Myrmikan Performance Report

QE7: Incoherence at the Fed

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Once upon a time, central bankers were practical men. Of the first nine Chairmen of the Federal Reserve, one was a prominent lawyer, one was a successful businessman, and the other seven were financiers. Then, in 1970, Nixon appointed Arthur Burns, a man with no practical experience whose career had bounced between academia and government. Over the subsequent eight years, Burns blindly followed the flawed Phillips curve model precipitating the worst dollar crisis since the founding of the Republic.

Burns' successors strengthened academia's hold on policy. Paul Volcker may have worked at Chase, but he did so as an economist – not a deal maker – having received his training at the Federal Reserve Bank of New York, his previous and first job. Alan Greenspan similarly worked as an economist at a few Wall Street firms before starting his unsuccessful consulting practice. Finally, there is Ben Bernanke, who did not bother with the fig leaf of an economist job at a bank, but went directly from academia to central banking.

Experience imparts both explicit and tacit knowledge. Explicit knowledge is that which can be codified and verbalized. Tacit knowledge is that which only an apprenticeship of practice and trial and error can impart, such as riding a bicycle or playing the piano or sculpting a figure. Paradoxically, because of tacit knowledge, an expert in a field will be unable to follow precisely in practice that which he has written in theory, since by definition he cannot express the depth of his knowledge in verbal terms.

The effect of handing monetary policy to academics was to eliminate the tacit knowledge of business and finance ingrained in previous policy makers. Arthur Burns had no experience to alert him that his model was flawed. Neither does Bernanke.

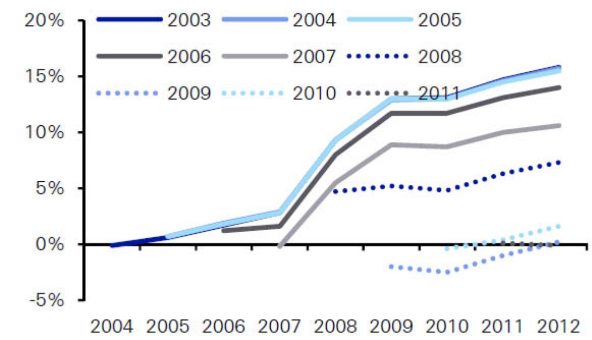
A conspiracy theorist reading Bernanke's infamous 2002 speech, *Deflation: Making Sure "It" Doesn't Happen Here* might understandably conclude that the financial crisis and policy responses had all been arranged in advance, so perfectly have Bernanke's actions followed the prescriptions set forth in that speech of ten years ago.

But, Ockham's razor suggests Bernanke is transparent because he has no tacit knowledge to interfere with his academic purity. Market participants can be confident that Bernanke's actions will match his words, and that innovative Fed actions will always be vetted first by quasi-intellectuals in Fed research papers, academic reviews, op-ed pages and, perhaps most importantly, research papers from the major banks.

It is not immediately obvious why banks spend so much on economic research. Chief economists of major banks make seven figures and command teams of data-crunchers to issue streams of reports, but their economic forecasts are notoriously inaccurate. Goldman Sachs chief economist Jan Hatzius recently confirmed: "Nobody has a clue. It's hugely difficult to forecast the business cycle."

As the chart at right from Deutsche Bank shows, even the banks know their economists' forecasts are useless. Only clients are expected to digest the prognostications of Wall Street economists. The value the banks themselves extract is influence. Hatzius's predecessor, William Dudley, left to head the New York Federal Reserve. Other Goldman Sachs alumni include Mario Draghi, the former head of the Bank of Italy and current head of the European Central Bank, Mark Carney, the current head of the Bank of Canada and appointed head of the Bank of England, and Mario Monti, resigning Prime Minister of Italy, all PhD economists.

Figure 18: Cumulative Real GDP miss since 2004 for US



Source: Deutsche Bank, Consensus Forecasts

The banks realize that to control academia is to control policy. They pay men such as Larry Summers millions to direct the prestige of academic associations and the prominence of political connections toward lobbying on their behalf. The pure academic deposed the practical man in the 1970s, but is now succumbing to sinister mercenaries bred in the nexus of big academia, big government, and big banking.

Therefore, when the prominent banks issue research reports that project future policy, they should be interpreted as requests. It should be no surprise that a June report from Goldman Sachs that suggested the "possibility" of a "flow" of QE purchases of roughly $50 billion per month should be implemented nearly precisely by the Federal Reserve at its September meeting. Unlike their economic forecasts, the banks' policy forecasts are stunningly accurate.

