Dutta's Weekly Economic Digest

RENMAC
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The "yo-yo" economy

Thursday, August 23, 2012

Review: Fed in the batter's circle

The latest FOMC minutes suggest the next easing maneuver is a question of when not if, listing a number of policy tools to further stimulate the economy and ease financial conditions.

Macro Mantra: The "yo-yo" economy

In the aggregate, this recovery has been remarkably stable when looking at a full year. However, at a micro level, there is more differentiation with some sectors of the economy continuing to exhibit low volatility while others showing an increase.

Data Preview: Bernanke delivers his Jackson Hole sermon

Chairman Bernanke will likely address the range of tools the Fed has at its disposal, how each would work, but not make a definitive commitment for additional action. The tools listed in the FOMC minutes: (1) extend rate guidance; (2) large scale asset program; (3) cutting IOER; (4) BOE style "Funding for Lending Scheme;" and (5) a rules-based framework that ties policy to economic variables.

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The week ahead: 24 to 31 August

Date	Time	Event	Period	Consensus	RM Estimate	Prior
08/24/2012	08:30	Durable Goods Orders	Jul	2.5%	2.0%	1.3%
08/24/2012	08:30	Durables Ex Transportation	Jul	0.5%	0.0%	-1.4%
08/27/2012	10:30	Dallas Fed Manf. Activity	Aug	--	--	-13.2
08/28/2012	09:00	S&P/CS 20 City MoM% SA	Jun	0.3%	--	0.9%
08/28/2012	10:00	Consumer Confidence	Aug	65	64.5	65.9
08/28/2012	10:00	Richmond Fed Manufact. Index	Aug	--	--	-17
08/29/2012	08:30	GDP QoQ (Annualized)	2Q S	1.7%	1.7%	1.5%
08/29/2012	10:00	Pending Home Sales MoM	Jul	1.0%	--	-1.4%
08/29/2012	14:00	Fed's Beige Book				
08/30/2012	08:30	Personal Income	Jul	0.3%	0.3%	0.5%
08/30/2012	08:30	Personal Spending	Jul	0.5%	0.6%	0.0%
08/30/2012	08:30	PCE Core (MoM)	Jul	0.1%	0.1%	0.2%
08/30/2012	08:30	Initial Jobless Claims	25-Aug	--	--	372K
08/30/2012	11:00	Kansas City Fed Manf. Activity	Aug	--	--	5
08/30/2012	/2012	ICSC Chain Store Sales YoY	Aug	--	--	1.9%
08/31/2012	09:45	Chicago Purchasing Manager	Aug	53.5	54.0	53.7
08/31/2012	09:55	U. of Michigan Confidence	Aug F	73.8	73.6	73.6
08/31/2012	10:00	Factory Orders	Jul	0.9%	--	-0.5%
08/31/2012	**10:00**	**Bernanke Jackson Hole**				

Macro Mantra
The “yo-yo” economy

- **Review:** Extending the forward rate guidance seems to be a done deal for the September FOMC meeting. While it is a close call, we believe the Fed will launch QE3 at the September meeting as well.

- **Macro Mantra:** In the aggregate, this recovery has been remarkably stable when looking at a full year. However, at a micro level, there is more differentiation with some sectors of the economy continuing to exhibit low volatility while others showing an increase.

Review: Fed in the batter’s circle

To postpone QE3, the Fed will need to see a “substantial and sustainable” acceleration in growth; stabilization at low growth will not cut it.

The minutes from the August FOMC meeting suggest the next easing maneuver is a question of when not if. They listed a number of policy tools to further stimulate the economy and ease financial conditions in the following order: (1) extend rate guidance; (2) large scale asset program; (3) cutting IOER; (4) Bank of England style "Funding for Lending Scheme". The FOMC also addressed a rules-based conditional policy framework, though that is a broad change to the Fed’s institutional structure that will take time to implement.

Growth remains below potential and has not picked up relative to H1. While it’s a close call, this argues for QE3 in September.

The order of policy options speaks volumes. Extending rate guidance seems to be a done deal for September. “Many” on the FOMC view QE as effective. To postpone QE3, the Fed will need to see a “substantial and sustainable” acceleration in growth; stabilization at low growth will not cut it. Despite upside data surprises, growth remains below potential and has not picked up relative to the 1.8% growth rate in H1. It is a close call, but this argues for QE3 in September.

Bernanke is unlikely to make any clear commitment at Jackson Hole next week, but will outline the Fed’s next steps.

Between now and the September 13 FOMC decision, the capital markets will digest Bernanke’s August 31st Jackson Hole Speech and the August employment report (released September 7th). Jackson Hole will play the same signaling role to the markets as it did in 2010 and 2011. Bernanke is unlikely to make any clear commitment, but will outline steps the Fed may take based on his economic outlook.

Macro Mantra: The “yo-yo” economy

Some sectors of the economy have seen a marked increase in volatility during the recovery while others have not.

A persistent feature in the US economy in the nearly three decades preceding the Great Recession was the steady decline in macro-economic volatility, popularly called the Great Moderation. Today, many market forecasters are quick to point out that because the economic outlook is increasingly uncertain, macro-economic volatility will naturally increase.

