

Tinker, Taylor, Fed Funds, Why

The Taylor Rule Suggests The Target Federal Funds Rate Should Be Higher

I still chuckle whenever I hear the phrase, “A computer study...” First, everything today is computer study. Second, I go back to the days of GIGO, or Garbage-In/Garbage-Out, a convenient way of remembering the results of most studies, programs and models are only as good as the assumptions involved.

Or, as I am fond of saying, “When you age bad wine, you get old, bad wine.”

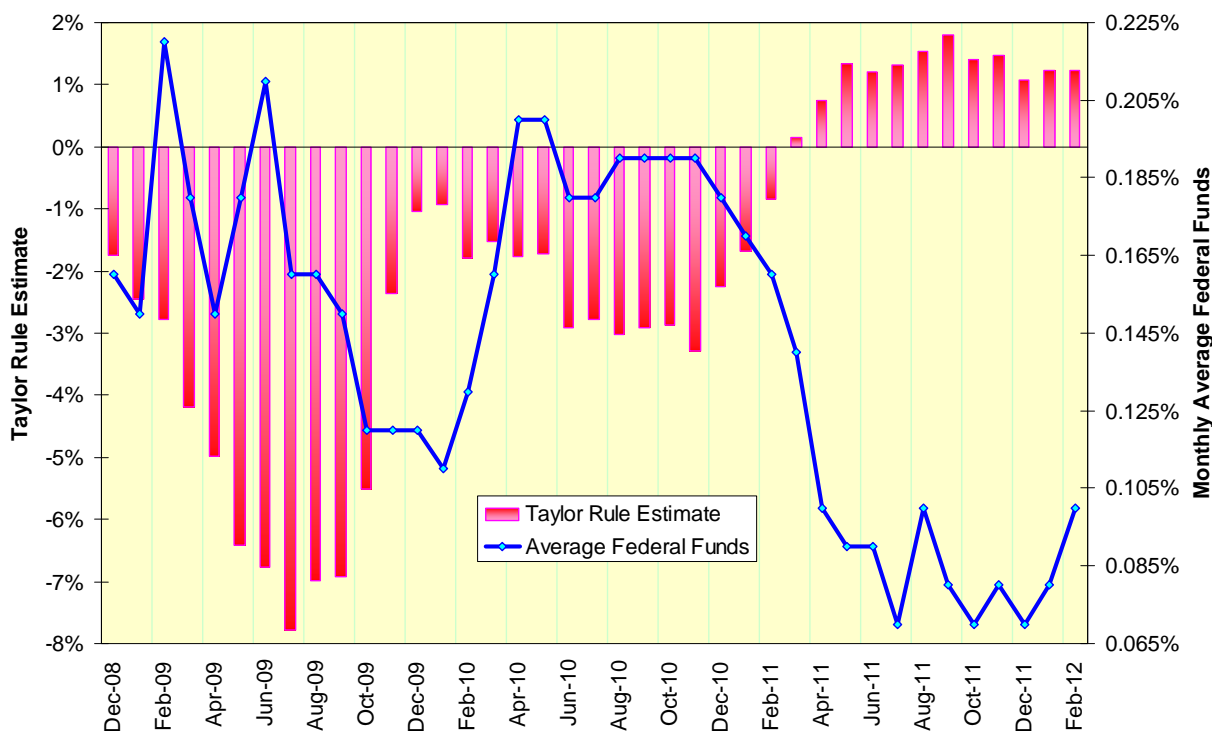
The Taylor Rule

If I have not made it clear by now, I am not a big fan of price-fixing in any form, especially from a body such as the Federal Open Market Committee involved in pretending monetary policy has deterministic outcomes. If they could have predicted the consequences of their previous bubble-inflating escapades as well as they have denied their involvement therein, I might have a different opinion, but they cannot and I do not.

If we are to tinker with the price of overnight money between consenting adults and Federal Reserve member banks, we should at least have a rule-based guide, such as the one offered by Stanford professor John Taylor. It involves inputs such as inflation, unemployment, the “Okun Factor,” or link between the output and employment gaps in the economy and other folderol such as NAIRU, or the non-accelerating inflation rate of unemployment. If you walk through the Taylor Rule piece by piece, you will understand its output is determined in large part by inputs with substantial statistical error bands. But it is a computer study, so we must obey.

Presented below are the Taylor Rule estimates for the target federal funds rate since December 2008, the beginning of the ZIRP (zero interest rate policy) era. Please note how the estimates reached their low point in July 2009, when Bernanke let it be know there would be no impending rate hikes, and how the estimates were again negative in mid-2010, right before Jackson Hole. Today the estimate is positive and centers on a target federal funds rate of 1.25%. Why are we talking about the possibility of QE3?

Taylor Rule And Effective Federal Funds In ZIRP Era



Twist Effect

But, as they say on late-night television, “Wait! There’s more!” I have my own computer-generated model of where the yield curve should be given present conditions and, without boring you with the mechanics, it says the yield

curve spread between two- and ten-year Treasuries (think of SHY and IEF), now about 170 basis points, should be about 310 basis points. As it would be very difficult for the yield curve to steepen by two-year rates driving lower, that should mean ten-year Treasury rates should be higher. They have declined since Operation Twist began in August 2011.

There you have it: The overnight rate should be higher and long-term rates should be higher. They are being forced lower by a combination of money-printing and buying from foreign central banks. Whenever you hear someone puzzle why Treasuries are unloved, think of this: Any rational person should hesitate to buy an asset propped up artificially. Or, at least that is what the computer says.