The Travelling Economist in the USA

More than a Feeling

August 2014

Contents

Executive Summary

On my third trip[1] to the United States (US) as the Travelling Economist, through late April and early May 2014, I was determined to gain a deeper understanding of what was happening in the US economy. My aim was to determine if the better macroeconomic indicators were pointing us towards an economic outlook that was 'more than a feeling'. The goal was to then examine what the implications of this better macroeconomic outlook were for policy – quantitative easing, official interest rates and fiscal policy. In addition, I looked at the upcoming mid-term elections and the political machinations ahead.

Most importantly, however, my focus was on what the economic, policy and political outlook implied for financial markets – bond yields, the US dollar (USD) and the equity market and what this means for our clients and investors.

Travelling to Dallas, New York and Washington, I met with senior members of the US Federal Reserve and the Department of Treasury, as well as Fannie Mae, the most important government body involved with the US housing market.

Along the way I also engaged with a number of economists from independent research houses, banks and hedge funds – many of whom I have known for a number of years.

At the outset of this trip I held **a relatively positive view on the US economic outlook, and this remains the case**. Nearly all of my meetings reinforced the view that **the US economic recovery is broadening and deepening and that this has major implications for policy and markets**.

There are, however, also **clearly more risks than I had appreciated**. And, if the very low yields still on offer in the Treasury bond market are any guide, investors remain very skeptical about the outlook for the economy, inflation and monetary policy.

As shown by the strong Q2 14 GDP report and the brutal winter weather aside, the US economy is showing signs of ongoing recovery that I will highlight in this report. The combination of good economic momentum and a better outlook for fiscal policy should help the US economy grow by around 2.75%-3% through the second half 2014 and 2015.

As a result, the US Federal Reserve (the Fed) will continue to reduce (or 'taper') its bond purchase stimulus program (QE3) to the point that this program comes to an end in October this year.

It is, however, **the next phase of the Fed's policy agenda that will be most critical**. Over coming months and FOMC meetings, **I believe the Fed will continue to adjust its rhetoric and evolve the conversation about how and when the monetary policy normalisation process will get underway**. The Fed is making substantial progress towards its dual mandate of full employment and price stability which needs to be further recognised in their rhetoric.

Stephen Halmarick
Head of Economic and Market Research

Note:
1. The first trip was February 2011 and the second September 2012.

Executive Summary
continued

I believe that the Fed will need to provide more detailed answers to some key questions, such as: how and when do they plan to raise official interest rates, what will they do with the over $US4.4tn of securities they have on their balance sheet (including $US2.4tr of Treasury bonds and $US1.7tr of mortgage-backed bonds), and what will they do with the income these bonds are generating. This will be a critical time for the Fed and markets.

It will be very important for the Fed to communicate its strategy and sequencing in a clear manner. As we saw in 2013, the risks from miscommunications are high.

In this regard one key issue will be what the Fed sees as the new 'neutral' Fed Funds rate – is it still around 4%, or as most, including me, now expect, lower?

Cyclically, I believe, this economic and policy outlook should see bond yields rise. In addition, **the USD should move higher and the equity market, after an initial period of downward adjustment and increased volatility, should continue to trend higher**. But, as we have seen recently, there are always factors (such as events in the Ukraine, Israel-Gaza and Iraq) that can throw these cyclical trends off course, at least for a period of time.

The bond market has, of course been holding, with yields still at relatively low levels after a strong rally in May. I will explore the reasons behind this move and what it implies for the outlook.

Another key factor is developments in the housing market. After leading the US economy out of recession (and indeed into the recession), the pace of both activity and price increases in the housing market has slowed in recent months. This is due to a combination of the brutal winter weather and the move up in mortgage rates over the second half of 2013. In this report, I look more closely at developments in the housing market and what the future holds.

Another key question for the housing market is, however, the outlook for mortgage financing and the role of the government entities – Fannie Mae and Freddie Mac. These two institutions currently dominate the mortgage market, with the private sector lenders in retreat. This is not a situation anybody seems happy with, so significant reform of the mortgage finance sector looks to be in prospect.

For the labour market, there seems no question that a solid recovery is in place. In this research note I will look at the interrelation between employment growth, the unemployment rate (both short-term and long-term) and the participation rate.

There is at least one piece of evidence that tends to point to a sustainable recovery in employment growth – and that is the upward trend in wages growth that is now underway at the lower end of the income spectrum. This increase in wages is likely to have a broad impact on the economy, inflation, Fed policy, and, perhaps most importantly, on the equity market.

The equity markets, and the broader economy, will also be affected by the upswing in private company capital spending (capex) that now seems to be underway. A move from 'survival' strategies to 'growth' strategies at the corporate level will be important not only for the companies involved, but the equity market in general and the overall economy. **Stronger capex spending is a critical part of my more upbeat view on the US economy.**

One key area of improvement in the US is fiscal policy. After expanding to around 10% of GDP in 2009, the US budget deficit is now just under 3% of GDP. For FY2015 the expectation is for a deficit of around 2.5% of GDP. This is a dramatic turnaround and a clear indication of a better economy.

The other factor to explore is the ongoing revolution in the US energy sector. Through the use of technology (some of which, such as "fracking", many parts of the world are not willing to use) the US is dramatically increasing its production of energy (oil and gas) and could even move into global trading markets in these key products.

Imagine a world where the US is energy self-sufficient and/or is exporting both oil and gas to the world. This is a real game-changer for not just the US, but the global economy. The geo-political implications are also significant.

Finally, there is the US political outlook. The November 2014 mid-term elections hold out the prospect of the Republican Party gaining a majority in the Senate. This would then give us two years of the Republican Party having a majority in both the Senate and the House – but with a Democratic President in the White House.

I also look at the 2016 Presidential election. While the list of potential Presidential candidates on the Democratic side seems shorter, there is a very long list of potential candidates on the Republican side.

But both major parties have a clear preferred candidate. For the Democrats that is Hillary Clinton. For the Republicans that is John Ellis (Jeb) Bush. Yes, 2016 could be Clinton v Bush.....it is going to be fascinating to watch!

I trust that you find this *Travelling Economist* report on the US both interesting and useful. Questions and comments are welcome.

Regards,

Stephen Halmarick
Head of Economic and Market Research

The Economy: Just feel better

Economic Outlook:

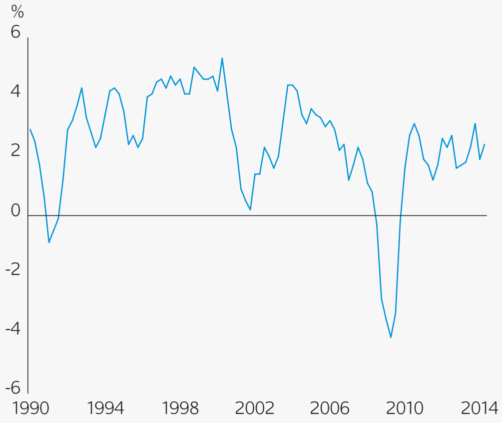
The view on the US economy from my key meetings in New York, Washington and Dallas was generally positive.

The people I spoke with, from both the public and private sector, noted that the US economy was 'healing' and that the economy had regained its 'growth muscle'. This can clearly be seen in the Q2 14 GDP report, which showed growth of 4%saar, well up from the revised -2.1%saar seen in Q1 14.

From the perspective of life in Dallas, my first stop on my US research trip, this was not surprising given how this part of the US has outperformed the national economy. As at June 2014 the unemployment rate in Texas was 5.1%, well below the national average of 6.1%. The solid housing market, strong corporate activity and the rapid development of the energy sector have all played their role.

This upbeat assessment helped support my own view that the outlook for the US economy has improved and will continue to do so into 2015. Again, despite the set-back in Q1 14 from the brutal winter weather, the Q2 14 GDP report showed robust growth.

US GDP Growth, Annual growth % yr



Source: Bloomberg. Data to 30 June 2014.

One of the key reasons for this positive view on the US economy centres on corporate health and changing management behaviour. It was highlighted to me that corporate balance sheets right across the US are generally strong and that the cycle of stock buy-backs and increased dividend payments looks like it has largely run its course.