Here, we will argue that the reality is more nuanced. This has been a yo-yo economy and a yo-yo market. In the aggregate, this recovery has been remarkably stable when looking at a full year. However, at a micro level, there is more differentiation with some sectors of the economy continuing to exhibit low volatility while others showing an increase.

Three factors drove down volatility

Academic literature points to three reasons behind the Great Moderation: structural economic changes, good luck (the absence of shocks), and improved policy.

As a background, let's explore the factors that led to the decline in macro-economic volatility during the Great Moderation. Academic literature has coalesced around three explanations for the drop in volatility:

1. **Structural economic changes:** Improved inventory management and financial innovations have helped households and firms smooth spending and investment through the business cycle, helping the economy weather external shocks.

2. **Good luck:** During the 1970s, the economy was subject to particularly large shocks, namely sizable increases in oil prices. Since then, the shocks have typically been smaller in scale and less frequent.

3. **Improved monetary policy:** Before the Volcker disinflation of the 1980s, the Fed would waffle on their goals. At times, the Fed went for growth, loosening policy aggressively. As inflation picked up, the Fed tightened policy, leading to a sharp downturn, setting in motion the next easing cycle. Since then, central bankers have become more competent doing their jobs, following a rules-based framework.

Limited structural changes to economy since Great Recession

Table 1: A surprisingly stable recovery

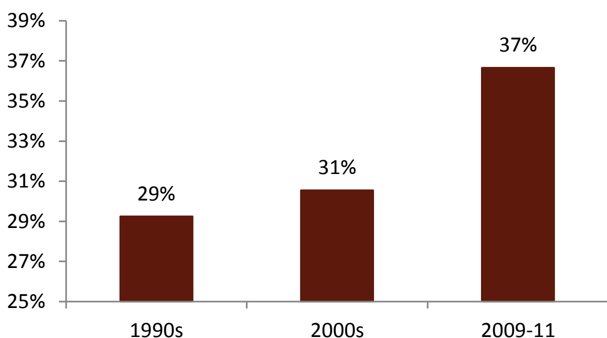
	Real GDP	Private payrolls	CPI
2010	2.4	104	1.6
2011	1.8	175	3.1
Present (YoY)	2.2	162	1.4
Average	2.1	147.0	2.0

It is certainly conceivable that the economy has undergone structural changes. On the one hand, because credit conditions remain tight, particularly for consumers, there is less ability for some households to smooth out consumption. On the other hand, credit conditions have eased for some borrowers and companies have not materially changed the way inventories are managed.

Indeed, since 2009, the aggregate economy has been surprisingly stable. As Table 1 shows, in each of the past two years, the economy has grown in a relatively narrow range of 2.0%. Looking beyond the quarterly ebbs and flows, private employment has expanded close to 150,000 per month after a slow start in 2010. While inflation has shown somewhat more variation, headline CPI has run at a 2.1% annual rate since the recession's end, close

to the Fed's target.[1] At a minimum, this implies that structural changes to the economy have relatively little to do with the recent swings in volatility.

Chart 1: More ups and downs
% of time monthly GDP contracts in an expansion



Source: Macroeconomic Advisers, Renaissance Macro Research

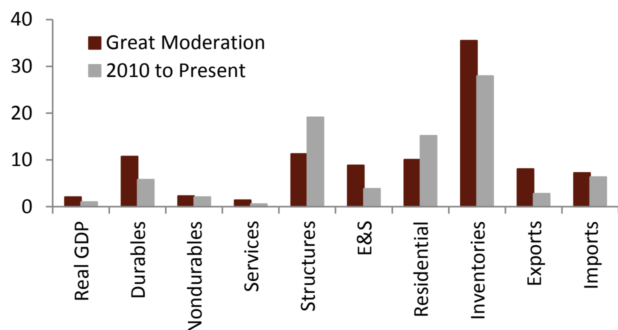
A rocky path to stable growth

Over the medium term (within the year), however, there has been a noticeable increase in macro-economic volatility. Growth averages 2.0% for the year, but the path to 2.0% is a rocky one. We can investigate this phenomenon drawing on the monthly GDP data compiled by Macro-economic Advisers. In a normal economic expansion, monthly GDP is contracting less than 30% of the time. By contrast, from the end of the recession in June 2009 through the end of 2011, monthly GDP has declined roughly 40%. Chart 1 summarizes our results. The increasing propensity for monthly measures of GDP to contract highlights the "yo-yo" nature of this recovery. What gives? In part, there has been an increase in the number of external shocks to the economy. As the effects of these shocks fade, the economy gathers momentum.

Volatility has not picked up uniformly across sectors

During the Great Moderation, volatility declined across every component of GDP. More recently, however, the rise in volatility is not uniform across all sectors. Using a standard deviation framework from 2005 to 2009, economists from the Kansas City Fed found that volatility rose sharply for goods sectors, business and residential investment, and measures of headline inflation (including food and energy). On the other hand, the rise in volatility has been relatively muted for services consumption, inventories, and core inflation (ex food and energy). Moreover, they highlight the stability in inventories. Had inventory volatility picked up, then structural economic change could be a more meaningful explanation behind the swings in volatility.

