with lots of explanations for the near-zero reading of r*. Actually, measuring it isn't so simple since it is supposed to approximate the nominal interest rate minus expected inflation, which is hard to measure. Nevertheless, most economists use the actual inflation rate instead. I don't think it makes much sense to focus on a short-term real rate since inflationary expectations should have more weight in the long run than in the short run to both borrowers and lenders. So I will focus on the real 10-year Treasury bond yield.

Since 1960, the real 10-year Treasury bond yield, using the core PCED inflation rate, has been as low as -2.8% during February 1975 and as high as 9.2% during July 1984 (*Fig. 1*). There is a market-based measure of the real 10-year yield. It is the yield on the 10-year TIPS. It is available only since January 2003, but is very highly correlated with the real yield using the core PCED inflation rate (*Fig. 2*).

The real bond yield was relatively flat during the 1960s and 1970s around 2%, with the exception of a big, but brief, swing into negative territory during the mid-1970s. It then soared to a 9.2% peak during July 1984. It's been on a downward trend since then, and down to about zero in August.

Previously, I've shown that the nominal 10-year bond yield and the growth in nominal GNP are closely correlated (*Fig. 3*). It's not a great correlation, but I've used it to explain my Bond Vigilante theory of the relationship of the economy and the bond market. The correlation is much less between the real bond yield and the growth in real GDP (*Fig. 4*). Above, I cited Dudley saying that the "historical norm" of the real short-term yield is 2%. That's close to the 3% average for the real long-term bond yield since 1960, but the real yield has been all over the place!

Many Fed officials have blamed the drop in r* down to zero on the weak performance of productivity. I don't see much correlation between the real yield and either the y/y or five-year growth in productivity (*Fig. 5*). They've blamed it on demographic factors including people living longer and having fewer kids. There is a correlation between the five-year trend in the nominal bond yield and the Age Wave, i.e., the percent of the labor force that is 16 to 34 years old (*Fig. 6*). However, the Age Wave doesn't work quite as well with the real yield (*Fig. 7*).

Another theory that was favored by both Fed chairmen Alan Greenspan and Ben Bernanke was the Global Savings Glut. This is a very Keynesian notion suggesting that monetary and fiscal stimulus are needed to boost investment demand to sop up the surplus of saving. Larry Summers' secular stagnation thesis as well as the new normal view both seem to share this idea. Summers has said that high-tech companies are generating more cash than they can spend. (Maybe they should pay more dividends.)

None of the official and academic macroeconomists have stressed what might be the real problem: too much government and policy intervention! Could it be that taxes are too high (including Obamacare's out-of-pocket costs)? Could it be that there are too many regulations, and more coming? Could it be that too many unconventional monetary policy tools have become all too conventional? I think so.

If Fed officials are giving more weight to the real yield, then they will continue to keep the federal funds rate awfully low (*Fig. 8*). However, they could be barking at their own reflections in the mirror.

CALENDARS

US. Wed: JOLTS, MBA Mortgage Applications, FOMC Minutes, Dudley, George. **Thurs:** Jobless Claims 254k, Import & Export Prices 0.1%/0.1%, Treasury Budget, Weekly Consumer Comfort Index. (Bloomberg estimates)

Global. Wed: Eurozone Industrial Production 1.5%m/m/1.0%y/y, Japan Machine Tool Orders. **Thurs:** Germany CPI 0.1%m/m/0.7%y/y, China CPI & PPI 1.6%/-0.3% y/y, China Trade Balance $53.0b. (DailyFX estimates)

STRATEGY INDICATORS

YRI Weekly Leading Index (*link*): Our Weekly Leading Index (WLI)--a good coincident indicator that can confirm or raise doubts about stock market swings--has climbed to a new record high. The WLI advanced 1.4% in the three weeks ended October 1, surpassing the previous record high recorded during the week of July 23. Our WLI is the average of our Boom-Bust Barometer (BBB) and Bloomberg's Weekly Consumer Comfort Index (WCCI). Our BBB climbed for the seventh week by a total of 4.0% to yet another record high. Jobless claims dropped for the seventh week to 253,500 (4-wa)--the lowest reading since 1973. The CRB raw industrials spot price index--another BBB component--is moving up again. Meanwhile, the WCCI declined for the third time in four weeks by a total of 5.9%.

