It's Deflation Stupid!!

Over the past year, the media has excessively speculated on when and how the Federal Reserve will adjust interest rates. While the media circus continues, we wonder if the potential deflation paradox is raising its ugly head.

At the end of 2007, most global strategists (who had a pulse) could see that the economy was slowing. On the other hand and staying true to history, the Federal Open Market Committee (FOMC) underestimated the severity of economic distress in the economy. This, quite frankly, is not surprising given that they had done just the opposite during the tech bubble by failing to act in a timely fashion. Yet, markets place great credence in their guidance.

Perhaps we should step back and look at FOMC history. In 2008 the Fed said that the unemployment rate in the 4^{th} quarter of 2010 would average 5 percent. By the end of 2009 the unemployment rate had risen to about 10 percent. The Fed then acted to combat the recession by using a dual-track approach of purchasing some 1.25 trillion mortgage-backed securities and reducing its interest rate target to zero. Did the FOMC really understand the risk of maintaining zero rates for a prolonged period of time or were they so spooked they felt they had to throw a "Hail Mary"? Most developed economies have natural business cycles that can only be manipulated so long. It is scary to think that they were not considering this as we came out the back end of the Great Recession.

The major difference this time is that we never had a classic recovery. A Pew Research Center Study at the end of 2014 compared the current recovery's performance on several metrics against the first five years of the other longest-running expansions (1961-69, 1982-90, 1991-2001 and 2001-07). By almost every measure, the current recovery has lagged well behind those of the past. According to the NBER, there have been 11 business cycles from 1945 to 2009 with the average length of a cycle lasting about 60 months, or a little less than six years. The average expansion has lasted 58.4 months, while the average contraction has only lasted 11.1 months.

So what's the point? This time the Fed has no bullets left in the chamber to stabilize the economy. Given the Japanese-looking course that Bernanke decided to take, we really think any attempt to raise rates will be short lived and result in a reversal. While it is very hard to argue against what the Fed did to save the system, lowering interest rates to raise asset prices should have been a temporary response, and Bernanke should have insisted to congress that they enact genuine fiscal policy to backfill the crisis. Instead, we got health care reform during a hurricane.

So did the higher asset prices really increase the wealth of households? NO! Most of the money ended up recapitalizing the banks and the balance sheets of businesses that lack confidence or visibility. The Wall Street Journal recently reported that publicly traded companies are using their available cash to buy other publicly traded company's corporate debt. This is going to end badly my friends.

As we have been saying all along, by keeping interest rates at zero we have greatly increased the odds that we will follow Japan and experience Japanese-style deflation. All we need is some kind of systematic shock that would then push inflation down to zero and maybe even below zero. Quite frankly, it would not surprise us if the real reason for the Chinese President's visit to the U.S. was to ask President Obama to maintain an accommodative stance thus buying China more time to manipulate their economy back from the abyss.

As we head into the 4th quarter keep a close eye on China, Brazil, and Commodities. If history is any judge, the Fed will get it wrong yet again. Don't agree? Take a look at the following charts. Is this a healthy economy?