The US Federal Reserve: Dove is in the air

Economic research note

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- In a surprise move for most market participants (including us), the US Federal Reserve decided on 18 September to maintain its current purchase program at $US85 billion per month. This decision came despite widespread expectations of a 'tapering' in the QE3 program, with a small reduction, say $US10bn-$US15bn, in the monthly bond purchases widely expected.
- The statement from the FOMC and Chairman Ben Bernanke was relatively dovish, while the Fed's forward guidance on monetary policy seems to have raised the hurdle on the economic conditions that will be required for any eventual increase in interest rates.
- The Fed's policy statement noted that the "Committee decided to await more evidence that progress will be sustained before adjusting the pace of its purchases".
- Chairman Bernanke cited two key risks: the ongoing fiscal drag and the tightening of financial conditions. Regarding fiscal policy, he noted that "a factor that did concern us in our discussion was some upcoming fiscal policy decisions." In the FOMC statement, the Committee noted that "the tightening of financial conditions observed in recent months, if sustained, could slow the pace of improvement in the economy and labour market."
- The Fed also trimmed its economic growth forecasts for 2013 and 2014 and reiterated its interest rate forward guidance with the first increase in the Fed Funds rate not expected until 2015.

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The US Federal Reserve: Dove is in the air

The US Federal Reserve (the Fed) has surprised markets and most economists (including us) and held its bond purchase stimulus program (QE3) unchanged at $US85bn per month. This decision came despite wide-spread expectations of a 'tapering' in the QE3 program, with a small reduction, say $US10bn-$US15bn, in the monthly bond purchases.

In addition, the statement from the Fed Chairman Ben Bernanke was relatively dovish, while the Fed's forward guidance on monetary policy seems to have raised the hurdle on the economic conditions that will be required for any eventual increase in interest rates.

Not surprisingly, financial markets have responded positively to this dovish turn of events and rallied hard. The US equity market is up by around 1%, while the 10-year US Treasury bond yield declined by 15bp to 2.70%. The US dollar (USD) is down 1.3% against the EUR, while the AUD has jumped by 1.6% to $US0.9515.

US 10-year Treasury bond yields (%)

Source: Bloomberg. Data as at 18 September 2013.

Fed Statement

The statement released by the Fed makes it clear that while the Fed sees ongoing signs of economic recovery, there remains a number of areas of concern that has forced it to hold monetary policy at its highly accommodative level.

The Fed noted that "economic activity has been expanding at a moderate pace" and that while the labour market has "shown further improvement in recent months", the "unemployment rate remains elevated."

In a clear signal that the Fed is worried about the impact of the recent increase in both bond yields and mortgage rates, the Fed stated that "the tightening of financial conditions observed in recent months, if sustained, could slow the pace of improvement in the economy and labour market."

The Fed also focused on the low rate of inflation, noting that "the Committee recognises that inflation persistently below its 2% objective could pose risks to economic performance."

The US Federal Reserve made specific mention of fiscal policy and, by implication, expressed concerns over the coming debate over the budget, the continuing resolution to avoid a government shutdown and the debt ceiling.

In its concluding remarks, the Fed stated that "taking into account the extent of federal fiscal retrenchment, the Committee sees the improvement in economic activity and labour market conditions since it began its asset purchase program a year ago as consistent with growing underlying strength in the broader economy. However, the Committee decided to await more evidence that progress will be sustained before adjusting the pace of its purchases."

Policy outlook:

In terms of the policy outlook, the Fed remarked that "the Committee will closely monitor incoming information on economic and financial developments in coming months and will continue its purchases of Treasury and agency mortgage-backed securities, and employ its other policy tools as appropriate, until the outlook for the labour market has improved substantially in a context of price stability."

In this regard it would seem, therefore, that the 29-30 October FOMC meeting is too soon to receive evidence that a 'substantial' improvement in the labour market has taken place. This likely means that the next opportunity for the Fed to begin tapering its QE3 program will be the 17-18 December FOMC meeting.

Overall, the Fed will need to see monthly increases in payrolls of at least 200,000 over the next few months, and an ongoing drift down in the unemployment rate. In addition, the Fed will be awaiting data on the housing market to ensure that the recent rise in the mortgage rate does not stall the recovery in the housing market.

