First Trust

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THE ECONOMIC ANTIDOTE
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Fed Done: So Is Gold

It was a Fed-watchers delight when Ben Bernanke told the US Congress that there would be no QE3 and that the next move by the Fed would be to tighten monetary policy.

Oops! That's not what he said. There were no quotable quotes to that affect. In fact, lots of people thought he said the opposite. A Wall Street Journal headline read *Recovery Worries Weigh on Stocks,* as "Bernanke took a cautious view of the U.S. recovery." The Washington Post said "*Bernanke Strikes Cautious Tone….*" If you take these headlines at face value, Bernanke was dour and his testimony was about a weak economy and the potential for more ease.

But the gold market did not miss the message – gold futures fell $77 yesterday. And stocks were down on disappointment about the potential for more quantitative easing (QE3). We agree with gold and read the testimony in the opposite way of the popular press.

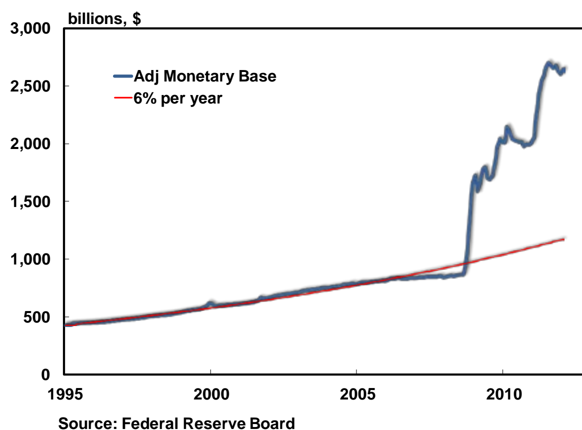
Bernanke's testimony actually showed incredulity at the strength of the economy. He explained that job growth has been strong, but then said that the "decline in the unemployment rate over the past year has been somewhat more rapid than might have been expected." The Fed is still stuck in the potential GDP trap. It believes the economy is well below its potential and not growing at its trend. As a result, the Fed is surprised that inflation remains above its forecasts, and it is incredulous that job growth has been strong.

Many look to the Fed for the final word on the economy and, therefore, this incredulity is interpreted as a dour outlook. In fact, the Fed, along with many forecasters, has been way too pessimistic on the US economy. But the data keeps coming in more strongly than the Fed thinks it should and it can no longer deny it.

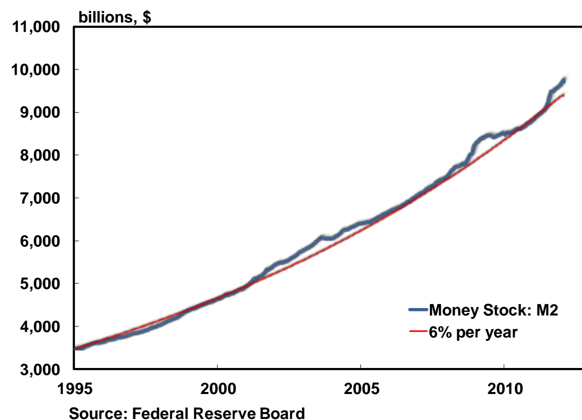
What this means is that Bernanke cannot possibly justify QE3. He wants to justify it, but he can't. This can be understood clearly by analyzing an answer to a question in the House Financial Services Committee, when Bernanke said "it is arguable that interest rates are too high, that they are being constrained by the fact that interest rates can't go below zero."

What he is talking about here is that some Taylor Rule-type-estimates say that the federal funds rate should be negative. These models use GDP relative to potential, unemployment relative to the natural rate and a target inflation rate, to estimate the correct target for short-term interest rates. But because rates can't go below zero, the Fed wants to do more quantitative easing.

This raises an important dilemma for anyone who does not view the world through models alone. If the necessary interest rate really is negative, but rates cannot go below zero, then how is the economy growing? The Fed says it is growing because of QE1 and QE2. We seriously doubt this proposition because there has been no QE3 and the economy and stock market are both doing better. Moreover, even though the Fed's balance sheet has grown, M2 has not accelerated. See charts below. The monetary base has exploded, but M2 has not, and if M2 is not rapidly expanding, then QE has not boosted the money supply.



Source: Federal Reserve Board



Source: Federal Reserve Board

The bottom line is that even though Bernanke wants to make the case for QE3, he can't. In fact, better news on the economy has cut the Fed off from doing more massive easing projects. In the end, we believe the Fed has finally run out of justification for its excessively easy monetary policy. As the quarters ahead unfold, the prospects of more ease will continue to wane. This is good news for stocks – which do not do well with accelerating inflation – but, it is bad news for gold. Gold is done….and so is the Fed.

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