



MORNING BRIEFING

December 11, 2019

More Easy Money in 2020

See the [collection](#) of the individual charts linked below.

(1) The Fed Grinch who turned the past four Fed chairs into Santas. (2) Powell pivoted from Grinch to Santa last Christmas. (3) It's been a very long Santa Claus rally since last Christmas. (4) Is it RM or QE? Who cares? The Fed's balance sheet is expanding again. (5) Draghi's swan song: Another open-ended QE aimed at stimulating MMT. (6) Kuroda says lots of bonds left for the BOJ to buy. (7) Don't fight the three major central banks. (8) Thank you, Paul Volcker!

Central Banks: Lots of Santas. Former Fed Chair Paul Volcker passed away on 12/8. Below, I briefly discuss his great achievement: He broke the back of inflation. Unfortunately, he had to cause a recession to do so, which broke the backs of lots of good hard-working people. He was widely viewed by them as the Grinch Who Stole Christmas. All of the Fed chairs who came after have preferred playing the role of Santa Claus, showering us all with lots of easy money. They were able to do so mostly because inflation has remained subdued ever since Volcker subdued it.

Actually, at the end of last year, Fed Chair Jerome Powell seemed more like a Grinch than a Santa. He roiled the financial markets by suggesting that the Fed would continue to raise the federal funds rate three or four times during 2019. He started to change his mind just around Christmas of last year and signaled that the Fed would halt rate hikes for a while. He completed his pivot by lowering the federal funds rate three times this year, on 7/31, 9/18, and 10/30 ([Fig. 1](#)).

As a result, the S&P 500 stock price index bottomed on Christmas Eve last year at 2351.10 ([Fig. 2](#)). It was up 33.2% to 3132.52 on Tuesday ([Fig. 3](#)). That's a very long Santa Claus rally.

At the 7/31 meeting of the FOMC, the committee decided not only to lower the federal funds rate, for the first rate cut since 2008, but also to terminate quantitative tightening (QT) ahead of schedule: "The Committee will conclude the reduction of its aggregate securities holdings in the System Open Market Account in August, two months earlier than previously indicated." From 10/1/17 through 7/31/19, the Fed's balance sheet was pared from \$4.4 trillion to \$3.7 trillion ([Fig. 4](#)).

The Fed and the other major central banks are all playing Santa during this holiday season and are on track to continue doing so in the new year:

(1) *Fed*. In a 10/11 [press release](#), the Fed announced that beginning on 10/15 it "will purchase Treasury bills at least into the second quarter of next year in order to maintain over time ample reserve balances at or above the level that prevailed in early September 2019." More details were released in a separate New York Fed [statement](#) (and accompanying [FAQs](#)).

The initial pace of these "reserve management" (RM) purchases will be approximately \$60 billion per month and will be in addition to ongoing purchases of Treasuries related to the reinvestment of principal payments from the Fed's maturing holdings of agency debt and agency mortgage-backed securities. As the new holdings mature, the principal payments will be reinvested again into T-bills.

Many have commented that these actions look a lot like quantitative easing (QE). After all, the Fed is expanding its balance sheet sizably, possibly by up to \$300 billion or more assuming \$60 billion a month through March as a ballpark figure. The Fed's balance sheet totaled \$4.0 trillion during the 12/4 week, including \$2.3 trillion in US Treasury securities, of which \$420 billion are Treasuries maturing in one year or less ([Fig. 5](#)). This portfolio of Treasuries maturing in under a year is up \$71 billion since the end of September.

(2) *ECB*. Mario Draghi's term as president of the European Central Bank (ECB) ended on 10/31. Before leaving, Draghi put together a monetary stimulus package. It is designed to induce Eurozone governments to borrow at zero or negative interest rates to spend on stimulating their economies.

The package includes an open-ended commitment to buy as much as €240 billion per year of bonds issued by Eurozone governments. In other words, Draghi set the stage for the implementation of Modern Monetary Theory (MMT) in the Eurozone. According to MMT, governments should borrow as much as possible as long as inflation doesn't heat up. All the better if the central bank enables such borrowing by lowering interest rates and purchasing government bonds—again, as long as inflation doesn't heat up. Now it is up to the various Eurozone governments to take the bait.

