Mitchell's Musings 7-1-13: Lessons of the Week

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The chart below shows the S&P 500 index. It indicates that the stock market was booming along until mid-May. Then came fears that maybe the Federal Reserve would end its purchases of various financial assets and the rise halted. When Fed chair Ben Bernanke indicated explicitly in the third week of June that the purchases might indeed be tapered off - assuming the economy continued to improve - the stock market tanked.[1] It was revived somewhat (at this writing) by a Bureau of Economic Analysis report indicating that real GDP in the first quarter rose more slowly than indicated in previous estimates.

So what are the lessons from this episode? **First**, although there have been complaints in some financial circles that the Fed was too aggressive in its efforts to stimulate the economy, the mere thought that the policy might halt created a panic. The objections to Fed stimulus were all in the abstract. But when push came to shove, it appears that Wall Street thinks the stimulus actually is necessary and fears any premature termination. The seeming rebound when the weak GDP report came out in fact gave hope to market transactors that the Fed would heed the fragility of the economy and would not pull back too soon.[2]

A **second lesson** comes from the GDP release itself. We have noted in prior musings that there is little virtue in having rushed preliminary data releases on key economic indexes that will later be revised. The initial estimate of real GDP put the annual rate of real growth for the first

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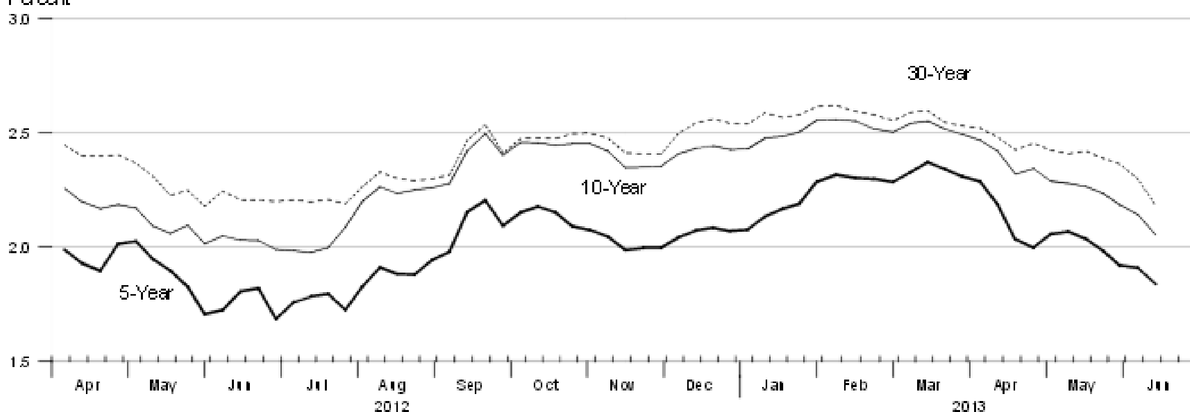
[1] http://www.forbes.com/sites/afontevecchia/2013/06/19/did-the-fed-chairman-just-kill-the-bernanke-put-fed-ready-to-taper-qe-this-year/

[2] http://www.bea.gov/newsreleases/national/gdp/2013/pdf/gdp1q13_3rd.pdf

quarter of 2013 at 2.5%. That figure was then revised down to 2.4% in the second estimate. The most recent number is 1.8%. If the Fed did make policy judgments using the earlier estimates – not necessarily what actually happened – what was the gain in putting out rough preliminary estimates? Why should we encourage policy making based on shaky data?

Critics of Fed stimulatory efforts have largely focused on fears of inflation. They acknowledge that inflation has been quite low since the Great Recession; the same media release that contained the real GDP figure also showed the gross domestic purchases price index rising at only a 1.2% annual rate. But critics are convinced that the credit creation activities of the Fed will inevitably produce rapid inflation, albeit at a date uncertain. The **third lesson** – one which we have pointed to periodically – is that financial markets are expecting no such thing. As the chart below shows, the spreads between inflation-indexed Treasuries and conventional Treasuries have not been suggesting high future inflation and in fact have been showing a downward trend over the past few months.[3]



