

It's Always Something

“Well, Jane, it just goes to show you, it’s always something – if it ain’t one thing, it’s another.”
– Roseanne Roseannadanna (Gilda Radner)

As I wrote in last week’s email to the direct distribution list, I won’t be publishing a full-blown note this Sunday. The last three notes – “[It Was Barzini All Along](#)”, “[Heeere Comes Lucky!](#)”, and “[Uttin’ on the Itz](#)” – need some room to breathe, and in general I intend to stick to a 3-weeks on, 1-week off publishing schedule going forward. On a related housekeeping note, the direct distribution list has doubled again over the past week (!), and I’m wrestling with the challenges of moving from a few hundred regular readers in June to thousands today. Apologies in advance if the distribution and publishing process isn’t as smooth or robust as we’d all prefer, but the writing comes first. As Shigeru Miyamoto, legendary videogame creator, once said in a slightly different context, “A delayed game is eventually good, a bad game is bad forever.”

That said, there’s just so much happening in the world that’s relevant from an Epsilon Theory perspective that I find it impossible to go cold turkey and write nothing today!

There was widespread speculation that the FOMC considered resurgent Fiscal Cliff risks in its decision-making process two weeks ago, speculation that was confirmed on Friday in a [speech](#) by New York Fed chief William Dudley. Speaking to an audience at Syracuse Univ., Dudley said that Congressional debate over the federal budget and the debt limit “creates uncertainty about the fiscal outlook and may exert a restraining influence on household and business spending.” In fact, he uses some variation of the phrase “fiscal uncertainty” 5 times in his 4 pages of prepared remarks on national economic conditions.

If you needed more evidence that QE is no longer an emergency government policy, but is now a permanent government program ... well, there you go. It’s not that Dudley thinks the US economy is weak. On the contrary, he sees “persuasive evidence of improving underlying fundamentals”, such that “we are experiencing a fairly typical cyclical recovery.” Despite this, Dudley and the rest of the FOMC are opposed to ANY reduction in QE right now given the growth risks created by domestic political dynamics and slow growth abroad.

One might well ask that if the Fed believes “a fairly typical cyclical recovery” requires all-out, pedal-to-the-metal QE, under what economic conditions would QE ever be wound down? What level of QE would be required the next time we experience a fairly typical cyclical recession? I mean ... it’s not like political risks and growth uncertainty are ever going to just magically disappear. It’s not like the business cycle has been eradicated. To paraphrase Gilda Radner’s tag line, there will always be *something* that poses an economic risk or creates an economic uncertainty. If there weren’t, we wouldn’t have a market at all! The Fed has expanded the rationale for continued QE to include *political risks*, as well as the maintenance of employment levels from 20 years ago, as well as the elimination of prices that are *too* stable. To repeat the skinny from last week’s note: QE is now a creature of Washington, forever and ever, amen.

I also think that the Fed has shouldered an extremely difficult analytic burden by incorporating fiscal policy uncertainty into its decision-making. Political outcomes are not continuous dependent variables

with a normal stochastic distribution, and it is impossible to incorporate political outcomes within the cybernetic system that IS Fed policy. Political outcomes are a set of discontinuous events, of leaps from one equilibrium outcome to another, that are determined by behavioral patterns which are entirely independent from anything the Fed does or doesn't do. Political outcomes are an entirely different animal than aggregate employment levels or aggregate price stability. They are exogenous events that the Fed may seek to respond to, but cannot anticipate or control.

Okay, I've used a lot of \$10 words here. What does it all mean?

It means that the Fed's use of QE as an insurance program against whatever fiscal policy errors they believe Congress might make in the future is not only a problematic expansion of the Fed's governmental authority, but is also myopic on its own terms. If you want Congress and the White House to establish "good" fiscal policy, then the last thing you want to do is provide an *incredibly* expensive insurance program against "bad" fiscal policy. It's moral hazard in the first degree, which any competent politician (and these are *very* competent politicians) will use to their professional benefit. I'm sure that FOMC members believe in their hearts that they are doing the responsible thing by "protecting" the economy from the "risks" posed by smash-mouth politics in Washington. But I believe that they have (again) misunderstood the *behavioral context* in which their signals are understood. Twice since June the Fed has missed the market context of their communications. Now I think they've done it with Washington.

All the best,
Ben

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