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Bernanke at Jackson Hole: market valuation can be a sometime thing

It is hard to ignore the immediate reaction of the equity market to the speech given by Chairman Bernanke to open the KC Fed's Jackson Hole Symposium: DJ 30 up 164.84 (1.65%); NASDAQ up 34.94 (1.65%);S&P 500 up 17.37 (1.66%) and the 30 year T-Bond at 3.6980% which is a 1.67% improvement in the price of the bond. Verdict: uniform appreciation of equities and bonds with the best gains in four weeks in spite of a tepid opening. On the real news front, there were warnings from Intel on sales and auto sales were sluggish. The natural question is what is it that Bernanke said that (a) we didn't already know and (b) that would give traders the confidence to go home with a bit more length? The real answer is that "only the Shadow knows," which is to say no one can be sure.

Pundits and bloggers like to speculate (because the internet has made it cheap and probably no one in the investment community takes them seriously?). Still, Bernanke did seem to make a commitment to be there with a boat if the flood of bad news does not abate, appropriately named QE2! This time it will consist of purchasing Treasuries and most likely at the long or longer end. The Chairman didn't see much value in his former colleague's WSJ Op Ed suggestion of raising the IOER (the interest rate paid on bank excess reserves held at the Fed). In fact he expressed concern that such a move would lessen liquidity in the very short term money market. He also rejected fiddling with the already imprecise wording over holding rates down for an "extended period," and he clearly was not willing to begin changing the range of his inflation target (raising it to accommodate a bit more inflation). All told, he didn't see the Bogeyman of Deflation looming on the horizon and he did recognize that the second half would be weaker than earlier Fed forecasts. The bottom line was that **"First, the FOMC will strongly resist deviations from price stability n the downward direction."** Note that he did not see deflation as a significant risk despite the recurrent catcalls from another Princeton colleague who writes for a major NY Newspaper. He also pointed out that if there were a "**significant weakening in the economic outlook [it] would likely be associated with further disinflation…"** that would create in the current environment **"little or no potential conflict between the goals of supporting growth and employment and of maintaining price stability."**

Put differently, QE2 would occur with a conflict between employment and output goals and could be accomplished (in his view) without forsaking his "inflation targeting" approach.

This was not new news. No one expected the Fed to sit on its hands. The last FOMC meeting sent a clear message that the Fed was willing to do something even if the meeting statement and minutes did not spell out the what, when and how of further intervention. The FOMC was unwilling to let the Fed's balance sheet decline. It was not willing to relent on the "extended period" doctrine. Yet, when the FOMC said as much, the market thought it was negative. That FOMC meeting statement was accompanied with a market decline. Now, with a reaffirmation that the Fed will buy more Treasuries and prevent a runoff in its balance sheet with no firm commitment as to the size of any new QE2, one has to puzzle why traders saw this as new news? What's in the price today at the end of the Chairman's speech that wasn't already there?

Perhaps the real bottom line was that he didn't see the Deflation Bogeyman as just around the corner and if the economy continued to undershoot his inflation target, Fed action would be forthcoming. Perhaps, emphasizing the obvious, while admitting that the SH2010 would be weaker than the Fed had told us at the recent Humphrey Hawkins testimony was sufficiently exciting to the Bulls to allow them to chase the Bears out of the circus tent on Friday. Sometimes one can just overanalyze the obvious! Monday will not bring revolutionary good news and the games will begin anew.

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