BULLARD WARNING TO CONGRESS: IF WE NEED TO CHANGE EXIT STRATEGY, TELL US NOW.

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Last Friday, Professor Jeremy Siegel and I spoke with St. Louis Federal Reserve (Fed) President James Bullard about his economic outlook, September liftoff and, quite critically, how politicians should be more focused on the Fed's exit policy. Senator Rand Paul recently issued a statement supporting a further audit of the Fed.[1] The Fed spent $6.1 billion on operating expenses and an additional $5.2 billion on interest paid to banks (interest on excess reserves pegged at 25 basis points (bps). The Fed has been clear that when it hikes rates, these excess reserve interest rates are also going to go up, which implies bank payments will go up. Bullard emphasized that interest on excess reserves—which are exceptionally high—is the linchpin of the Fed's normalization policy[2]. The plan is to raise three rates: 1) Excess reserves go up by a likely 25 bps, 2) the reverse repurchase rate also goes up 25 bps and 3) the Federal Funds Rate would trade between these two numbers. Bullard appreciates Paul as a tough critic of the Fed who is playing his role—as a politician—correctly. He emphasized that Congress must fully vet the Fed's plan to pay interest on excess reserves. Bullard made clear: The Fed's plans should mean large payments to banks in the United States and some foreign banks. If Congress is not comfortable with this plan, Bullard emphasized, "they should definitely tell us right now as the Fed would need to change exit strategy dramatically if they cannot rely on interest rate on excess reserves." Interest payments on excess reserves were prohibited until Congress authorized them in 2008. Bullard has brought this up as an issue having major political ramifications, as not everyone realizes what is scheduled to happen, and the Fed needs support from both sides of the aisle. His preferred policy for normalization is to sell off the Fed's balance sheet before hiking interest rates. Former Chairman Ben Bernanke, in particular, wanted to raise rates first and then shrink the balance sheet, and that argument carried the day. Bullard believes there is a credible backup plan if Congress is not comfortable with the Fed's current plans. Siegel pointed out that another option would be to change reserve requirements of banks that could absorb some of the excess reserves. **With the sell-off in the equity markets, does this change the outlook for hiking rates?** Bullard said the Fed does not react directly to equity markets or other markets, but equity markets are forward looking and trying to assess trends in the global economy, and so does the Federal Open Market Committee (FOMC), so they are looking at similar indicators. Bullard said he would not have the same assessment on the outlook for the global economy—especially being more sanguine about the impact of global growth coming from fears regarding China. Anecdotal reports Bullard has heard from businesses with exposure in China are downbeat—and many people don't trust the government's 7% growth statistics. The devaluation of the yuan is further causing some investors to question China's growth. Whether investors should change equity valuations as much as they seem to be—with slim amounts of data out of China—is really questionable to Bullard. **Unemployment Rate to Head to Low 4s, Driven by Continued Fall in Labor Force Participation** Bullard stressed that no decision has been made for September liftoff. He pointed to signs of improvements in the U.S. growth picture—revisions to the first