A Sign of Recovery: The Freedom Tower. Source: First State Investments.

After 4-5 years of management being focused on defensive strategies that controlled costs, reduced employment and improved productivity, **management is now turning to strategies that are 'geared for growth' and that involve capital spending and job creation.**

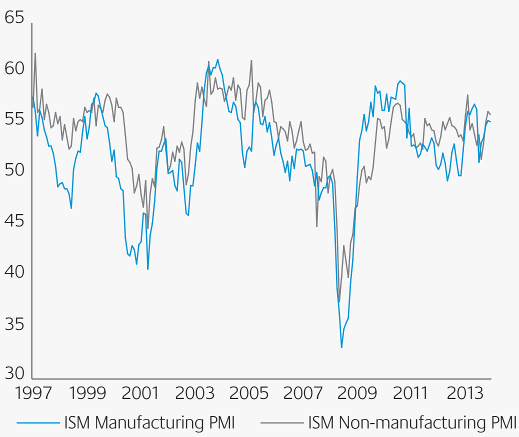
As a result, one key point that resonated with me following my meetings was that the US economy is not so much as accelerating, but, perhaps more importantly, **the recovery is 'broadening and deepening'**.

The Economy: Just feel better
continued

Lunch with Alan Greenspan and the Economics Club of New York. Source: First State Investments.

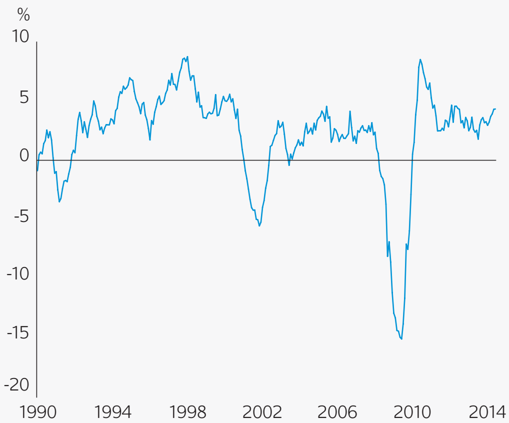
As can be seen from the following series of charts, there are many sectors of the US economy that are improving – some quite substantially.

US PMI (Purchases Managers Index)



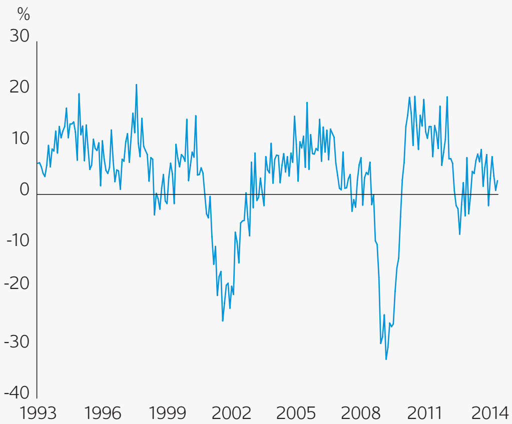
Source: Bloomberg. Data to 30 June 2014.

US Industrial Production, % yr



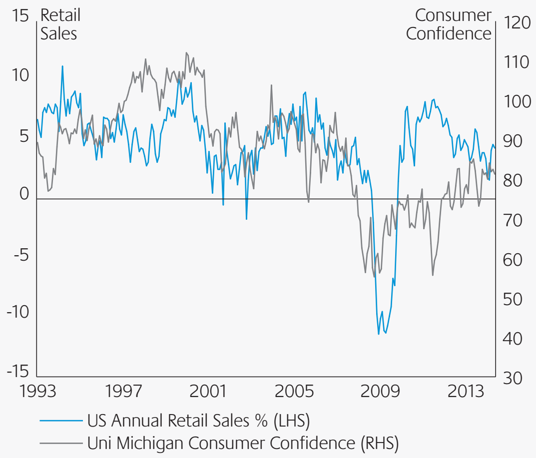
Source: Bloomberg. Data to 30 June 2014.

Core Durable Goods Orders, % yr



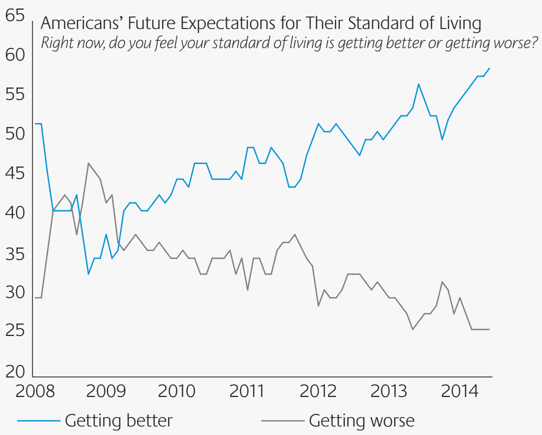
Source: Bloomberg. Data to 30 June 2014.

Retail Sales and Consumer Confidence



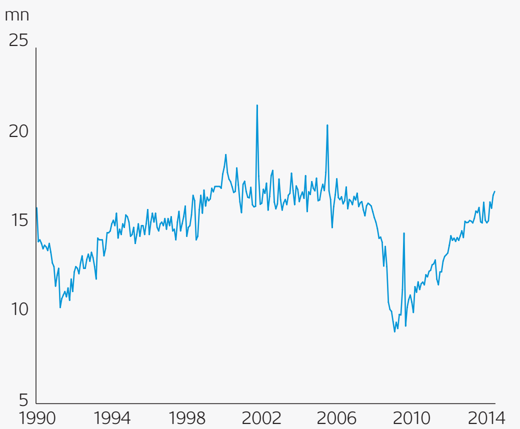
Source: Bloomberg. University of Michigan Consumer Confidence Index data to July 2014 and retail sales data to June 2014.

US Household Standard of Living Expectations



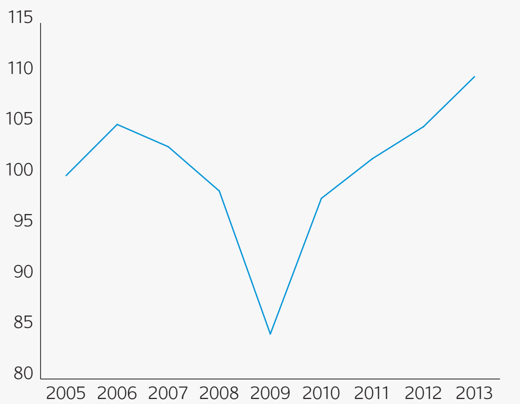
Source: Gallup. Data to June 2014.

US Auto Sales, $USbn



Source: Bloomberg. Data to 30 June 2014.

US Rail Freight – Index



Source: Association of American Railroads. Index = 100 in 2005.

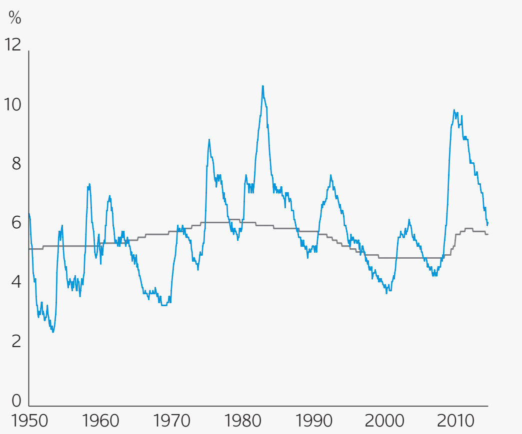
The Economy: Just feel better
continued

The Labour Market:

One of the key issues for the ongoing recovery in the US economy is the strength of the labour market.

As shown in the chart below, the unemployment rate, at 6.2% in July, has declined significantly from the post-GFC peak of 10%. Indeed, at the current levels, the unemployment rate is fast approaching the latest estimate of the NAIRU (non-accelerating inflation rate of unemployment) at 5.8%. This is good news.

