THE ECONOMIC OUTLOOK GROUP

475 Wall Street
PRINCETON, NEW JERSEY 08540 Tel: 609 - 529 - 1300
www.economicoutlookgroup.com

ECONOMIC TALKING POINTS

Bernard Baumohl
Chief Global Economist

December 12, 2012

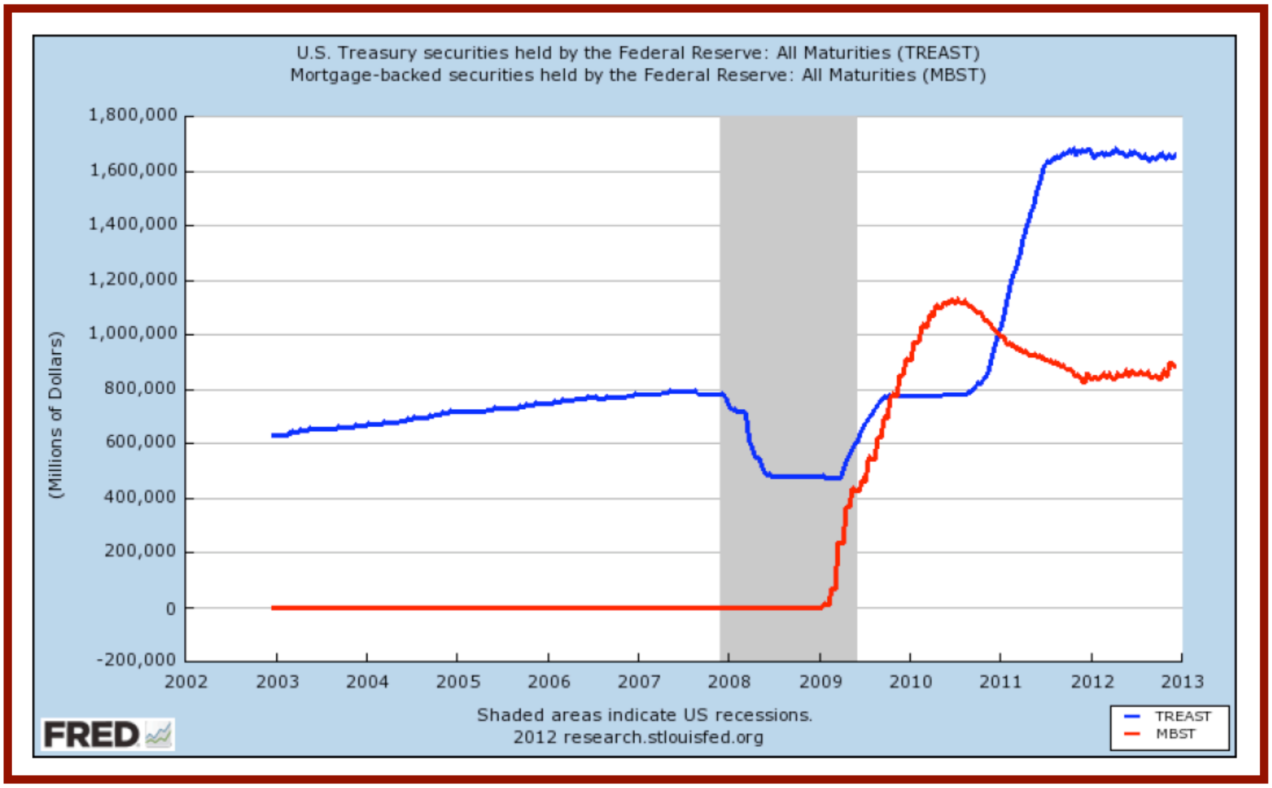
A High Octane QE 4

Fiscal cliff or not, Ben Bernanke has chosen this time to slam his foot down hard on the gas pedal --- and keep it there until the economy speeds up and unemployment tumbles.

There was nothing subtle or ambiguous about the Fed's latest change in strategy. Frustration apparently has set in at the Fed because the economy has so far been largely unresponsive to five years of exceptionally easy money. So out comes a plan with the characteristics of a super high octane QE 4.

The Fed today reiterated its strategy to keep monetary policy loose even after "the economic recovery strengthens." How much after? That's what's new. For the first time, the central bank has explicitly said that policy will remain highly accommodative "at least as long as the unemployment rate remains above 6.5%" and the outlook for inflation holds around 2%.

In so doing, the Fed announced it will not only continue to purchase $40 billion a month in mortgage backed securities, but that Operation Twist (which expires at the end of the year) will be replaced with additional outright purchases of longer term Treasury securities in the amount of $45 billion each month. There you have it.



But will it work?