Chart 2: All volatility not built equally
(average standard deviation)



Source: Bureau of Economic Analysis, Renaissance Macro Research

We extended this research to the present. Our results, shown in Chart 2, tend to confirm the broad contours of the Kansas City Fed findings. From 2010 to present, volatility has declined in real GDP. However, volatility has increased in residential and structures (CRE) investment. Volatility in goods consumption declined, but not as much relative to the drop in overall GDP.

Let's isolate the higher volatility sectors: residential investment, business investment, goods consumption, and headline inflation. The increase in residential and structures investment volatility is not particularly surprising given that housing and the unprecedented tightening in lending conditions was the epicenter of the recent financial crisis. Outside of residential

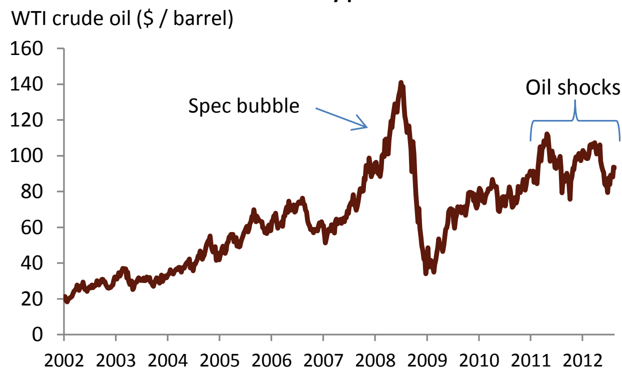
[1] For a similar discussion, see "The (Unfortunately?) Consistent Record of the Recovery" by Dave Altig at the Federal Reserve Bank of Atlanta

investment, business investment, goods consumption and headline inflation are particularly sensitive to swings in commodity prices.

Running out of good luck

And, that's the point. Since the recession's end, shocks have become more frequent. Consider the volatility in the commodity markets (Chart 3). From 2002 to 2007, we saw a steady increase in oil prices. Thereafter, oil entered a speculative bubble in 2008. And, in each of the last two years, oil prices have climbed on intensifying geopolitical tensions in the Mideast. Last year's tsunami sent the global auto supply chain in a tailspin. And, for whatever reason, extreme weather conditions have led to periodic spikes in food prices. So, it seems that the string of good luck the US economy enjoyed during the Great Moderation has run out.

Chart 3: More shocks to commodity prices
WTI crude oil ($ / barrel)



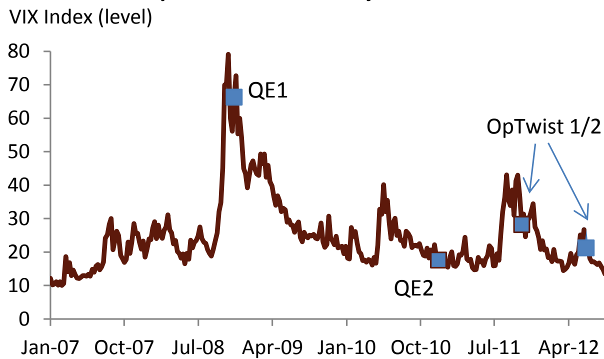
Source: Haver Analytics, Renaissance Macro Research

Monetary policy response has lowered volatility

The debate over the efficacy of monetary policy is beyond the parameters of this piece. We believe quantitative easing is a small positive for growth and the stock market, with limited upward pressure on inflation. However, investor opinion over the growth implications of the Fed's unconventional policy measures runs the gamut. While the Fed has taken steps to boost transparency, it still takes time for the markets to find clarity on Fed action.

Nevertheless, we have a difficult time pinning the swings in volatility on the Fed, primarily because volatility has tended to glide down after the Fed takes action (Chart 4). The political brinksmanship around fiscal policy is a somewhat easier sell. Market volatility picked up somewhat during last year's debt ceiling debate. But, even here, the pickup in volatility was more noticeable after the debt downgrade, not during the legislative squabbling. All in all, we think changes in policy have had little to do with the upward sporadic swings in volatility since the recession ended.

Chart 4: Volatility tends to fall after major Fed moves
VIX Index (level)



Source: Haver Analytics, Renaissance Macro Research

Volatility measures will not necessarily mean revert

We view low-growth as a cyclical – not structural – feature of the economy. Potential GDP will accelerate as the economy heals. Volatility has not picked up uniformly across all sectors of the economy, which suggests that structural changes to the economy have been limited. Thus, the economy is not relegated to a permanently higher level of volatility. However, in a lower-growth environment, the economy is more susceptible to shocks, implying periods where measures of volatility can rise significantly.

The simplest investable hypothesis is that market measures of volatility will not necessarily mean revert. Moreover, given the economy's vulnerability to shocks, households will likely boost savings to help smooth out consumption on the chance that a shock does materialize.

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