In a recent report, Morgan Stanley chief U.S. equity strategist Adam Parker wrote: "QE3 will likely be insufficient to significantly boost equity markets and we wouldn't be at all surprised to see the Fed dramatically augment this program before year-end." Goldman Sachs, wielding more power, was unafraid to quantify its demands, "projecting" that the Fed will convert Operation Twist into direct non-sterilized purchases of long-term Treasuries that, combined with QE3, will reach a total intervention of $2 trillion by mid-2015.

True to script, last week the Fed announced, QE3+, QE4, or QE7, depending on how the count is kept, matching the expectations of 48 of 49 economists surveyed by Bloomberg. The surprise was that the Fed shifted from calendar guidance to specifying that it will not tighten before inflation goes above 2.5% or unemployment falls below 6.5%.

Bernanke explained that relating "policy to observables in the economy, such as unemployment and inflation" would offer markets greater clarity to predict future Fed actions. But, embarrassingly, during his post-statement press conference, he managed to deconstruct the definitions of inflation and unemployment rendering the official statement incoherent.

In terms of unemployment, Bernanke pledged that the committee would look through the official unemployment numbers and consider discouraged workers. As the graph at right shows, the

U6 unemployment rate is currently 14.4%, not the 7.7% headline number, giving the Fed unlimited flexibility in determining their proprietary unemployment rate. Since the market does not know how much consideration will be given to the U6 rate, it cannot evaluate if unemployment is approaching 6.5%, rendering the defined threshold useless.

In terms of inflation, the Fed plans to consider not the CPI but "projected inflation" one to two years out. This will allow the Fed to "look through purely transitory fluctuations in inflation, such as those induced by short-term variations in the prices of internationally traded commodities . . ." Commodities the demand for which are the least elastic, such as food and energy, usually rise first in a general inflation. Since these are precisely the prices Bernanke plans to ignore, the Fed will forever be behind the inflation curve.

Bernanke says the Fed's "projected inflation" will be determined by surveys, outside forecasters, and econometric models. As discussed above, outside forecasters, i.e., economists at large banks, are notoriously inaccurate at projecting anything but policy actions. Nor did any of the Fed's models manage to project the tech bubble, the internet bubble, the housing bubble, or the current bond and currency bubbles. Moreover, the models that do project unpleasant outcomes are discarded. Consider an excerpt from a New York Fed Staff report from October:

> The problem, however, is that these DSGE models appear to deliver unreasonably large responses of key macroeconomic variables to central bank announcements about future interest rates – a phenomenon we can call the "forward guidance puzzle". For instance, Carlstrom et al. (2012) show that the Smets and Wouters model would predict an explosive inflation and output if the short-term interest rate were pegged at the ZLB [zero lower bound] between eight and nine quarters. This is an unsettling given that the current horizon of forward guidance by the FOMC is of at least eight quarters.

Yet, absurdly, and contrary to some of their own puzzling models, the Fed projects inflation will not rise beyond 2% through 2015 and beyond.

Robin Harding of the Financial Times asked Bernanke the obvious question: since he had cited so many sources to determine "projected inflation," how was the market supposed to divine its height? Bernanke responded:

> The committee will include in its statements its views on where inflation is likely to be a year from now. . . . The intellectual exercise we'll be doing is asking ourselves if we maintain low rates along the lines suggested by this policy, would we expect inflation to cross the threshold. . . . Just to be clear, the projection that matters for our determination is the one that the committee collectively comes up with.

In other words, projected inflation is whatever the Fed says it is, meaning there is no "observable" for the inflation metric either, undermining the stated goal of clarity which the statement was meant to achieve.

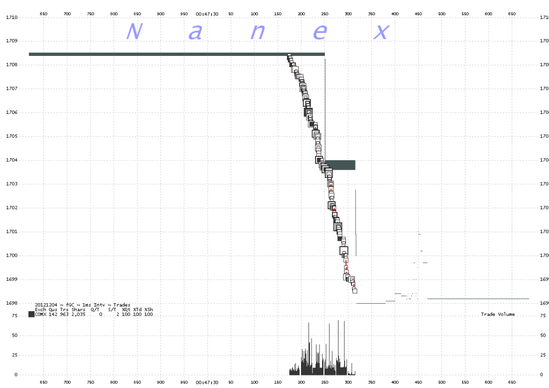
Having undefined "unemployment" and "inflation," Bernanke claimed even more flexibility by saying: "Reaching one of the thresholds, however, will not automatically trigger immediate reduction in policy accommodation." He provided the example of unemployment falling below its threshold without inflation breaching its, in which case the Fed might keep printing. The alternate possibility is far more likely, meaning the Fed will keep printing even after visible, official inflation arrives.