The ECB terminated its QE1 program at the end of 2018. Under the program, which started 1/22/15, the ECB's "securities held for monetary policy purposes" increased by €2.4 trillion to €2.7 trillion ([Fig. 6](#)). Draghi's QE2 program will once again expand the ECB's balance sheet to new record highs.

(3) *BOJ*. In an 11/18 Reuters [interview](#), Bank of Japan (BOJ) Governor Haruhiko Kuroda said the BOJ has room to deepen negative interest rates, but he signaled there were limits to how far it can cut rates or ramp up stimulus.

According to Reuters, "Kuroda also said there was still enough Japanese government bonds (JGB) left in the market for the BOJ to buy, playing down concerns its huge purchases have drained market liquidity. After years of heavy purchases to flood markets with cash, the BOJ now owns nearly half of the JGB market."

The BOJ's QE program started in April 2013 and has yet to be terminated. This can be seen in bank reserve balances at the BOJ. They rose to a record high of ¥352 trillion during November, up 740% since the start of the program ([Fig. 7](#)).

(4) *All together now*. The total assets of the Fed, ECB, and BOJ rose \$264 billion y/y during November to \$14.5 trillion ([Fig. 8](#)). On this basis, they had been falling from December 2018 through September 2019. This total is on track now to rise to record highs in 2020.

That should be good for the stock market, which has been tracking the total assets of the three major central banks since the start of the current bull market ([Fig. 9](#)). Don't fight the three major central banks.

Paul Volcker: The Great Disinflater. The following is an excerpt about Volcker from my forthcoming book, *Fed Watching for Fun and Profit*.

When Volcker took the helm at the Fed, the Great Inflation was well underway. During the summer of 1979, oil prices were soaring again because of the second oil crisis, which started at the beginning of the year when the Shah of Iran was overthrown. Seven months later, in March 1980, the CPI inflation rate peaked at its record high of 14.8%. When Volcker left the Fed during August 1987, he had gotten it back down to 4.3%.

How did he do that?

Volcker didn't waste any time attacking inflation. Eight days after starting his new job, he had the FOMC raise the federal funds rate on 8/14/79, by 50 basis points to 11.00%. Two days later, on 8/16/79, he called a meeting of the seven members of the Federal Reserve Board to increase the discount rate by half a percentage point to 10.50%. This confirmed that the federal funds rate had been raised by the same amount. Back then, as I previously noted, FOMC decisions weren't announced. The markets had to guess.

On 9/19/79, Volcker pushed for another discount-rate hike of 50 basis points to 11.00%. However, this time, the vote wasn't unanimous; the Board was split four to three. In his memoir, Volcker wrote that market participants concluded that "the Fed was losing its nerve and would fail to maintain a disciplined stance against inflation." The dollar fell and the price of gold hit a new record high.

Volcker, recognizing that the Fed's credibility along with his own were on the line, came up with a simple, though radical, solution that would take the economy's intractable inflation problem right out of the hands of the indecisive FOMC and the Board: The Fed's monetary policy committee would establish growth targets for the money supply and no longer target the federal funds rate.

This new procedure would leave it up to the market to determine the federal funds rate; the FOMC no longer would vote to determine it! This so-called "monetarist" approach to managing monetary policy had a longtime champion in Milton Friedman, who advocated that the Fed should target a fixed growth rate in the money supply and stick to it. Under the circumstances, Volcker was intent on slowing it down, knowing this would push interest rates up sharply.

On 10/4/79, Volcker discussed his plan with the Board. In his memoir, he noted, "Even the 'doves' who had opposed our last discount-rate increase were broadly supportive, having been taken aback by the market's violent reaction to the split vote." A special meeting of the FOMC was scheduled for Saturday, 10/6/79. Holding an unprecedented Saturday night press conference after the special meeting, Volcker unleashed his own version of the Saturday Night Massacre. He announced that the FOMC had adopted monetarist operating procedures effective immediately. He said, "Business data has been good and better than expected. Inflation data has been bad and perhaps worse than expected." He also stated that the discount rate, which remained under the Fed's control, was being increased a full percentage point to a record 12.00%. In addition, banks were required to set aside more of their deposits as reserves.