US Unemployment Rate and the NAIRU

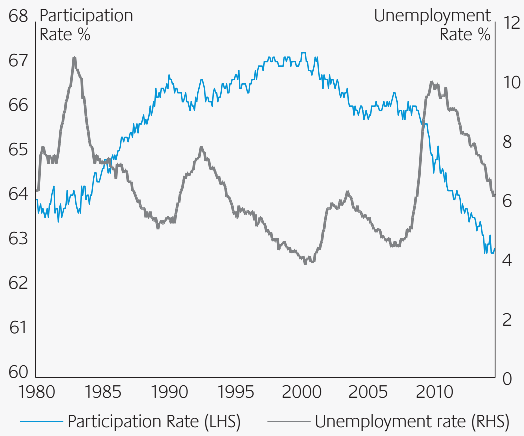


Source: Bloomberg and Congressional Budget Office. Unemployment rate as at 31 July 2014. NAIRU last updated Feb 2014.

It is all about Jobs! Source: First State Investments.

However, part of the reason the unemployment rate is falling so fast is that the participation rate has also been declining. In fact at 62.9%, it is at around a 36 year low. While I was in the US there was certainly a debate raging over the differing impacts of the short-term vs the long-term unemployed and the significance of the collapsing participation rate.

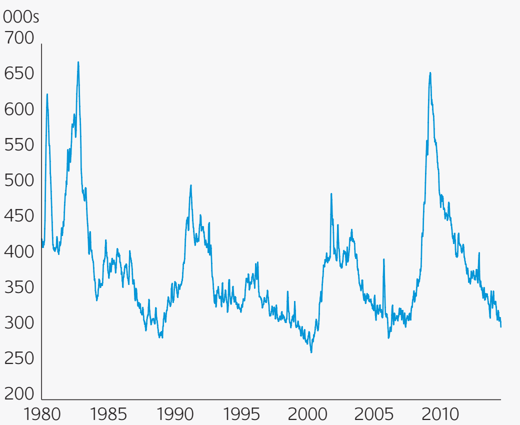
US Participation Rate and Unemployment Rate



Source: Bloomberg. Data as at 31 July 2014.

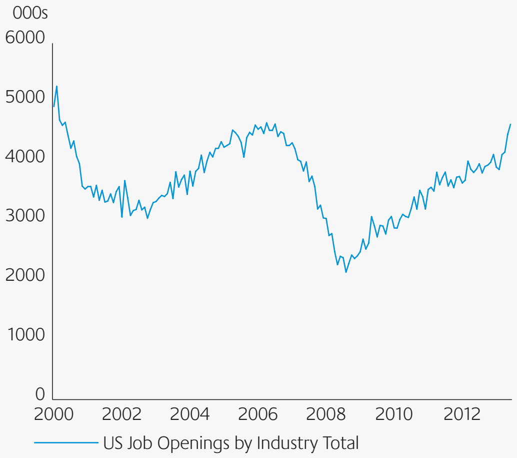
It seems clear, however, that notwithstanding the fall in the participation rate, **the labour market is healing and strengthening**. As shown below, the number of people claiming initial jobless benefits has fallen dramatically. In addition, the total level of employment is now back to pre-GFC levels. Although this has taken an extraordinarily long time (77 months) relative to past recessions, the good news is that it has now occurred.

US Jobless Claims



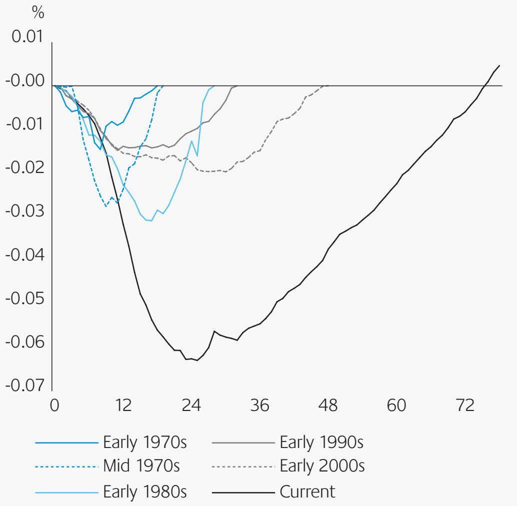
Source: Bloomberg. Data to 18 July 2014.

US JOLTS Job Openings Indicator



Source: Bloomberg. Data to May 2014.

Employment Growth v Other Recessions over time



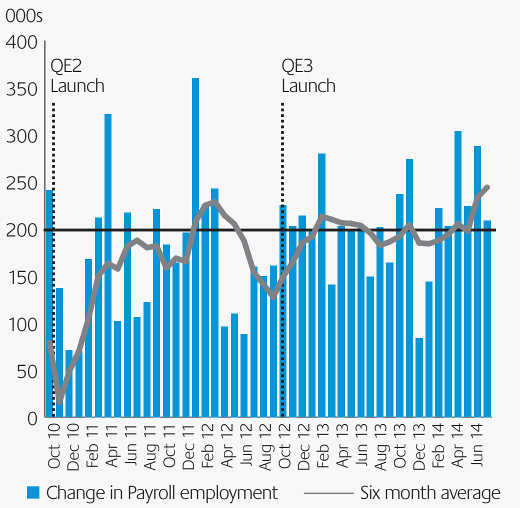
Source: Bloomberg and First State Investments.
Data to 31 July 2014.

The most important employment statistic is, however, the monthly payrolls numbers. The Fed has made it clear in previous discussions that they want to see a minimum of 200,000 jobs created each month.

As shown in the chart below, as at July 2014 the six-month average of the monthly payrolls numbers had clearly moved well above the 200k level – after the weather affected numbers of late 2013-early 2014.

Indeed, it is instructive to note that as soon as the six monthly average for payrolls hit the 200k level in October 2013 (data released early November) the Fed started reducing or 'tapering' its bond purchase stimulus program (QE3) at the very next meeting in December 2013. I would expect that monthly payrolls will be in a 200k-250k range over H2 2014 and perhaps higher through 2015.

US Non-farm payrolls, month and 6 month moving average



Source: Bloomberg and First State Investments.
Data to 31 July 2014

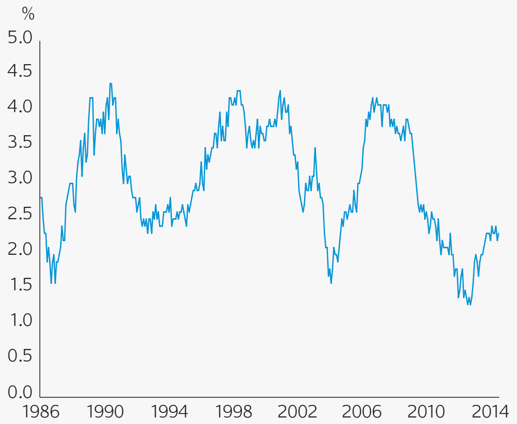
Wages:

One follow-on from this key point is that **wages growth is now beginning to accelerate**. In just about every meeting that I held in the US, the economist I met would show me some type of chart on wages growth. Some thought the outlook was relatively benign, while others are of the view that the pick-up in wages growth that now looks to be underway – at least at the lower income spectrum – was the warning of inflation pressures to come.

The chart that I found most compelling was the one below – which shows the annual pace of average hourly earnings growth for production and non-supervisory workers (ie. people who have no manageria responsibilities).

As can been seen in the chart, the trend has clearly turned up. Perhaps more importantly, although the total rate of wages growth is still very low at around 2.5%, the trend usually is that once a upward move is set in place it lasts for a number of years and could take annual wages growth to around 3.5%-4.5%.

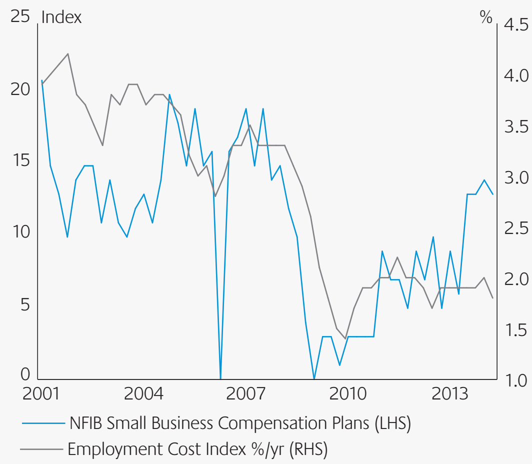
Average hourly earnings ($US/hr): production and non-supervisor (annual rate)



Source: Bloomberg. Data to 31 July 2014.