We certainly believe linking an economic target like the unemployment rate makes far more sense than proclaiming a timetable to keep short-term rates zero bound until mid 2015. The latter only reinforced the public's impression that the economy would remain soft at least another 2.5 years, so why would companies rush to invest or ramp up hiring now. What's the hurry? Moving away from a timetable was thus a good idea.

But there is a larger issue here. Can the Fed really make a major dent in lowering unemployment simply by promising to keep the cost of credit low? No. Let's take a step back and see why?

Here's what have we learned about the Fed's QE policies so far.

Clearly QE has done some good. By allowing its balance sheets to swell, the Fed has knocked down short and long-term rates to record lows. As a result, the economy has grown every quarter since the recession ended in mid-2009. More recently, the cheap cost of credit has clearly helped boost motor vehicle sales. Indeed, sales of autos and light trucks jumped to a 15.5 million unit rate last month, the most in five years! Even more important for the economy is how the housing industry has bounced back. Fed actions have allowed rates on conventional mortgages to plummet to levels never seen before, and that has revived the all-important housing market this year. Just about every metric on housing --- construction starts, permits, new and existing home sales, prices, homebuilder confidence --- has moved in the right direction. What's more, as real estate values rebound so does household wealth. During the last recession, Americans watched in agony as $16 trillion in household wealth went up in smoke, largely because of home values performed a Mexican cliff dive.

The Fed's commitment to drive down the cost of long term borrowing has lifted both real estate values and stock prices to the point where households have now recouped 85% of the wealth lost during the downturn, according to the latest flow of funds report.

So let's be clear here. Ben Bernanke deserves some kudos. He has been the most innovative and transparent Fed Chairman ever. And now, after today's announcement, Bernanke has just about pulled all the levers available to him to promote faster economic growth without heating up inflation.

But the Fed has also seen the limits of its power when there is paralysis on fiscal policy.

What Bernanke found frustratingly elusive up to now was that last critical spark to bring about a virtuous cycle of economic activity; He can't seem to get the private sector to hasten employment enough to slash joblessness.

Why fail here? Simple. The calculus that goes into deciding whether or not to hire workers is the same today as it has always been. Companies do not beef up their workforce simply because credit is cheap. Nor, for that matter, will firms add workers simply because the government offers tax subsidies for every job created. That strategy never made much sense.

The fact is employers will only accelerate hiring if demand for their products increases enough to justify the expense of adding on workers. And the hurdle to make that justification has gotten higher in recent years because companies face tough global competition, an uncertain outlook over health care costs and a desire to control future pension liabilities.

That's not all. What has also depressed hiring this past year has been the constant worry that a recession is likely in 2013 if Washington cannot agree on a plan to avert the fiscal cliff. Until that matter is resolved, households and businesses will remain hyper cautious about spending, and

there is nothing the Federal Reserve can do to change that sentiment.

Again, what drives payroll growth is demand for goods and services, productivity, and the outlook for earnings --- not simply low interest rates.

What if we escape the fiscal cliff and the economy comes alive next year?

Let's now assume we avoid the fiscal cliff and the economy picks up speed. Then today's announcement introduces a different concern, namely the Fed's exit strategy.

If the White House and Congress successfully reach a long term budget agreement, the economy is likely to respond favorably as years of pent up demand by households and companies gets unleashed. The urgent question then is whether the Fed really has the know-how to pivot away from aggressive accommodation and move to a policy that begins to sop up excess reserves ***before*** they convert into credit, drive up monetary velocity and cause the money supply to explode. Again, the Fed is in uncharted territory when it comes to unwinding trillions of dollars of assets on its balance sheets. They say they can carry out an orderly exit strategy, but who knows? It has never been done before on such a scale.

Adding to this concern is the rumor that Bernanke, the leader who engineered the blow-up in the central bank's balance sheets, may not even stick around after his term expires the end of next year. What then? Even if he were replaced with someone who shares his philosophy, questions would arise whether the Fed's new leader can adroitly transition from monetary accommodation to tightening without causing the economy to stumble, or kick inflation higher.

For the past year, the world's spotlight has focused on fiscal cliff talks in Washington. If this gets resolved in the coming weeks, that harsh spotlight will rotate quickly to the Federal Reserve. And no group will be ready to pounce faster than the bond vigilantes. If they start to lose confidence in the Fed in 2013, the backdrop is set for the bond bubble to finally burst.

So there you have it. If we go over the fiscal cliff and a recession ensues, you end up with job losses no matter what the Fed does in the short run.

On the other hand if we avert the fiscal cliff, another risk starts to loom large. When you combine the unprecedented injection of liquidity by the major world central banks with a stronger US economy next year, more positive economic numbers out of China, and an easing of the debt crisis in Europe, it is understandable why bondholders are eyeing the exit door. If they stampede out of fixed incomes, the jump in yields can derail growth too.

Thus a cage fight may be brewing between the Fed and bond vigilantes, and if it were to erupt the victim could once again be the economy.

===============================