S&P 500 LargeCaps & SMidCaps (*link*): The SmallCap and MidCap market-cap indexes are easily leading their LargeCap counterparts ytd, and all indexes are up ytd after recovering from steep declines in February and again in late June. All the market-cap indexes reached record highs following the early summer selloff with the exception of the Russell 2000, which remained 1.4% below its June 2015 peak.

Here's the ytd score and the percentage from their record highs: S&P SmallCap 600 (12.7% ytd, -1.1% from record high), S&P MidCap 400 (10.5, -2.3), Russell SmallCap 2000 (10.1, -3.5), Russell MidCap (7.8, -2.0), Russell LargeCap 1000 (5.9, -1.2), and S&P LargeCap 500 (5.9, -1.2). The yearly change in forward earnings for all three indexes has been edging higher from six-year lows in early 2016 as y/y comparisons have eased. In the latest week, LargeCap's forward earnings improved to an 18-month high of 2.0% y/y from 1.4%, which compares to a six-year low of -1.8% in October 2015; MidCap's dropped to 3.4% from 3.7% and from a 17-month high of 3.8% in late September, which compares to a six-year low of -1.3% at the end of December; and SmallCap's rose to a 20-month high of 6.2% from 5.3%, which compares to a six-year low of 0.3% in early December. Growth rates now expected for 2016 and 2017: LargeCap 0.0% and 13.9%, MidCap 3.3% and 12.0%, and SmallCap 8.9% and 16.4%.

S&P 500 Growth vs. Value (*link*): The S&P 500 Growth index is up 4.7% so far in 2016 after rising 3.8% in 2015, but is down 1.4% from its record high on August 15. During 2015, Growth outperformed Value (which fell 5.6%), but so far this year has underperformed Value (up 7.1% ytd, 1.3% below its September 8 record high). Growth is expected to deliver higher forward revenue (STRG) and forward earnings growth (STEG) than Value over the next 12 months (6.9% STRG and 11.1% STEG, respectively, versus 4.2% and 9.6% for Value). Looking at forward revenues, Value's is up 3.4% from its five-year low in February, but is down 8.4% from its record high in October 2014. Growth's forward revenues is the highest since October 2008 and 3.7% below its record high in September 2008. Value's forward earnings has stalled recently; it's up 3.2% from its three-year low in March and remains 6.0% below its record high in October 2014. Growth's forward earnings is up 6.0% from its 12-month low in January, but has slipped 0.5% since its record high in early September. Growth's P/E of 18.8 is up from the October 2015 low of 16.8, and approaching its 10-year high of 19.1 in February 2015, while Value's, at 15.5, is up from January's two-year low of 13.2 and is nearing the 11-year high of 15.8 in February 2015. Value's NERI was negative for a 26th straight month in September, but edged up to -3.4% from -4.3% in August; that compares to a 10-month low of -18.0% in February and a five-year low of -20.3% in April 2015. Growth's NERI has been positive in four of the past five months and rose to 0.1% from -0.8% in August; that compares to a five-year high of 5.8% in June and a five-year low of -16.2% in April 2015. The projected forward profit margin of 9.0% for Value remains near January's eight-year high of 9.2%, while Growth's 13.3% is up from a three-year low of 13.1% in April and down from a record high of 14.2% in December 2015.

US ECONOMIC INDICATORS

NFIB Small Business Survey (*link*): Small business confidence dipped lower before the election as owners remained "deeply uncertain about the future, and that is affecting their decisions," according to NFIB's President and CEO. The Small Business Optimism Index (SBOI) slipped for the second month from 94.6 in July to 94.1 in September--4 points below the 40-year average of 98. Of the 10 components, four increased and six decreased. There was a huge improvement in the outlook for business conditions (to 0% from -12%), though the reading improved from "awful to bad," according to the report. Real sales expectations (4 from -1), earnings trends (-20 from -23), and hiring plans (10 from 9) also contributed positively. More than offsetting these gains were large losses in plans for inventory investment (-7 from 1), job openings (24 from 30), and inventory satisfaction (-7 from -2). Top issues for small business owners are not expected to be addressed this year. "The presidential election is so divisive that it offers little promise of a bipartisan effort to deal with any of these important issues," noted NFIB's chief economist.

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