Another wages measure that was shown to me was the Employment Cost Index (ECI). As shown in the chart below, by this measure there looks to be very little upward pressure on labour costs. However, as this chart also shows, the correlation between the ECI and the number of companies that are planning to increase wages in the months ahead is quite striking. If this relationship holds true, the ECI will soon be heading higher – much like other measures of wages growth and costs.

The ECI and NFIB companies planning to increase wages



Source: Bloomberg. NFIB Small Business Compensation Plans Index as at 30 June 2014. Employment Cost Index as at March 2014.

For most of the economists I met with, **this increase in wages growth, coupled with the gains in employment, was seen as a very positive development for the economy** – especially for the consumer and the government. I would agree.

But as I will discuss later in the report, **it could be a negative for equity markets**, or at least some companies, as the wages share of the economy could now be on an upward trend, at the expense of the profits share of the economy.

Inflation:

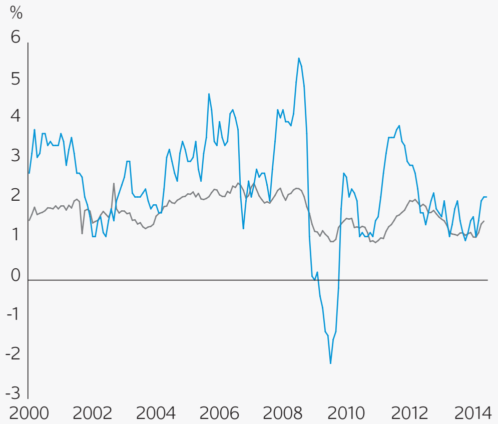
This increase in wages growth certainly does not guarantee that inflation will follow. Given the high levels of profits in the US economy and the strength of corporate balance sheets, it could certainly be the case that a number of companies decide to take this higher wages cost as a margin-squeeze, rather than passing them onto their customers as higher prices.

But there is clearly a risk that some wages induced prices pressure could eventuate and that this could show up in higher inflation.

Indeed, a number of economists that I met, but certainly not all, had some concerns that the rate of inflation was likely to rise faster than the market currently expects.

While the base case is that inflation (as measured by the core private consumption expenditure index, core PCE) is expected to trend gradually up to the Fed's target of 2%, the risk around this scenario was for a more rapid pick-up in inflation pressures. This could come from technical factors around the calculation of the CPI, expected gains in medical costs and/or the wages trend discussed above.

US inflation headline and core PCE

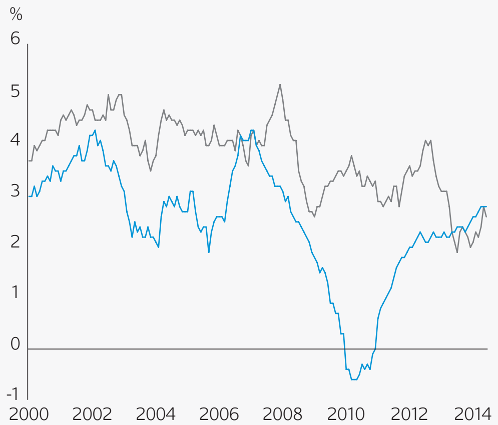


Source: Bloomberg. Data to 31 May 2014 for Core PCE. 30 June 2014 for headline inflation.

Those with a more benign view on inflation pointed to low inflation pressures globally and the still significant slack in the US labour market. My own view is that, at this stage, the upside risks to inflation clearly outweigh the downside risks. And as shown in the chart above, the trend on inflation certainly looks like it has turned higher.

One of the key issues for inflation is that the trend higher is likely to be supported by both general macro-economic issues, as well as technical or measurement issues. This latter point relates especially to the health sector and shelter costs. As the chart below shows, there has been a recent rapid increase in the Healthcare industries sub-category of the CPI series, while shelter costs are also on the rise.

Healthcare CPI Index Annual Change and Shelter Costs



Source: Bloomberg. Data to 30 June 2014.

Overall, **while a jump in inflation may not be the base case, it is certainly the risk that financial markets are least prepared for!**

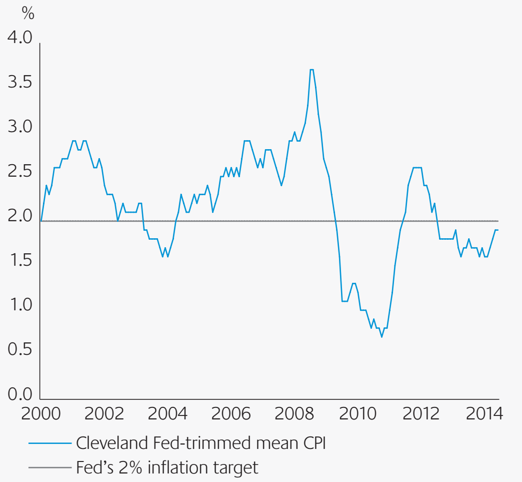
From recent levels around 1%-1.5%, core inflation (as measured by the Fed's favourite indicator, core PCE) is expected to move up to a 1.5%-2% range, ie. much more consistent with the the Fed's 2% inflation target.

Indeed, at the 18 June FOMC meeting the Fed specifically raised its own inflation forecasts. Inflation (as measured by the core PCE) is now forecast at 1.5%-1.6% at the end of 2014, 1.6%-2.0% at the end of 2015 and 1.7%-2.0% at the end of 2016, ie. in line with the Fed's 2% medium-term target.

At the 29-30 July FOMC meeting the Fed stated that "inflation has moved somewhat closer to the Committee's longer-run objective."

Another way to look at inflation is to use the Cleveland Federal Reserve's measure of Trimmed Mean CPI. As show in the chart below, this measure of underlying inflation is now also clearly trending higher and approaching the Fed's 2% target.

Cleveland Fed Trimmed Mean CPI



Source: Bloomberg. Data to 30 June 2014.

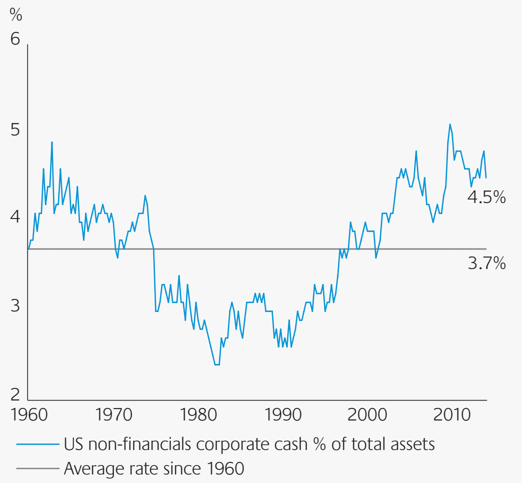
Capex:

At this point in the economic cycle, one of the key factors that will be needed to ensure that the recovery continues is private company capital spending (capex). More than one economist I met mentioned that the signs were positive, with leading indicators pointing towards a noticeable increase in capex. There was also a corresponding increase in business confidence.

Part of the reason for this gain in business confidence and the expected increase in capex is that, as detailed below, there are less risks coming out of Washington, with no debt ceiling/budget deadlines this year. In addition, with the Fed tapering QE3 and interest rates across the yield curve likely to be rising in 2015, the time to get on with borrowing and investing is now.

My view is that **an increase in capex by US corporates is absolutely critical to the outlook for the US economy**. As shown in the chart below, US corporates currently are holding a historically high level of cash on their balance sheets. Solid economic growth will partly depend on using this cash to invest and grow.