Other highlights of Bernanke's press conference included his admission that if the U.S. went off the "fiscal cliff," a phrase he himself coined, "on the margin we would try to do what we could; we would, perhaps, increase [printing] a bit." He also denied the claim that plans to monetize half a trillion dollars of Treasury debt in 2013 would allow Congress to continue its profligacy, saying:

> We've been very clear that this is a temporary measure . . . We've been equally clear that we will normalize the balance sheet and reduce the size of our holdings . . . so again this is only a temporary step. It would be a quite different matter if we were buying these assets and holding them indefinitely. That would be a monetization. We're not doing that.

It is possible that Professor Bernanke is so enamored of his models that he actually believes the Fed's intervention to be temporary. He continues to discuss ever more unlikely "exit strategies" to return the balance sheet to its pre-crisis levels. The Austrian economic model, which predicted the balance sheet could only grow, has proved far more prescient. Ludwig von Mises's model holds that the printing must accelerate into hyperinflation unless the government is willing to withstand a total collapse of the banking system and, therefore, the economy and its tax revenues. Unlike with Dr. Bernanke's theories, events continue to substantiate the explanatory and predictive powers of Austrian Business Cycle theory, with gold being the only financial asset sure to survive the Austrian prognosis.

It is odd, then, that gold should drop on last week's Fed action. Open-ended printing cannot strengthen the dollar over time. One possible explanation is that traders were caught off-sides. With 48 of 49 economists getting it right, traders were undoubtedly poised to make fast money from a gold pop while protecting their positions with tight stops. The bullion banks surely sensed an opportunity to pick the pockets of overexposed fast money hedge funds by driving gold prices down through the sell stops. Powerful Asian central banks may be running stops as well in order to dislodge metal to ship east.



This analysis is supported by the very odd trading gold has seen over the past few weeks. There have been numerous bouts of concentrated selling during the most illiquid trading times. For example, on November 29 at 8:20 AM, before the liquid market opened, someone dropped 24 tons of gold, worth over $1 billion, in just a few minutes sending gold down $26/oz. The chart at right shows another raid that occurred on December 4. The chart covers one second beginning at 00:47 and 29.6 seconds. Over 200,000 ounces of gold worth $345 million were sold in two tenths of a second, sending the price down $10/oz. Sellers trying to get a good price do not behave in this manner. The numerous raids are clearly designed to artificially lower the gold price.

Falling gold prices have knocked gold mining shares lower as well. After the double bottom in mid-May and mid-July, gold shares had moved strongly higher into the QE3 announcement. Since then, shares have retraced about the half the move with weakness especially prominent since mid-November.

In addition to chaotic gold prices, gold shares have had to contend with liquidations by some of the major players in the space, including Libra Advisors which is returning most of its $2 billion fund to outside investors so as to convert to a private entity to avoid the new Dodd-Frank rules. The performance of other players in the junior gold mining sector, such as Salida Capita, which was down 53% in 2011 and 50% so far in 2012, have disheartened investors running for the exits even while the value of the economic insurance provided by gold shares continues to grow.

Tax loss selling is another factor weighing on share prices. The marginal investor in gold shares is primarily the Canadian retail investor, and Canada allows capital losses to be used retroactively to offset gain from up to three prior years. In other words, those Canadians who paid capital gains taxes in 2009 or 2010 can get cash back by taking losses in 2012.

Whether it is rogue governments, predatory banks, or transient tax and regulatory market conditions capping gold prices and gold mining shares, the laws of economics cannot for long be resisted. By the end of 2012, the Federal Reserve will own no short-term Treasuries which could be sold to protect the dollar when the inevitable currency crisis arrives. By the end of 2013, the Fed's balance sheet will be at least another $1 trillion larger. At some point, at least one of Professor Bernanke's theories will be vindicated:

> By increasing the number of U.S. dollars in circulation, or even by credibly threatening to do so, the U.S. government can also reduce the value of a dollar in terms of goods and services, which is equivalent to raising the prices in dollars of those goods and services. We conclude that, under a paper-money system, a determined government can always generate higher spending and hence positive inflation.

Bernanke's actions will match his words. The Fed will print until there is visible inflation, and it will discover then that it is uncontainable. Prices manipulated lower by banks, central or commercial, present an opportunity to buy not sell.