The Carter administration immediately endorsed Volcker's 10/6/79 package. Press secretary Jody Powell said that the Fed's moves should "help reduce inflationary expectations, contribute to a stronger US dollar abroad, and curb unhealthy speculation in commodity markets." He added, "The Administration believes that success in reducing inflationary pressures will lead in due course both to lower rates of price increases and to lower interest rates."

The notion that the Fed would no longer target the federal funds rate but instead target growth rates for the major money supply measures came as a shock to the financial community. It meant that interest rates could swing widely and wildly. And they did. The economy fell into a deep recession at the start of 1980, as the prime rate soared to an all-time record high of 21.50% during December 1980. The federal funds rate rose to an all-time record high of 20.00% at the start of 1981. During 1980, the discount rate was raised to 13.00% on 2/15/80, then lowered three times to 10.00%, then raised again two times back to 13.00%, on the way to the all-time record high of 14.00% during May 1981. The trade-weighted dollar index increased dramatically by 56% from 95 on 8/6/79, when Volcker became Fed chair, to a

record high of 148 on 2/25/85.

The public reaction to Volcker's policy move was mostly hostile. Farmers surrounded the Fed's headquarters building in Washington with tractors. Homebuilders sent Volcker sawed-off two-by-fours with angry messages. Community groups staged protests around the Fed's building. Volcker was assigned a bodyguard at the end of 1980. One year later, an armed man entered the building, apparently intent on taking the Board hostage.

At my first job on Wall Street as the chief economist at EF Hutton, I was an early believer in "disinflation." I first used that word, which means falling inflation, in my June 1981 commentary, "Well on the Road to Disinflation." The CPI inflation rate was 9.6% that month. I predicted that Volcker would succeed in breaking the inflationary uptrend of the 1960s and 1970s. I certainly wasn't a monetarist, given my Keynesian training at Yale. I knew that my former boss [at the Federal Reserve Bank of New York] wasn't a monetarist either. But I expected that Volcker would use this radical approach to push interest rates up as high as necessary to break the back of inflation.

Volcker must have known that would cause a severe recession. I did too. Back then, I called Volcker's approach "macho monetarism." I figured that a severe recession would bring inflation down, which in turn would force the Fed to reverse its monetary course by easing. That would trigger a big drop in bond yields. Arguably, the great bull market in stocks started on 8/12/82, when the Dow Jones Industrial Average dropped to 776.92. On 12/6/19, it was 27,677.79.

Thank you, Paul Volcker.

CALENDARS

US. Wed: Headline & Core CPI 2.0%/2.3% y/y, Monthly Budget Statement -\$206.9b, MBA Mortgage Applications, DOE Crude Oil Inventories, FOMC Rate Decision 1.63% (1.50%-1.75%), Interest Rate on Excess Reserves 1.55%, Powell. **Thurs:** Jobless Claims 212k, PPI Final Demand 0.2% m/m/1.3% y/y, EIA Natural Gas Storage. (DailyFX estimates)

Global. Wed: Japan Machine Orders -1.7% y/y. **Thurs:** UK General Election, Eurozone Industrial Production -0.5% m/m/-2.4% y/y, Germany CPI -0.8% m/m/1.1% y/y, Mexico Industrial Production -1.6% y/y, France Sovereign Debt Rated by Fitch, ECB Central Bank Rate Decision 0.00%, ECB Marginal Lending & Facility Rates 0.25%.-0.50%, Lagarde, Poloz. (DailyFX estimates)

US ECONOMIC INDICATORS

NFIB Small Business Optimism Index ([link](#)): "Owners are aggressively moving forward with their business plans, proving that when they're given relief from the government, they put their money where their mouth is, and they invest, hire, and increase wages," noted NFIB Chief Economist William Dunkelberg in the NFIB's November report. The Small Business Optimism Index (SBOI) posted its biggest monthly gain since May 2018, jumping 2.3 points last month to 104.7 (only 4.1 points below August 2018's record high of 108.8). Seven of the 10 components of the SBOI advanced last month, led by a 10-point increase in earnings trends (to 2% from -8%). Owners reporting it's a good time to expand (29 from 23) jumped 6 points, and those expecting better business conditions (13 from 10) improved 3 points. Current inventory (1 from -4) shot up 5 points—moving above zero for the first time since May 2013. Both employment measures improved in November, as 38% of business owners reported job openings they couldn't fill, up from 34% in October, and 21% of small businesses plan to increase employment, up from 18% in October. Sales expectations (13 from 17) and inventory investment (3 from 5) deteriorated slightly, while expected credit conditions was unchanged at -3%.