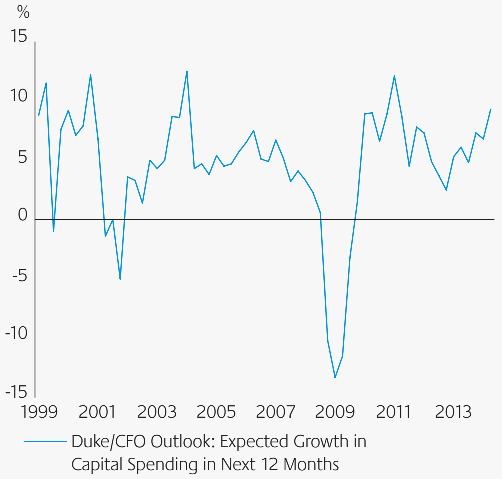
US Non-Financial corporate cash positions



Source: Strategas. Data to 31 March 2014.

However just because US companies have a large amount of cash on their balance sheets, it does not necessarily mean that they are about to spend it. The following chart does indicate, nevertheless, that chief financial officers are planning to increase capex over the next 12 months – and this is good news.

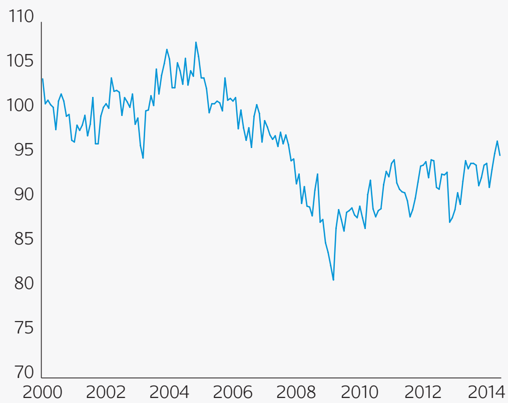
Duke University CFO Survey of Capex Intentions



Source: Duke University. Data to June 2014.

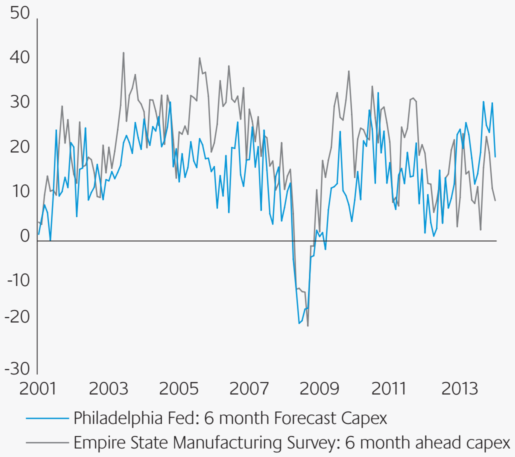
This same trend can be seen in the survey undertaken by the NFIB (National Federation of Independent Business). The Philadelphia Federal Reserve and the Empire State index are, however, a little softer – all shown below.

NFIB Small Business Optimism Index



Source: Bloomberg. Data to 30 June 2014.

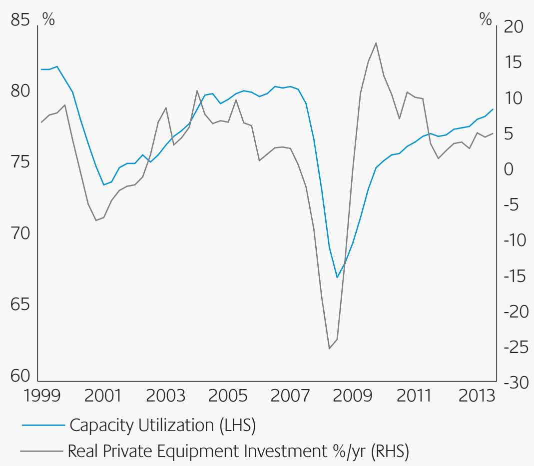
Empire State and Philly Fed Outlook



Source: Bloomberg. Data to July 2014.

These capex intentions look to be supported by the recent increase in capacity utilisation. As shown in the chart below, capacity use is now back close to its long-term average and should be expected to see the recent slight uptick in real private equipment investment strengthen.

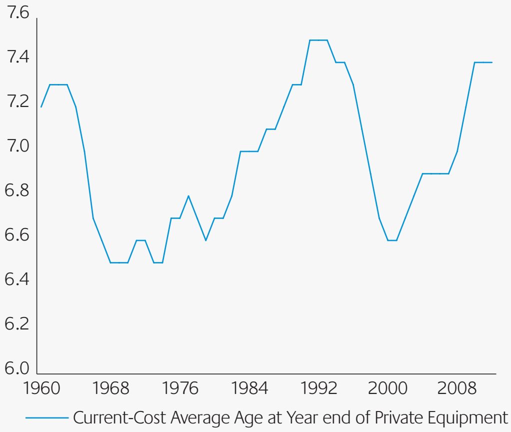
US capacity use and real private equipment investment



Source: Bloomberg and Bureau of Economic Analysis. Data to 30 June 2014.

This trend to stronger capex also seems to be warranted by the increased age of private equipment among US firms. As the chart below shows, the average age of private equipment surged higher during the years of the US recession post the GFC, and has held at this old level for the past four years.

US average age of private equipment – years



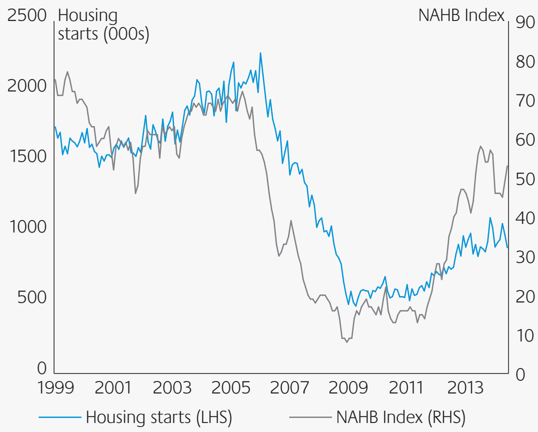
Source: Bureau of Economic Analysis. Data to 2012.

Increasing profits, high levels of cash on strong balance sheets, the need for productivity enhancements, greater capacity utilisation and the increased age of equipment all argue for a solid upswing in US capex in the months and years ahead. And as stated above, this will be an important part of the ongoing recovery in the US economy.

Housing:

One of the key issues for the US economy and its recovery is the housing market. As the following chart shows, both housing construction activity (new starts) and the level of confidence within the sector (the National Association of Home Builders, NAHB, confidence index) started turning down in 2005 and kept falling all the way into 2009.

US Housing starts and NAHB Index

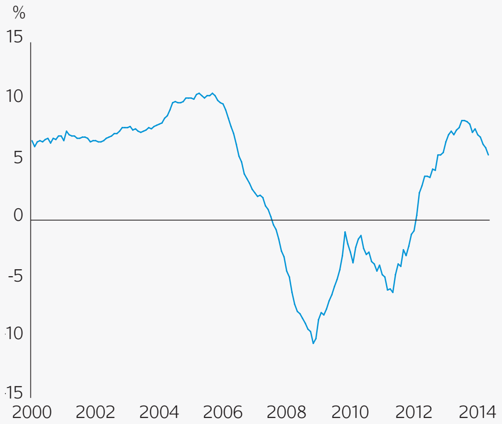


Source: Housing Starts to June 2014 and NAHB Housing Market Index to July 2014.

But equally as important is the fact that the housing market also led the US economic recovery, with solid gains especially from 2011. Of course, this was driven by deliberate government policy, including the significant decline in mortgage rates (with the average 30 year fixed rate mortgage dropping from over 5.5% in mid-2009 to a low of just on 3.5% in mid-2012) and the Fed's purchasing of mortgage-backed securities as part of its QE3 program.

Although there were some fits-and-starts to the recovery process, house prices also performed strongly through much of 2012 and 2013.

US house prices



Source: Bloomberg. Data to 31 May 2014.
Federal Housing Finance Agency measure.

But what is also clear from the charts above is that the housing recovery has stalled more recently. This is a concerning trend – not just for the economy and financial markets, but also the Fed.

