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In Pursuit of Value

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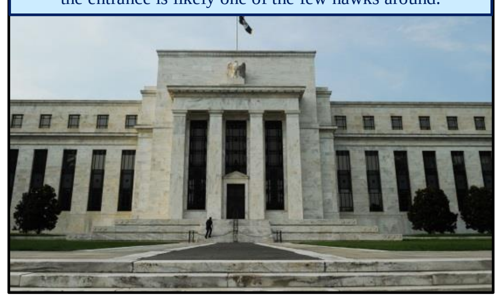
How Dovish is Janet Yellen?

One of the biggest surprises of 2014 for investors must be the persistently low yields on bonds. Just over a year ago when former Fed Chairman Ben Bernanke raised the issue of scaling back the Fed's program of Quantitative Easing (thus triggering the "Taper Tantrum" as equity markets swooned in fear) ten year treasury yields briefly touched 3.0%. They exceeded that level earlier this year as the Fed's planned reduction in bond buying got under way. In a few months the Fed's bond buying program will be over in its current form, although they intend to reinvest interest received and principal from maturities, so their $4TN balance sheet will continue to grow. Bond markets are calm, as the reality has been less harmful than feared, and ten year treasury yields languish around 2.5%. Whereas prospective investors in equities are often persuaded to wait for a better opportunity in the form of lower prices, bond investors are rarely so patient. James Carville, lead strategist for Bill Clinton's successful 1992 Presidential campaign, once said he wanted to be reincarnated as the bond market, so he could intimidate everybody. Today's bond investors are a far cry from those of a generation ago as they passively accept the paltry yields on offer and have little fight left in them.

Incoming Fed Chair Janet Yellen is generally expected to continue the policies followed under Ben Bernanke. Her predecessor laid the ground nicely for his successor and so far she has not faced any controversial decisions. Almost assuredly that time will come, at which point we'll see how ably her leadership skills can be used to reflect her economic biases.

A thoughtful article in The New Yorker titled *"The Hand on the Lever"* provides interesting material for those seeking to forecast interest rates under a Yellen Fed. The label of "dove" (meaning biased towards easy monetary policy; "hawks" favor tighter policy) has never slipped as long as she's been at the Federal Reserve. A career that includes teaching Economics at Berkley, briefly running the Council of Economic Advisors under Clinton and heading up the San Francisco Fed put her squarely in the liberal camp for most observers. Yellen's public comments including in the abovementioned article reveal a sensitivity to unemployment not articulated by past Fed chairmen.

The Federal Reserve in Washington DC, where the eagle above the entrance is likely one of the few hawks around.



The Fed has a dual mandate of pursuing maximum employment and price stability. In practice this has come to mean around 2% inflation, whereas the level of *sustainable* unemployment (the point at which it reflects normal labor market turnover as opposed to inflation-triggering shortages) is open to debate. Labor force participation has fallen notably in recent years, and it's not clear if past levels of maximum employment still apply.

While maximizing employment has long been one of the Fed's two economic goals, it rarely received as much attention as inflation until the aftermath of the 2008 financial crisis. Past periods of interest rate hikes under Greenspan and Volcker were regarded as consistent with maximum employment over the long term even while they caused job losses in the short term, since high inflation has been shown to be negative for growth and employment. The notion that the short run/long run trade-off could be reversed (i.e. allow inflation to rise over the short term in the interests of reducing unemployment) has never been seriously considered before, and yet much of Janet Yellen's history and public comments show on which side of the twin mandate her heart lies.

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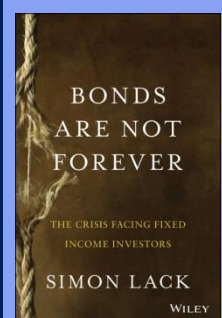

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In April, during a speech in New York shortly after assuming her new role, Yellen noted her, "expectation that the achievement of our economic objectives will likely require low real interest rates for some time." She's telling us to expect low real rates (i.e. adjusted for inflation) and cares very much about what monetary policy can do to improve employment. Her vote on the Fed's policy making Federal Open Market Committee (FOMC) could not be plainer. There are hawks to be sure who will balance her dovishness, and nobody yet knows how the interaction between the two camps will play out. Fed chairmen have varied from dominant to collegial, and one imagines she'll rely more heavily on the power of her intellect than a forceful personality to steer monetary policy where she desires.

My view is that she's easily the most dovish Fed chairperson in at least 35 years and one of the most dovish FOMC voting members in recent memory. Since 2008 we've experienced only moderate GDP growth of 2% and unemployment has been slow to fall, although at 6.2% it's reaching the 6% threshold that has been the Fed's initial objective. However, the debate over the drop in participation continues with some arguing it represents temporarily discouraged workers who will return when jobs are more plentiful, thereby adding capacity to the labor force and reducing inflationary wage pressures. Others see a more permanent loss of relevant skills as the long term unemployed become eventually unemployable.

Fixing these problems is unarguably a noble objective. Janet Yellen's husband George Akerlof, a retired Economics professor, has frequently collaborated with his wife on academic papers. He told The New Yorker, "Both of us, separately and together, really, really care about unemployment." We'll soon see how effectively Janet Yellen can lead her FOMC colleagues along a path of extended monetary accommodation aimed at fostering an economic climate in which everyone who wants a job can find one.

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The most recent statement from the FOMC in late July acknowledged the steady improvement in the economy but also noted that that the current target for Federal Funds (short term interest rates) will remain within its present range of 0-0.25% for, "a considerable time" after the end of their asset purchases (which are likely to finish in October). The prospect of inflation drifting back up to 2% coincident with a labor market containing plenty of spare capacity is increasingly likely. It should provide for lively public comments from some FOMC members as the doves and hawks publicly air their contrasting views.

None of this is intended as a criticism. The Fed's ample monetary stimulus has done far more good than harm. But it does tilt the risks towards higher inflation, because low real rates (as we've been promised) and a deep concern for the unemployed relegate inflation to a secondary priority. Inflation today, at least as conventionally measured by the Bureau of Labor Statistics, remains low and indeed below the Fed's own 2% target although this week they noted it was "somewhat closer" to that level. Inflation may stay low indefinitely, but if it drifts up before the economy has unarguably employed every willing soul, expect a non-preemptive Fed to find at least some reasons why a pick-up in inflation is temporary.

This is what financial repression looks like. Low interest rates, and low or even negative real rates must be especially seductive as a means to alleviate underemployment and perhaps other public policy challenges such as continued income disparity. Or put another way, if one day Janet Yellen announces that interest rates need to rise because of inflation, it'll be in spite of her deep seated concerns for the unemployed. Based on her history, this Fed chair won't be in a hurry to establish her "inflation fighting credentials" as has been required of her predecessors.

As public policy it has been more successful than many observers originally expected. In fact, the Fed may ultimately restore interest rates to a more normal level and begin to de-lever their balance sheet without precipitating another financial crisis. There's never a shortage of critics warning of the severe difficulties we will endure due to current policy. That may be right too, but what does seem pretty clear is that sharply higher interest rates, and especially high *real* rates, are unlikely to be a solution adopted by this central bank in response to any plausible set of economic challenges. Investors shouldn't bother fighting it, but should simply deploy their assets towards businesses that can raise their prices as their input costs go up. Bonds remain the very antithesis of such an approach. So far, *Bonds Are Not Forever* remains accurate.