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MICHAEL SHAOUL, CEO, OSCAR GRUSS & SON, INC TALKS ABOUT CENTRAL BANKING AT BLOOMBERG SURVEILLANCE
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TOM KEENE, BLOOMBERG SURVEILLANCE HOST: Michael Shaoul with us from Oscar Gruss. Good morning, sir.
MICHAEL SHAOUL, CEO, OSCAR GRUSS & SON, INC: Good morning.
KEENE: I love a man who brings in a chart that has to do with LIBOR and LIBOR- OIS. LIBOR-OIS I used to quote like crazy and then it sort of went away with the debacle. Itôs grinding higher. Why should we pay attention to LIBOR now?
SHAOUL: Well, you know I think - when we looked at the LIBOR chart back in 2007 and 2008, it was all about credit. It was all about credit risk and we were all very nervous at the spread between LIBOR and where the Fed wanted LIBOR to be got extremely wide, wider than we ever thought was possible. You know if we fast forward to where we are today, itôs a completely different environment. Where we are today is we are entering a period in which interest rate risk is something that we need to start thinking about. And this has really been off the agenda after many, many years. You know the Fed has basically been telling us for 18 months or more that it is on hold and itôs (ph) going to stay on hold for a long period of time. Weôve probably reached the apotheosis about belief on the day that QE2 was announced. If you go back and look at what LIBOR expectations were ï
KEENE: Right.
SHAOUL: You know, we thought that the Fed would take until about the end of 2014 to get as high as 2 percent, which is as far as Iôm concerned forever. You know if Iôm looking out three or four years, it really doesnôt matter how long it actually takes. That to us, struck us at the time as a very, very unrealistic position. And you know weôve started to renormalize since that point. And you see that reflected in the middle of the treasury curve (ph).
KEN PREWITT,BLOOMBERG SURVEILLANCE CO-HOST: So the Fedôs on hold. Bank of Englandôs on hold. European Central Bankôs pretty much on hold. When does it all come to an end?
SHAOUL: Well, I think sooner than people are expecting and sooner than the central banks are expecting. The history of central banking is that itôs always surprised by the power of the recovery. You know I think ï
KEENE: And theyôre always behind the curve, whether itôs Timberlake or Meltzer or whoever you read on central banks, theyôre always ex-post (ph), arenôt they?
SHAOUL: Yes, well central banking is a product of the committee decision, which by its nature takes a consensus and consensus always takes longer to coalesce.
PREWITT: Well, what should we look for up ahead here? I mean what sort of hence (ph) will you be seeking out?
SHAOUL: Well, I think the economic data is basically shouting at you that this is a very, very strong recovery. About the only two pieces of data left which give the Fed reason to hold are employment data, which frankly is recovering very quickly. I think todayôs jobless claims is a good indication of that. The other one remaining piece of data is probably the new housing market, which remains roughly where it was in the late 1960ôs, you know near a record-low of activity. I think itôs perverse to believe that consumers are going to recover their retail trends and theyôre going to recover their cost purchasing trends

(ph), both of which weôve seen, and in not later in the cycle probably in the next few months, start to buy new homes again. So I think you get those two pieces of data, youôre going to start to see a lot of misbehavior in the interest rate market and I think youôre going to see a lot of misbehavior amongst Federal Reserve governors. This cozy consensus which has been in place, you know if you ignore Tom Hoenig, who is pretty much the only governor calling for rate hikes last year. This consensus is going to start to fracture.

KEENE: We can tell youôre not from America. Is this a British accent?

SHAOUL: This is a London accent actually.

KEENE: Who does this better; the Bank of England with their dissent and their visible complex votes politically call it or do we do it better where we have one token dissent?

SHAOUL: You know, I donôt think thereôs a better or worse way to do it. Itôs the decision which is the problem, not the dissent. The Bank of England has just as bad a history of being behind the curve as the Federal Reserve has. It may be more polite about it.

PREWITT: So whatôs in front of the curve, stock market?

SHAOUL: No, I think youôre going to see the middle of the Treasury curve start to misbehave. Weôd be watching the portion of the curve between 2 to 5 years. Itôs an open question as to which maturity the Fed ultimately controls by keeping the Fed target rate at 25 basis points. You know, the two years probably anchored to that level, but if you go out as far as the 5-year, itôs probably not anchored to that level. So you know, weôd be watching the 5-year very carefully.

KEENE: I mean the 2-5 (ph) spread, which you know, folks, we got spread-itis (ph) today here on Bloomberg Surveillance. We have not mentioned the difference in yield between those notes. Itôs quite a post- QE2 shock, isnôt it? It has really steepened out.

SHAOUL: Yes, you know if you went back and you looked at what people were saying in the last weeks of October ahead of QE2, the no-brainer trade was to buy the middle of the curve because thatôs what the Fed was going to be buying. Of course, what happened was we ended up with 5-year yields, which were nonsensical at 1 percent. If you think about what that implies about future Fed activity. And I think weôre on our way back to ultimately testing the April 2010 highs, which would give you a 5-year yield at about 2.75 percent. Thatôs probably the upper bound of how far the 5-year can get without people changing their mind about the pace of Fed tightening.

KEENE: Right now - Iôm looking here at BTMN (ph). 5-year yield, where are we? 115, 2.34 percent (ph).

SHAOUL: Yes and we were as high as nearly 2.40 a couple of days ago. You know going from here to 2.75 is possible without changing peopleôs minds about the Fed. Once you get beyond roughly about 2.75 though, well, I think that means people are pushing the Fed to do something.

KEENE: Michael Shaoul with us, Oscar Gruss. So well does that mean youôre going to see the QE2 on the balance sheet pulled in first? Are you going to see target rate action before or as they amend the balance sheet?

SHAOUL: You know my feeling is theyôre going to complete QE2. I think they realize that it doesnôt really make any difference to the economy whether they complete it or not. And they would look somewhat foolish to decide to buy say, $400 billion worth of bonds rather than $600 billion worth of bonds. Iôm not sure whether the market moves ahead of the Fed or the Fed moves ahead of the market. If you go back to the last two surprises, in 2004 the market moved ahead of the Fed when we were given extremely strong non-farm payroll numbers on April 2, 2004. If you go back to 1994, the Greenspan Fed absolutely shocked the market in early February by raising rates at a time that nobody was expecting it. So both possibilities are there for you.

KEENE: Thank you so much for coming in.

PREWITT: Thank you.

KEENE: Bring a LIBOR chart anytime.
SHAOUL: Thank you for having me.
KEENE: Michael, thank you so much. Michael Shaoul, Oscar Gruss as we look at Fed policy.
9:43
END OF TRANSCRIPT