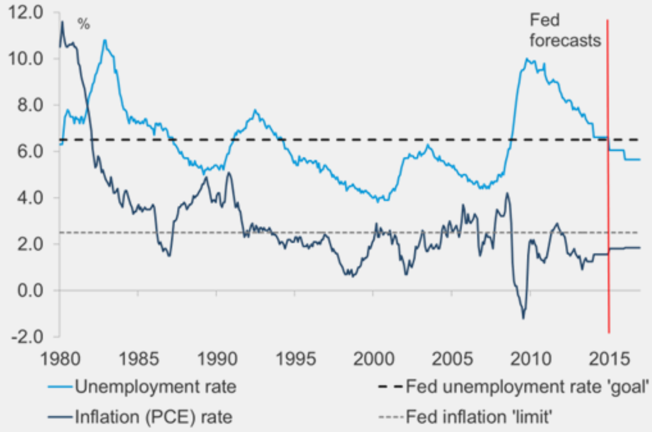
Critical also is the forthcoming debate on the budget, the need for a 'continuing resolution' and the need to further increase the $US16.7 trillion debt ceiling - all of which have the ability to add to market volatility and uncertainty.

Forward guidance:

The Fed has also released updated economic forecasts and forward guidance on interest rates. The Fed Chairman has made it clear that the 6.5% unemployment rate that will serve as a guide to when monetary policy should be tightening, i.e. the Fed Funds target rate will be raised from near zero, is very much a guide only and not a trigger for imminent policy action.

Monetary policy is unlikely to be tightened, therefore, for an extended period. The vast majority of the members of the FOMC (12 out of 17) expect that the first increase in the Fed Funds target rate will not occur until 2015. Three members expect the first move in 2014, with two looking at 2016.

US unemployment rate and PCE inflation (%) and Fed forecasts



Source: Bloomberg. Unemployment rate data to August 2013. PCE data to July 2013. Fed forecasts as at 18 September 2013 to 2016.

More specifically, the 17 FOMC members have provided their forecasts for the Fed Funds target rate as at year end for each year to 2016 and a long run average.

For year-end 2014 the vast majority expect the FOMC expect the Fed Funds rate to remain at 0.25%. For 2015 the year-end rate rises to an average of 1.25%, with a range of 0.25%-3.25%. For year-end 2016 the average expected Fed Funds target rate increases to 2.25%, with a wide range of 0.5%-4.25%. Over the long run, the vast majority of the FOMC members look for the Fed Funds target rate to average 4.0%, with a relatively tight range of 3.25%-4.25%.

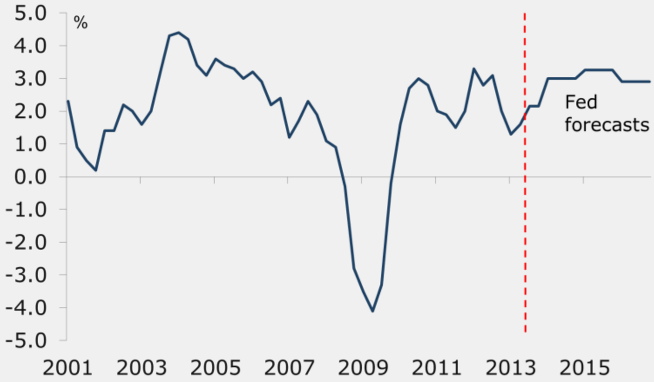
New forecasts

In terms of the revised economic forecasts, it is instructive that the relatively modest tightening of monetary policy expected by the majority of the FOMC will be in the context of an economy performing close to trend. For 2014 the economy is expected to grow by 2.9%-3.1%, accelerating to 3.0%-3.5% in 2015 and then moderating to 2.5%-3.3% in 2016. The long term average growth rate is estimated at 2.2%-2.5%.

Over that time the unemployment rate is expected to move down to 6.4%-6.8% in 2014, 5.9%-6.2% in 2015 and 5.4%-5.9% in 2016. The long term average unemployment rate is estimated at 5.2%-5.8%.

Over this entire time period the rate of inflation, as measured by the core PCE, is expected to remain below the 2% target set by the Fed.

US GDP growth with forecasts



Source: Bloomberg: Data to 30 June 2013. Fed forecasts as at 18 September 2013 to 2016.

Fed Chair

As has been much discussed, including by us in previous notes, the monetary policy outlook in the US is wrapped up with the fact that Ben Bernanke's term as Chair of the Fed ends in January 2014 and that, given he is unlikely to be reappointed, a new Chair needs to be found.

Up until early this week the race to succeed Ben Bernanke, public commentary had narrowed to the current vice Chair, Janet Yellen, and the former Treasury Secretary Larry Summers. Of course, we know that Larry Summers, who looked to be the Presidents favoured candidate, removed himself from consideration on the view that his confirmation process would have been very difficult.

The role of Chair of the Fed now looks to be Janet Yellen's to lose. However, other names also keep coming up, including former vice Chair Don Kohn and former Treasury Secretary Tim Geithner. This suggests that Janet Yellen's promotion into the job is far from assured. Financial markets will be keen, however, to see President Obama make this appointment after a formal approval process is conducted over the coming weeks.

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