The FOMC And Fearing Fear Itself

Most of us agree intuitively with Oliver Wendell Holmes' opinion in *Schenck v. United States*, "The most stringent protection of free speech would not protect a man in falsely shouting fire in a theatre and causing a panic" even if this opinion is not an innocuous as it may seem on the surface.

I do believe a corollary, one deriving from the principle of democratic centralism as defined by the Communist Party of the Soviet Union, should apply in the present situation of the FOMC's externalized internal debate over the future course of quantitative easing: "Freedom in discussion and unity in action." Restated, if you start hanging your dirty laundry out to dry, you might scare people.

As an aside, both *Schenck* and the Russian date from 1917, a time when cinema was transforming mass-media. Every subsequent expansion of mass communications up to and including our present hyper-connected age when false Tweets can move markets, has grappled with the boundaries of what is and is not responsible public speech.

Unnecessary Uncertainty
I commented two months ago we were set up for a continuation of QE:

"The Federal Reserve keeps telling us, and keeps telling itself in its public-yet-internal debates, that it will persist with QE until certain targets are met. The evidence above suggests QE will last forever as it is wholly ineffective at accomplishing macroeconomic goals."

By early May, the generalized money-printing campaign around the world started to come a-cropper starting with a high level of pushback in Japanese markets. While the swift downturn in Japanese equities as evidenced by the MSCI Japan Index Fund's 13.62% loss since May 20, 2013 has received the most attention, more subtle signs such as the expansion of five-year credit default swaps on Japanese government bonds and an increase in volatility on Japanese yen forwards were underway for at least two weeks.

Once the FOMC added to the confusion with the release of its Minutes on May 22, 2013, the confusion rout began in earnest with a key reversal in U.S. equities and the acceleration of a selloff in long-term Treasuries. While the -2.97% and 1.81% declines in the SPDR and iShares Barclays 20+ Year Trusts since May 21, 2013 have been minor in historic context, their dependence on money-pumping became obvious.

The real question is why any of this confusion was necessary. If we look at the Taylor Rule designed to optimize the target federal funds rate by incorporating variables such as inflation and unemployment, it says we should remain in an accommodative mode; at the most, only a tapering of future purchases is indicated. Effective federal funds have been trading below the midpoint of their post-December 2008 range, and overnight indexed swaps, strips of federal funds, have been in what technical analysts call a waterfall decline since mid-February.

Once "Fire!" has been shouted, it cannot be un-shouted. U.S. swap spreads and swaption volatilities, both measures of the demand by floating-rate borrowers to fix their payments before rates move higher still, surged, especially in the five-ten year maturity segment. As swap spreads rise, corporate credit spreads begin to rise and send the prices of corporate bonds lower. The iBOXX High-Yield Corporate and Investment-Grade Bond Funds have lost 3.70% and 2.86%, respectively, over the past month.

In the adding-insult-to-injury department, the rapid shift to "risk-off," a fire drill well-known in these parts, has redounded once again to the benefit of Treasury bonds; this has the odd effect of raising apparent corporate credit spreads even in the absence of an intrinsic decline in corporate credit quality. It also reduces TIPS breakevens as nominal Treasury yields fall relative to TIPS yields.

What has been purchased for all of this turmoil? Nothing: We are no closer to knowing the future disposition of monetary policy and the ultimate fate of QE than we were before. The FOMC continues to operate without rules, without targets, without a plan and without clear communications; in fact, the past month has devastated their public clarity. They have created fear itself, and we fear it, but why anyone felt this was necessary is beyond me.