half's growth numbers are now tracking at 2%—and continued progress in labor markets over the last two years. The unemployment rate has come down to the committee estimates of the natural rate of unemployment, which are around 5% to 5.2%. The labor force participation rate peaked in 2000—not 2008—and Bullard sees it continuing to fall based on demographic trends. He does not see this as a cyclical factor, which is key for monetary policy. Bullard thinks this will continue to impact the unemployment rate, which could trend down toward the low 4% range over the next two years unless there is a big shock that sends us back into recession. Given that the Fed committed to a low-rate environment for the next few years, with a strong labor market likely over next two to three years, Bullard is convinced this will lead to inflationary pressures. **The Fed has said we made progress on labor markets, but how can it be confident inflation is trending to 2% as commodities hit new lows?** The big move in oil—a 50% fall in price last year—was mostly supply-driven. There is huge new production in the U.S. compared to where it used to be, and developments in the Middle East are bringing more supply online. Bullard said markets are looking at the price of oil and think it's global demand, but he really thinks that is a wrong interpretation. This move in oil is having a big impact on headline inflation, which is around 0%. And Bullard says in normal times, he would not veer from using headline inflation to gauge progress. But this is not normal, so he looks at other measures of inflation—Core CPI (1.8%), Cleveland Median CPI (2.3%), Sticky Price CPI by Fed of Atlanta (2.2%)—all tracking around 2%. The FOMC prefers a measure of Personal Consumption Expenditures (PCE) to track inflation, and here the Dallas Fed Trimmed Mean PCE was 1.7% year over year. The last six months was 1.9%, cutting out the move in oil from last year. In short, Bullard sees inflation heading toward the Fed target, barring an unforeseen recession. **Long-Run Fed Policy Debate** Bullard is concerned about market expectations for Fed policy and how those compare to the FOMC outlook. He thinks once the Fed makes its second move, the market will have a better idea of what the FOMC means by gradual pace of increase. He said that because the Fed has not raised rates in 10 years, there may be unseasoned traders who just do not know what to expect. Professor Siegel urged Bullard to consider a long-run neutral rate of 2% to 2.5%—given slower growth, higher risk aversion and demographics. Bullard had made a small nudge to his rate to bring it down to 3.75%, which is where he ultimately sees the Fed rate headed—in a gradual and data-dependent way. Bullard comes up with this 3.75% by taking nominal growth in the economy (2%) and adding inflation to that 2% and getting 4%. Siegel suggested this is appropriate for a 10-year government bond, but not the short-term bond. Bullard recognized the average spread between short rates and long rates was about 1.75%, but he said he still likes his 3.75% target. But the biggest news of the discussion was really the warning to Congress: If you want us to change our exit strategy, tell us now. **Unless otherwise noted, data source is Bloomberg, as of 8/21/15.** Investments focused in China can be impacted by events and developments associated with the region, which can adversely affect performance. Investments in commodities may be affected by overall market movements, changes in interest rates and other factors such as weather, disease, embargoes and international economic and political developments. [1]Source: Newsmax, "Fed Balance Sheet Needs a More Thorough Audit: Senator Rand Paul", 8/21/15. [2]Source: Bloomberg, Federal Excess Reserves.

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DEFINITIONS

Basis point : 1/100th of 1 percent.

Excess reserves : bank reserves in excess of a reserve requirement determined by local central bank. They represent reserves of cash more than the minimum required amount.

Reverse Repo Rate : Reverse repo rate is the rate of interest that banks get when they keep their surplus money with the RBI.

Federal Funds Rate : The rate that banks that are members of the Federal Reserve system charge on overnight loans to one another. The Federal Open Market Committee sets this rate. Also referred to as the “policy rate” of the U.S. Federal Reserve.

Balance sheet : refers to the cash and cash equivalents part of the Current Assets on a firms balance sheet and cash available for purchasing new position.

Federal Open Market Committee (FOMC) : The branch of the Federal Reserve Board that determines the direction of monetary policy.

Valuation : Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

Monetary easing policies : Actions undertaken by a central bank with the ultimate desired effect of lowering interest rates and stimulating the economy.

Inflation : Characterized by rising price levels.

Headline CPI : measure of the total inflation within an economy, including commodities such as food and energy prices.

Core CPI : Long run trend in the price level that excludes items frequently subject to volatile prices, like food and energy. Can also be known as, CPI ex-Food & Energy

Cleveland Median CPI : Instead of calculating a weighted average of all of the prices, as the BLS does, the Cleveland Fed looks at the median price change—or the price change that’s right in the middle of the long list of all of the price changes. According to research from the Cleveland Fed, the Median CPI provides a better signal of the inflation trend than either the all-items CPI or the CPI excluding food and energy.

Sticky Price CPI : published by Federal reserve Bank of Atlanta, sticky price index sorts the components of the consumer price index (CPI) into either flexible or sticky (slow to change) categories based on the frequency of their price adjustment.

Personal Consumption Expenditure (PCE) Price Index : measure of price changes in consumer goods and services in the U.S. economy.

10-year government bond : a debt instrument backed by a government guarantee with an original maturity of 10 years.

Spread : Typically refers to a difference between a measure of yield for one asset class and a measure of yield for either a different subset of that asset class or a different asset class entirely.