First Trust
Monday Morning OUTLOOK
September 23rd, 2013
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Loose and Looser

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Larry Summers took his name out of the hat and won't be considered for the top spot at the Federal Reserve. And while nothing is a slam dunk, it looks very much like current Vice Chair Janet Yellen is going to get the call from President Obama to step up and replace Bernanke.

The political nature of this entire process – Summers' withdrawal under pressure from Democratic Senators and the pivot to Yellen – is an awful sign. Monetary policy should be independent of politics. It hasn't always been. And when the Fed becomes a key part of the regulatory process, its independence is more easily compromised.

As we wrote only four weeks ago, "*Yellen is a talented, smart, and experienced candidate, but so was Arthur Burns, President Nixon's Fed chief whose policies generated double-digit inflation. Yellen is more likely to risk persistently higher inflation by trying to use easy money to bring down unemployment.*"

In hindsight we would not change a word. Exhibit A is the Fed's statement from last week (when the Fed said "no" to tapering QE), which we see as the first of the Yellen-era. Don't take this the wrong way. We are not forecasting double-digit inflation. Today's deeper and more sensitive financial markets would punish a 1970s-type inflationary monetary policy much more quickly than they did back then.

But, under Yellen, the Fed will stay loose until even the traditional Keynesians get worried, and that is significantly higher inflation than today. At present, the Fed says it thinks inflation should average 2% per year over long periods of time. Yellen is more likely to prefer a higher average rate.

In addition, Yellen is more likely to make excuses that lean in the direction of keeping monetary policy loose to try to improve the labor market. For example, since the late 1980s, she has been fond of the "quit rate," the share of the unemployed who quit their previous job, as a sign of health in the labor market. The theory is that a higher quit rate would show a better employment picture. So far in the current recovery, the quit rate has remained unusually low given the drop in the unemployment rate. So the quit rate could be used to try to justify keeping the federal funds target rate near zero even as the jobless rate keeps moving toward (and thru) 6.5%.

Get ready for more excuses. We expect a Yellen Fed to argue that any increase in inflation is temporary or caused by supposedly less important factors like food and energy.

Stocks should do well in this environment. Monetary accommodation and strong profits suggest more growth ahead. For bonds, it's more of a mixed bag than meets the eye. Yes, short-term rates will stay low, helping anchor long-term rates. But looser monetary policy also means more inflation over time, which will eventually lead to a steeper yield curve. Traditionally, the spread between the 10-year Treasury and the federal funds rate reaches a peak of roughly 3.75% when the Fed is at its most accommodative stance.

Gold and other precious metals could normally benefit from looser money, but we still think they ran up a few years ago to a point that anticipated more inflation than we are likely to get. Real estate, on the other hand, is a traditional hedge against inflation that, given the boom-bust cycle in the prior decade, is probably still undervalued relative to fundamentals.

In the end, loose money is not a free lunch. There will be inflation, and even the Fed expects that when it eventually starts to tighten policy the funds rate will go to 4%. Keeping short-rates near zero longer, under Yellen's leadership, risks pushing them even higher than that - eventually.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
9-24 / 9:00 am	Consumer Confidence – Sep	80.0	**79.5**		81.5
9-25 / 7:30 am	Durable Goods – Aug	-0.0%	**-0.7%**		-7.4%
7:30 am	Durable Goods (Ex-Trans) – Aug	+1.0%	**+1.2%**		-0.8%
9:00 pm	New Home Sales – Aug	0.420 Mil	**0.429 Mil**		0.394 Mil
9-26 / 7:30 am	Initial Claims – Sep 21	325K	**315K**		309K
7:30 am	Q2 GDP Final Report	2.6%	**2.7%**		2.5%
7:30 am	Q2 GDP Chain Price Index	0.8%	**0.8%**		0.8%
9-27 / 7:30 am	Personal Income – Aug	+0.4%	**+0.5%**		+0.1%
7:30 am	Personal Spending – Aug	+0.3%	**+0.3%**		+0.1%
7:30 am	U. Mich Consumer Sentiment- Sep	78.0	**77.0**		76.8