From my meetings in New York and Washington, it seems that there are three key reasons for the softness in the housing market through the first half of 2014 – the winter weather, higher interest rates and the availability of credit.

As has been stated many times, large parts of the US experienced brutal winter weather at the start of the year that made it largely impossible to step out of the house, let alone try and build one or buy/sell one. However, this does not tell the whole story, as some parts of the US that did not experience the severe cold, such as California, also saw a downturn in housing activity.

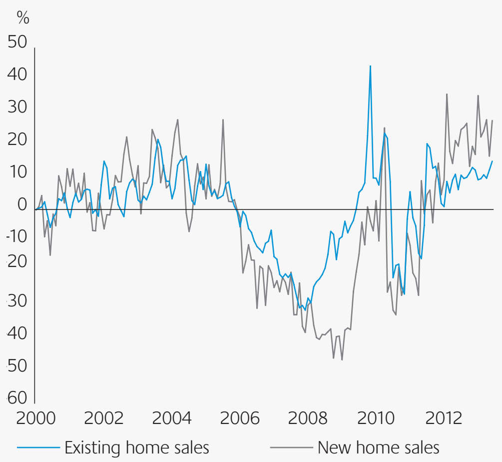
From late 2012 to mid-2013, the average 30 year fixed rate mortgage rose from around 3.5% to over 4.5%, reflecting the sell-off (the 'taper tantrum') in the bond market around mid-2013. This higher cost of mortgage credit clearly had an impact on the housing market. It is worth noting, however, that the recent rally in the bond market has taken the average 30 year fixed rate mortgage back down to around 4.13% (as at late July 2014).

On this trip to Washington I was lucky enough to meet with a senior person from Fannie Mae, which, along with Freddie Mac, is one of the two government sponsored enterprises (GSEs) providing the bulk of financing to the mortgage sector.

Key points from this meeting are as follows:

- A downturn in existing home sales started before the bad weather hit the US
- This was correlated to an increase in mortgage rates from around 3.5% to 4.5%
- There has also been a big fall in distressed home sales which is good news
- Cash purchases of homes remain high and this is both 'mum and dad' buyers as well as institutional investors buying up parcels of homes to on-sell to retail investors.
- The supply of existing homes for this cash-only market is now beginning to dry up as purchases have outpaced the construction of new homes.
- Confidence among home builders is expected to improve again, as mortgage rates are now back down to around 4.3%, but there are a number of reasons why we shouldn't expect a near-term surge in residential construction.
- These include a lack of the availability of credit for new home buyers (see below for details around this and the reform process) and a lack of new land supply on which to build houses/apartments.
- Some of the reasons for this shortage of new land include environmental hold-ups and the fact that, under significant budget pressures, many local governments have not been undertaking the necessary investment in public infrastructure (ie. utilities, schools, fire stations etc) to enable the development of new communities.
- Overall, the US economy needs the supply of around 1.2 million new residences each year and, as shown in the chart below, is struggling to meet this 30 June target.

New and existing home sales – % yr



Source: Bloomberg. Data to 30 June 2014.

- While, as stated, mortgage rates have come down again recently, any future sell-off in the bond market (which we expect) would see mortgage rates rise again and this would likely have a negative impact on demand for housing.
- This would be offset, however, by the expected better economic conditions and further declines in the unemployment rate that we expect.
- Any further increases in demand would likely see prices begin to rise more strongly again – especially given the concerns over the level of supply to meet the natural level of demand.
- Another issue is that there is now less than the usual level of 'churning' in the housing market. People are generally reluctant to sell their existing home if it still is in a negative equity position, while the share of first-home-buyers in the market is very low given the deteriorating affordability and tightness of credit availability.
- The level of first-home-buyer activity has declined from around 40% of the market to closer to 20%. A big part of this story is student loans, which have increased dramatically. Young people, in some instances, are finishing their education with 'mortgage-sized' debts and are, therefore, reluctant to then take on another mortgage to buy a house or apartment.
- There are concerns also over who will buy the RMBS (residential mortgage backed securities) in the market once the Fed winds up QE3, given that, on occasions, the Fed has been buying up to 100% of all new RMBS issuance. The role of pension and mutual funds, as well as REIT investors, will be critical here.
- The reform process for Fannie Mae (and Freddie Mac) is both critical and extremely difficult – details below.

The bad news is, therefore, that the outlook for the housing market over H2 2014 and into 2015 remains challenging. The good news is that this is not a major risk to the economic recovery that I expect with, as stated above, the US recovery broadening and deepening to the extent that other parts of the economy can take up primary responsibility for generating growth while the housing market consolidates.

The Housing market and the reform process:

One of the key factors for the US economy and markets in the months and years ahead is the reform of the Housing finance sector. Currently Fannie Mae and the other GSE's are close to 50% of the residential mortgage market. **There is a strong consensus that there needs to be reform of the housing finance sector to bring the private sector back into the market as the primary source of mortgage financing.**

While there appears to be agreement on what the sector should look like after the reform process, there is very little consensus on how to achieve that objective without completely disrupting the availability of mortgage credit and creating significant volatility in the current RMBS market.

A number of bills or proposed reforms for the housing finance sector have gone through the political process in either the Democratic-led Senate or the Republican-led House of Representatives, but very little bi-partisan agreement seems to have been reached.

One such example is the so-called Johnson-Crapo bill. This proposal to reform the housing finance sector passed the Senate Banking Committee by a vote of 13-9 on 14 May, but has not been heard from since.

The long-term goal seems to be that the current GSEs (Fannie Mae and Freddie Mac) are wound down and eliminated. A new entity would then be created. This new entity would not be supported by the government, but the securities (RMBS) that it issues would have some type of government support.

There remains, however, significant political disagreement on how large a role the government should take in supporting the mortgage market.

There also remains significant risk as to whether the private sector would become more actively involved in the mortgage market if the roles of Fannie Mae and the other GSE's were dramatically reduced. The private sector may only provide mortgages at a higher interest rate and/or with higher credit scores.

Any move that would (further) restrict the supply of credit to the mortgage market is clearly not seen as a good thing at this stage of the US economic recovery.

As a result, there remains a significant degree of uncertainty over the outlook for the mortgage market in the US, both by market participants and the political process itself.

There is a real sense that something needs to be done to reduce the role of the government and GSE's in the mortgage market and to increase the role of the private sector – but no real sense on how to achieve this outcome without creating substantial uncertainty and risking the ongoing recovery in the housing market.

Some risks and observations on the economy:

While there is clearly, in my view, a broadening and deepening of the US economic recovery underway – and that is good news, the bad news is that there remains a number of risks.

Some of these risks were highlighted to me in my meetings in Dallas. The fact that this area is one of the fastest growing parts of the US economy made these observations even more interesting.

It was made clear to me that many people from this part of the US have a dim view of Washington, including both Congress and the President. The regulatory environment, the path of fiscal policy and government debt were all cited as medium-term concerns for companies and the economy.

The outlook for inflation was considered, however, to be relatively benign. The US is expected to enjoy an extended period with inflation around the Fed's target of 2%. As noted above, however, the risks around this view were generally skewed to the upside, rather than concerns over deflation.

Less positively, I was told in some of my meetings in Dallas that there was clearly some over-pricing in asset markets, including both bonds and equities. So that even though the macro-economic outlook was positive, the path for asset prices could be more volatile.

As stated, it is worth noting that the Texas economy has been outperforming the national economy. One of the big positives for Dallas is that it is becoming more internationalised. This was especially focused on the energy sector (which in an under-stated manner was described to me as 'not unimportant'), and on an increased exposure to China.

While I enjoyed the benefits of the direct Sydney-Dallas flight (which includes avoiding LAX), I was informed that Dallas would soon have direct flights to Shanghai and HK. The feeling in Dallas was that this would bring greater access to China – its people and money.

As is well known, the President of the Dallas Federal Reserve, Richard Fisher, is a voter on the FOMC this year and a noted 'hawk'. To get a better understanding of his views on the outlook for Fed policy I was advised to read a recent speech he gave in Hong Kong ("Forward Guidance", Remarks before the Asia Society Hong Kong Center, April 4, 2014).

