Thinking like Ms Yellen

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Ray Dalio wrote another editorial for the *Financial Times* last week saying the Fed is making a policy blunder. His fund, Bridgewater, invests heavily in carry trades of every ilk so what the Fed does with rates matters a lot to him. His case rests on how QE works and what happens when the Fed tries to reverse course. Namely, the Fed's asset purchases in effect remove Treasuries and mortgages from the realm of marketable securities, so the price of the remaining stock of those securities is bid up and long-term yields decline (i.e. the yield curve flattens). That outcome is exactly what the Fed wants - a flatter yield curve for benchmark bonds and lower fixed rate mortgage rates. Studies estimate the cumulative effect of the Fed's purchases of Treasury securities (about one fifth of the outstanding) is a reduction in the yield on the 10-year bond of 115 basis points. Importantly, that reduction in long-term yields will persist as long as the Fed holds the bonds; it is unaffected by the rise in short-term rates.

The next phase of QE is slightly different, though. As benchmark rates decline, investors are forced to reach for yield to risky credits - corporate bonds, emerging market securities, loans and, eventually, structured products with leverage. For institutional investors with access to leverage, such as Bridgewater, returns can be enhanced by borrowing funds at low or zero short-term rates and buying high yielding bonds or equities, the standard strategy of carry traders. Indeed, an environment of zero central bank policy rates inherently is a breeding ground for carry trades of all sorts, including property and leveraged buyouts. Risk premiums then begin to decline across the board or, in common parlance, asset price bubbles begin to percolate.

Now let's put ourselves in the place of Janet Yellen and her colleagues at the Fed, most of whom understand this dynamic. They know, for example, that the effects of asset purchases diminish as yields decline. In Dalio's words, QE only works when yields are high and can go lower. We saw this simple observation in Europe when nominal yields turned unsustainably negative - there was no more 'effect on yields' possible once they already were negative. Second, the Fed knows that investors will continue to stretch for yield until circumstances change. That means risk premiums become 'distorted' - in other words, credit risk is mispriced. When Fed officials speak of 'distortions in financial markets', this is what they mean. Unlike benchmark yields that are anchored by the Fed's holdings, carry trades are affected by a rise in short-term rates because the carrying costs of the trade increase. In that context, carry traders were faced with a perfect storm in January. Sovereign wealth funds - especially those in oil producing countries whose incomes imploded with oil prices - were selling marketable securities that were carry opportunities, while some Fed officials openly discussed the possibility of several more rate hikes in the months ahead that would increase the cost of funding those trades.

My guess, however, is that Chair Yellen thinks of January's selloff in different terms.

Namely, her main concerns with ZIRP were the obvious distortions to risk premiums that in themselves could be a likely source of the next financial crisis. January's selloff has widened credit spreads to more sensible levels and equity valuations now are lower. Having accomplished her intent, at least temporarily, she no longer needs to be so strident about subsequent rate hikes.

Note that this rationale is much different that the Greenspan 'put'. I doubt Ms Yellen worries about equity prices and am even more skeptical that lower asset prices might have 'wealth effects' on consumer spending, or will deter lending to innovative companies or other such rubbish. She has wanted to nip a brewing asset price bubble before it was too late. Now she has gotten the attention of the market, she take her foot off the brake without having to say it has anything to do with the stock market.

Look for more discussion of market 'distortions' or risk premiums, and monitoring the situation rather any talk of bailing out the equity market. By any measure, this will amount to a more 'dovish' stance, as reported by the media. As Ray Dalio said in his op-ed piece - just my opinion, for what it is worth.

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