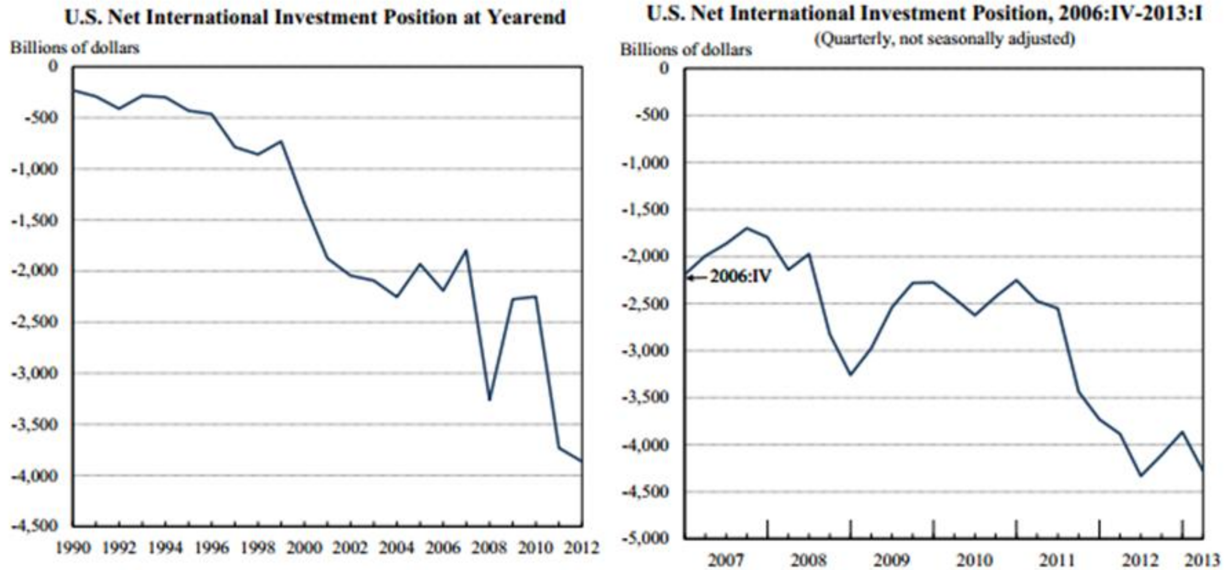
A **fourth lesson** comes from what was ignored. While much attention was focused on the GDP media release, another release that came out around the same time was ignored.[4] As the charts on the next page show, that release indicated that the march of the U.S. to ever-greater net debt to the rest of the world – thanks to our trade imbalance- continues. The negative impact on jobs in the U.S. – particularly in manufacturing – thus continues, too.

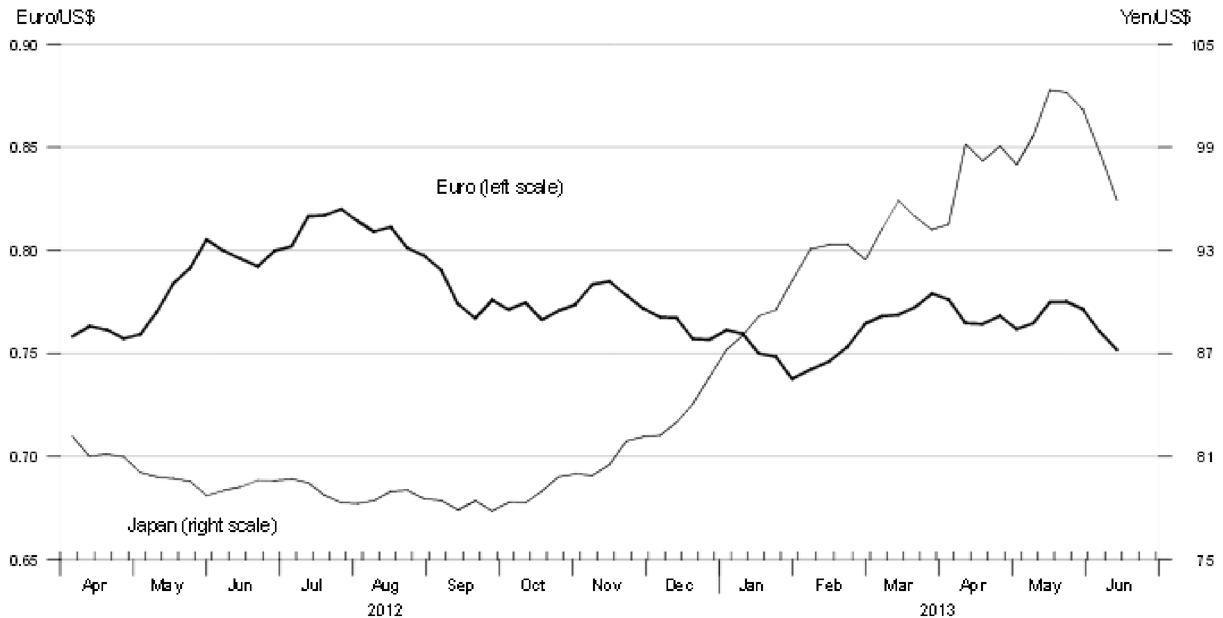
As we have noted in previous musings, much of the imbalance is linked to undervalued currencies. While the U.S. takes a *laisser-faire* view of exchange rates, other countries do not.

[3] http://research.stlouisfed.org/publications/usfd/20130621/usfd.pdf

[4] http://www.bea.gov/newsreleases/international/intinv/2013/pdf/intinv113.pdf

Although the focus in this regard has been on China, policies of holding down or reducing national currency values are not confined to that country. The euro-zone countries have been content to wallow in austerity, but - of late - Japan has not. And as the can also be seen below, the yen/dollar ratio began to climb (the yen depreciated relative to the dollar) when Japan decided its economy needed stimulation. To Japan, stimulation means more exports.





I haven't heard any comments from the legislative or administrative branches in Washington about exchange rates or about the sluggish recovery as reflected in the slow advance of real GDP, whatever the estimate may be. From time to time, there is official rhetoric about "good jobs" and about bringing manufacturing back. But the disconnect between those concerns and U.S. international economic policy (or lack thereof) is striking. Calls for a proactive American policy concerning foreign exchange rates policies are met with charges of "protectionism" or vague statements about living in a global economy. On the upcoming Independence Day, it would be nice to see some signs of independent thinking among the powers-that-be.