In that speech, the Dallas Fed President spent time discussing the limits of 'forward guidance' in an uncertain world and was critical of the financial markets hanging on every word or 'dot' forecasts of members of the FOMC. He stated that "the FOMC is seeking to make sure that we have a sustained recovery without giving rise to inflation or market instability. We will conduct monetary policy accordingly. Regardless of the way we may finally agree at the FOMC to write it out or have Chair Yellen explain it at a press conference, we really cannot say more than that."

He also noted that, as Chair Yellen had recently said in a speech in Chicago, that "central bankers have hearts, and the Fed is working to harness monetary policy to relieve the plight of the cyclically unemployed."

Critically, however, he added that "but we also need to be vigilant in making clear that we are obligated to maintain price stability and that allowing inflation to take grip is a cardinal sin for a central bank, for it is the cruelest of afflictions for all of society."

Energy:

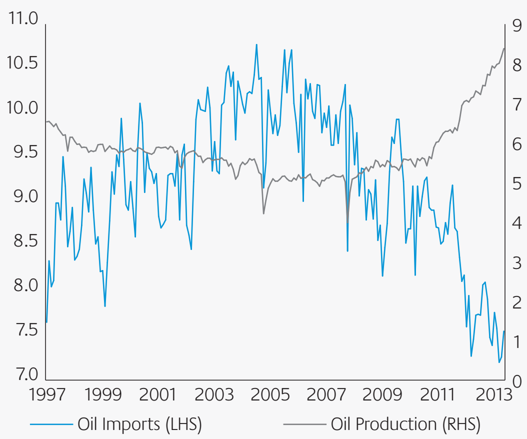
A significant structural positive for the US economy is the dramatic change in the energy sector, with US energy imports declining sharply as domestic production rises – see chart below for details.

Everywhere I went in the US, but especially in Dallas, the discussion always turned to the energy revolution that is currently underway. I am not an engineer, so I have to take on board the views of others that know much more about this subject than I do, but **it seems very clear that the boom in energy production is the real deal.**

The significant increase in domestic energy production in the US (both oil and gas) is likely to have a dramatic impact on not just the US economy, but the wider global economy and, perhaps most importantly, the global geo-political landscape.

Imagine a world where the US does not need to import any oil from the Middle East or elsewhere and indeed the US itself could become a major exporter of oil and/or gas – that is the type of major geopolitical shift we are talking about.

US Oil production and imports – million barrels per day



Source: Bloomberg. Data to 30 April 2014.

To gain a better understanding of the outlook for the US energy sector, a number of economists I met recommended that I read the May/June 2014 edition of the "Foreign Affairs" magazine that had a series of major feature articles on energy – all under the banner of "Big Fracking Deal". For all those interested in this industry I would highly recommend you get a copy.

The article "Welcome to the Revolution" by Edward L. Morse states that "the recent surge of US oil and natural gas production has been nothing short of astonishing. For the past three years, the United States has been the world's fastest-growing hydrocarbon producer, and the trend is not likely to stop anytime soon. US natural gas production has risen by 25% since 2010, and the only reason it has temporarily stalled is that investments are required to facilitate more growth."

"Having already outstripped Russia as the world's largest gas producer, by the end of the decade, the United States will become one of the world's largest gas exporters (note – along with Australia), fundamentally changing pricing and trade patterns in global energy markets."

"US oil production, meanwhile, has grown by 60% since 2008, climbing by three million barrels a day. Within a couple of years, it will exceed its old record level of almost ten million barrels a day as the United States overtakes Russia and Saudi Arabia and becomes the world's largest oil producer."

This same article then goes on to talk about the economic benefits of the US energy revolution. It states that "two factors … should bring down prices for a long time to come. The first is declining production costs, a consequence of efficiency gains from the application of new and growing technologies."

"And the second is the spread of shale gas and tight oil production globally. Together, these suggest a sustainable price of around $US5.50 per thousand cubic feet for natural gas in the United States (note: the current Henry Hub spot gas price is around $US4.00) and a trading range of $US70-$US90 per barrel for oil globally by the end of the decade (note the 2014 range for Brent oil has been $US103pb – $US115pb).

"These trends will provide a significant boost to the US economy. Households could save close to $US30bn annually in electricity costs by 2020, compared to the US Energy Information Administration's current forecast. Gasoline costs could fall from an average of 5% to 3% of real disposable personal income. The price of gasoline could drop by 30%, increasing annual disposable income by $US750, on average, per driving household. The oil and gas boom could add about 2.8% in cumulative GDP growth by 2020 and bolster employment by some three million jobs."

Even if all of this is only half-true, it would seem that the potential economic benefits to the US are large and significant. And the geopolitical implications of the US turning from a major importer of oil to a potentially large exporter of oil and gas are likely to be perhaps even more significant!

When I mentioned that Australia was facing significant environmental hurdles in implementing the fracking technology that is a large part of the US energy revolution, I was often met with bewildered stares!

It does seem to me that, perhaps, the environmental issues surrounding the new energy technology are likely to play a much bigger role in the potential exploitation of resources in places like Australia and Europe than they are in the US.

Overall, however, it seems clear that the energy revolution currently underway in the US is the real deal and holds out the prospect of being a significant positive for the medium-term outlook of the US economy.

The Dallas Federal Reserve. Source: First State Investments.

The Fed and Monetary Policy: Approaching the dual mandate

As the Fed has shown in their Federal Open Market Committee (FOMC) meetings so far this year, including most recently on 29-30 July, the process of reducing or 'tapering' the bond purchase program stimulus program (QE3) is set to continue at the pace of a $US10bn reduction per meeting. From an initial program of $US85bn per month, the Fed's QE3 bond buying is now down to $US25bn per month – see table below.

With further meetings scheduled on 16-17 September and 28-29 October, the US Fed will be done with QE3, having already announced in July that the October meeting will see a final $US15bn 'taper' down to zero in bond purchases. **QE3, therefore, ends in October – this is good news!**

Why is this good news? Because the Fed will only continue reducing its QE3 stimulus program if they think that the economy is growing strongly enough to withstand this change in policy. Perhaps more importantly, the Fed will also be expecting that financial markets will be able to function without the extra liquidity they have been providing.

The policy statement following the 29-30 July FOMC meeting did not seem to alter this policy course.

However, **over the next few months/meetings it is my strongly held view that the rhetoric from the US Fed will need to continue to evolve. The key reason behind this is that the Fed is making substantial progress towards its dual mandate of full employment and price stability.**

Up until now and even as the 'taper' of QE3 continues at a steady pace, the rhetoric has largely been along the lines of "there is still plenty of spare capacity in the economy, so official interest rates are going to stay near zero for a very long time." This was even the case at Chair Yellen's Congressional testimony in mid-July and at the 29-30 July FOMC meeting.

But we are now within the 12 month window when official interest rates are expected to rise. Sometime in the next few months, the rhetoric is going to need to evolve to the next phase. The issue is, are the markets ready for this change in rhetoric?...Perhaps not?

In terms of the key events upcoming for the Fed where Chair Yellen may begin this progress of changing the language she is using to describe the outlook and the Fed's reaction function, the following dates will be important. The 20 August Minutes of the July FOMC meeting, the 21-23 August Jackson Hole symposium, the 16-17 September FOMC meeting and the 28-29 October FOMC meeting when QE3 ends.

In my view, there are six key questions confronting the Fed as policy transitions into the next phase in the normalisation process. How the Fed addresses each of these questions will play a critical part in determining how markets move over the months and years ahead.

1. When will the Fed start raising interest rates and begin the policy normalisation process?
2. How will the Fed raise short-term interest rates?
3. What will be the pace of policy tightening?
4. What is the (new) neutral Fed Fund rate the Fed will be aiming for over the coming years? Is it 4%, or 2%, or something in between?
5. What will the Fed do with the $US4.4tr in securities currently on their balance sheet?
6. What will the Fed do about the reinvestment of coupon income back into the bond market?

Let's look at each of these questions in turn.

