Federal Reserve Hid In Plain Sight

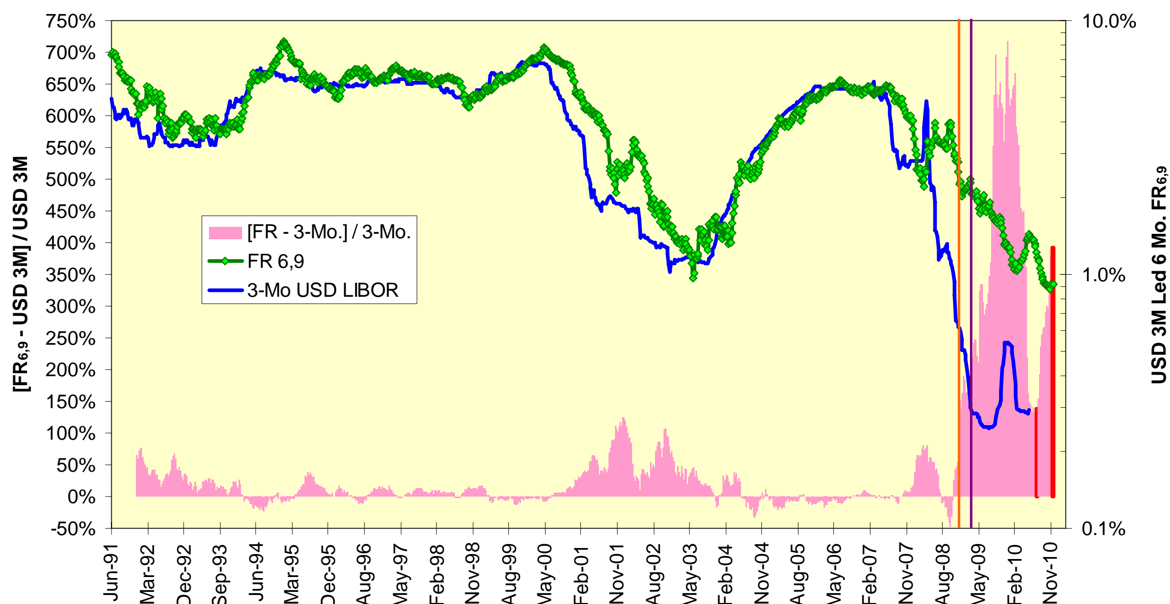
Of all the negative human emotions, the feeling you have been had is one of the worst. We all have heard the adage, "fool me once, shame on you; fool me twice, shame on me," and if I had a nickel for every time I have heard "Won't Get Fooled Again," both former President Bush and I would have a lot of nickels.

Well, it is red-face time: Even though the Federal Reserve has been on a mission-from-wad since August 17, 2007, the date when executed a premarket rate cut in the target federal funds rate, to 6.00%, and even though they had already executed QE1 and were three months away from hinting at QE2, they managed to drive short-term interest rates unexpectedly low by the end of July. This is after I wrote, "Short-Term Interest Rates No Longer Unexpectedly Low" in May.