Meanwhile, the uncertainty index sank to an 18-month low of 72—down from a recent peak of 87 just five months ago. According to the report, “November reflects a stark departure from previous months of clatter months about a possible recession that dampened owners’ economic outlook. But the current focus and noise in Washington, D.C. around impeachment is proving to have little, if any, impact on small business owners, no different than during the impeachment proceedings of President Bill Clinton.”

Productivity & Unit Labor Costs ([link](#)): Revisions for Q3 showed little change in overall productivity from initial estimates, though there was a notable downward revision to Q3 labor costs. Nonfarm productivity during Q3 fell a revised 0.2% (vs -0.3% initial estimate), the first quarterly decline since Q4-2015, following gains of 2.5% and 3.5%, respectively, during Q2 and Q1—the best two-quarter performance since Q3-2014. There were minor upward revisions to both Q3 output (to 2.3% from 2.1%) and hours worked (2.5 from 2.4), with both accelerating from 1.9% and -0.5%, respectively, during Q2. Unit labor costs accelerated from 0.1% during Q2 to 2.5% (saar) during Q3—which was a downward revision from the initial estimate of 3.6%—as hourly comp was revised down to 2.3% (vs 3.3% initial estimate), now showing a slight slowing from Q2’s 2.5% advance. Productivity rose 1.5% y/y during Q3, holding around Q2’s 17-quarter high of 1.8%. The recent bottom was -0.1% y/y during mid-2016. Unit labor costs rose 2.2% y/y during Q3, with hourly comp up 3.7% y/y.

GLOBAL ECONOMIC INDICATORS

UK GDP ([link](#)): Real GDP growth began Q4 weak, showing no change in October, impacted by the global economic slowdown and the approaching Brexit deadline. In October, only the construction industry (-2.3%) posted a decline—its biggest since January 2018—while services (which accounts for roughly 80% of the UK economy) recorded its first increase in three months, up 0.2%. Production industries, which include manufacturing, rose 0.1% in October, with manufacturing advancing 0.2%. On a rolling three-month basis, overall GDP growth was flat, with services (0.2%) the only industry in the plus column. Production industries fell 0.7% over the comparable three-month period, with manufacturing matching that decline; construction output was 0.3% lower. On a year-over-year basis, real GDP expanded only 0.7%, its weakest yearly growth since March 2012. The service industry climbed 1.2% y/y, its weakest yearly performance since November 2017. Production industries fell 1.3% y/y, with manufacturing falling 1.2%; mining slumped 9.0% y/y. Construction (-2.1% y/y) was negative for the first time since the end of last year.

UK Industrial Production ([link](#)): Output ticked up in October though was 2.8% below March’s cyclical high. Headline production edged up 0.1% after a 0.9% decline during the two months through September, with factory output rising 0.2% and falling 1.1% over the comparable periods. Since peaking in March, manufacturing output is down 4.0%, with all the main industrial groupings in the red, though only intermediate goods production recorded a decline in October, falling 0.7% m/m and 4.7% during the seven months through October. Both consumer durable and capital goods production advanced for the second month in October, by 1.0% and 0.9%, respectively, while consumer nondurable goods output recovered 0.6% in October after a two-month slide of 2.3%. Energy output edged up 0.4% after falling 2.2% over the prior three-month period. Looking ahead, IHS Markit’s M-PMI in November remained below 50.0 for the seventh month, dipping to 48.9 in November after improving from 47.4 in August to 49.6 in October, as “November saw UK manufacturers squeezed between a rock and hard place, as the uncertainty created by a further delay to Brexit was accompanied by growing paralysis ahead of the forthcoming general election,” according to the report. “Downturns in output and new orders continued amid a renewed contraction in exports.”

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