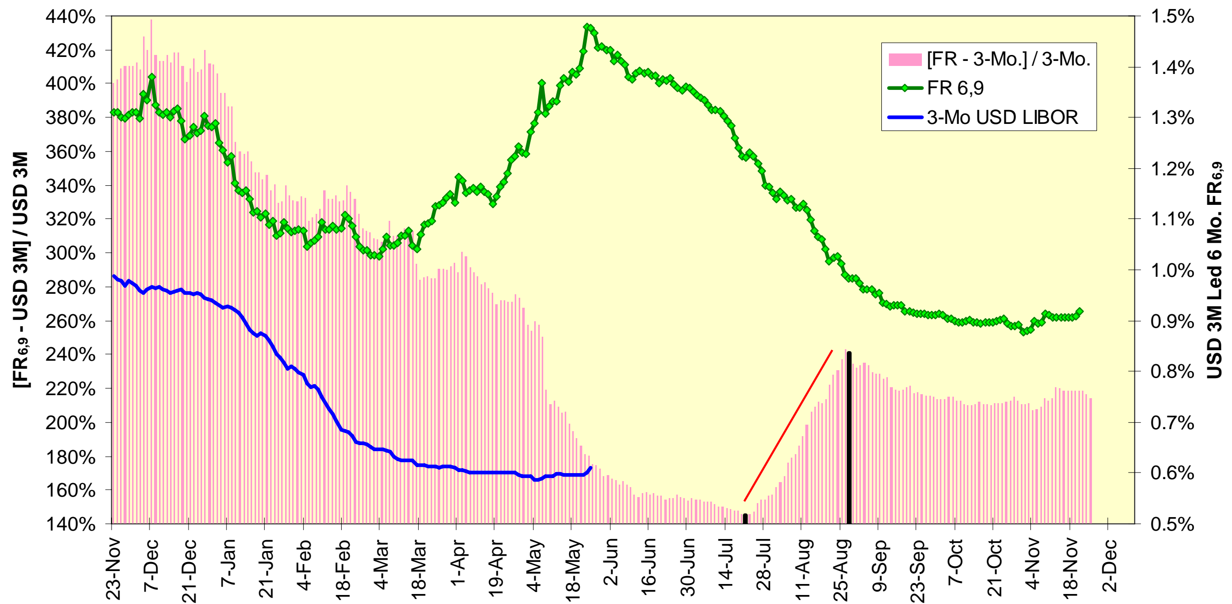
Let's update that piece in light of what I have to admit was, in technical terms, a pretty good stunt on their part. First, a review: If we take the forward rate of LIBOR between six and nine months ($FR_{6,9}$); that is, the rate at which we can lock in borrowing for three months starting six months from now, we have the market's hedgeable measure of where rates will be. I cannot emphasize strongly enough this is not an interest rate forecast, but a rate at which two parties can do business and presumably both make a profit given this locked-in rate. This can be compared to what the actual three month rate was six months later.

That "expectations gap" is depicted in the roseate columns below. The December 2008 and March 2009 dates when the U.S. first went to zero interest rates and quantitative easing, respectively, are marked with orange and violet vertical lines; both the July 30th and the last datum are highlighted with bright red columns.

The High Bias Of U.S. Forward Rates Returned



The chart above is done at a weekly frequency and is long-term to demonstrate how unusual the last two years have been in the ability of three-month rates to trade well below the market's expectations from six months ago. Let's shorten the timeframe and move to a daily frequency.



Two points are marked in black on this chart, one in mid-July when I identified the market's demand for lower short-term interest rates and the August 27, 2010 date of Bernanke's Jackson Hole speech promising new asset highs if he could drive money to new lows.

The market took the bait, as we all know, and rallied strongly into the actual announcement of QE2 whereupon a large number of FOMC officials and foreign poobahs started wandering around like the somnambulant Lady Macbeth or Alec Guinness' Colonel Nicholson in The Bridge on the River Kwai wondering, "What have I done?"

You counterfeited the U.S. dollar to a fare-thee-well, that's what you have done. Didn't you think about this beforehand?

We have seen twice in the past two years how mainlining some high-grade monetary heroin can lead to higher returns for risky assets; this should be about as surprising as learning nitroglycerine can be noisy when handled improperly. Now that we are into QE2 and our friends in the European Monetary Union are about to reprise their May stunt of backstopping Greece by backstopping Ireland – it will take them a long time to form a circle, sing kumbaya in their various languages and have each of the sixteen members of the euro rescued in turn – we have to wonder we are at last at the end of the line for monetary stimulus. Methinks we are.

The implications are not as dire as they may sound. If the end of the printing-press era means we do what we should have started doing in 2007, recognizing losses rather than trying to roll them forward, we can lay the foundation for a new era of prosperity. It would be the right thing to do.