The US Feds QE3 taper

	QE3	Taper1 Dec 2013	Taper2 Jan 2014	Taper3 March 2014	Taper4 April 2014	Taper5 June 2014	Taper6 July 2014
Monthly bond purchases	$US85bn	$US75bn	$US65bn	$US55bn	$US45bn	$US35bn	$US25bn
– Treasury bonds	$US45bn	$US40bn	$US35bn	$US30bn	$US25bn	$US20bn	$US15bn
– Mortgage backed bonds	$US40bn	$US35bn	$US30bn	$US25bn	$US20bn	$US15bn	$US10bn
Forward guidance	Rates to remain low at least as long as unemployment rate remains above 6.5%.	Rates to remain low well past 6.5% unemployment rate.	Rates to remain low well past 6.5% unemployment rate.	Rates to remain low based on a range of indicators of employment, inflation and financial market developments.	Rates to remain low based on a range of indicators of employment, inflation and financial market developments.	Rates to remain low based on a range of indicators of employment, inflation and financial market developments.	Rates to remain low based on a range of indicators of employment, inflation and financial market developments.

Source: US Federal Reserve.

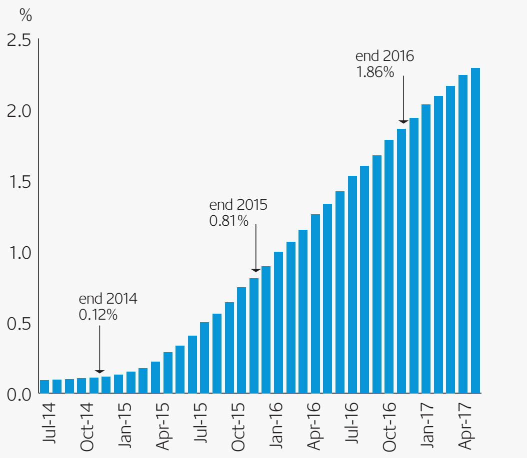
1. When will the Fed start raising interest rates?

My view is very close to consensus, and that is that **the first rate hike from the US Fed will be around mid-2015**, ie. most likely at the 18-19 June 2015 meeting. So we are now within the 12 month window for the Fed to begin raising interest rates.

This is in-line with a number of economists I met with on my trip and a number of members of the Fed have hinted at this timing. However, expectations currently priced into markets are for a slightly later start to the tightening cycle, ie. skewed towards Q3 or even Q4 2015.

Over coming months I would expect the market expectations for the first rate hike from the Fed to shift forwards.

US monetary policy tightening expectations.



Source: Bloomberg. Data as at 31 July 2014.

2. How will the Fed raise short-term interest rates?

This is a much more difficult question to answer, although since July the Fed has begun filling in some details.

In the good-old-days, ie. pre-GFC, the Fed would use the Federal Funds target rate as the major indicator of monetary policy. The Fed Funds rate is simply the interest rate at which banks borrow and lend from each other, usually overnight, to settle balances at the Federal Reserve. The market is dominated by banks regulated by the Federal Deposit Insurance Corporation (FDIC).

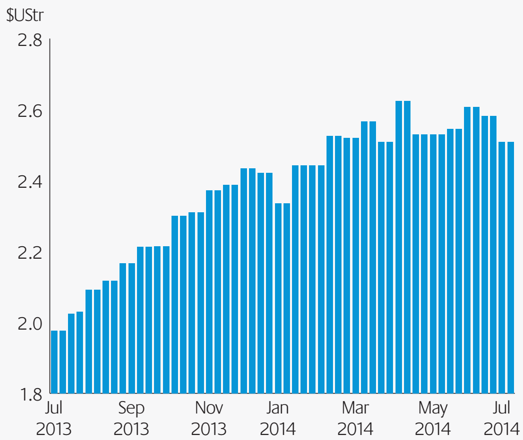
However, the amount of borrowing and lending undertaken by FDIC regulated banks has fallen significantly since the GFC and the short-end of the US financial markets are now significantly less influenced by these institutions.

To force short-term interest rates higher for the whole economy, not just the now more narrowly based banking system; the Fed will need to use other monetary policy tools.

Since October 2008 (ie. not long after the collapse of Lehman Bros in mid-September) the Fed has been paying banks interest on the excess reserves they hold with the Fed. This interest rate, known as the Interest on Excess Reserves (IOER) is currently set at 25bp.

As shown in the chart below, the value of excess reserves (defined as 'balances maintained that exceed the top of the penalty-free band') of the banking system held at the Fed has grown sharply since 2008 and now stands at around $US2.5tr. As the Fed begins to tighten monetary policy, the IOER rate is expected to be pushed higher than the current 25bp. This rate will likely be one of the primary monetary policy tools for the Fed.

Banking system excess reserves at the Fed, $UStr



Source: Bloomberg. Data to 9 July 2014.

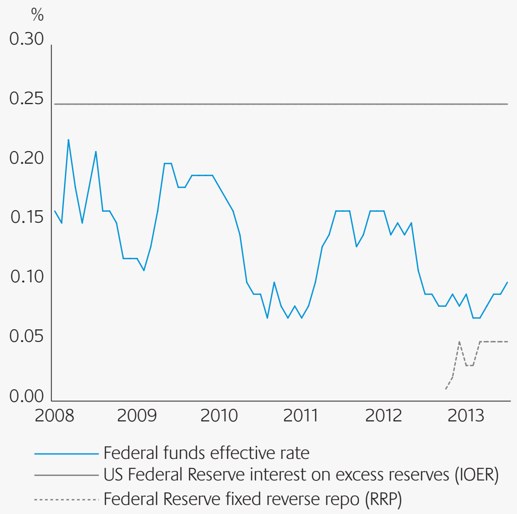
However, one of the key issues here is that a significant proportion of financial market participants in the short-end of the market do not have access to IOER – and that includes money market mutual funds and the major Government Sponsored Entities (GSE) – ie. Fannie Mae.

For the Fed, the need to drain liquidity from the whole financial system, as opposed to just the banking system, and push up short-term interest rates (when the time comes) has seen it develop a new financial instrument – the Reverse Repo Program (RRP).

The Fed and Monetary Policy: Approaching the dual mandate
continued

The Fed Funds effective rate, the IOER, the general collateral repo rate and the RRP are all shown in the chart below. As can be seen the RRP only began operation in September 2013 and is currently at just 5bp.

US short end interest rates



Source: Bloomberg. Data to 31 July 2014.

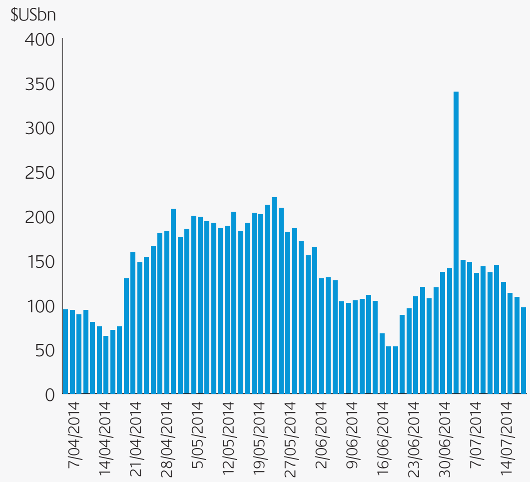
As detailed by the Minutes of the June FOMC meeting, the RRP is expected to be an important part of the Fed's attempts to force short-term interest rates higher.

As stated by Nomura's US Chief Economist (April 29, 2014) the RRP is a "way for the Federal Reserve to give a comprehensive set of market participants a way to earn a set of interest on short-term liquid funds with a highly preferred counterparty. Such transactions, if done with enough financial intermediaries, and in sufficient volume, should be able to provide an effective floor for short-term rates."

Since it started using the RRP mechanism in September 2013 the Fed has been testing the RRP system with a wide range of counterparties (there are currently 139 counterparties, including 18 banks, 94 money market mutual funds, 6 GSEs and 21 primary dealers) and in varying volumes.

Under the RRP the Fed temporarily drains cash from the financial system by borrowing funds overnight from the banks, the money market mutual funds and others, offering them Treasury securities (that are on the Fed's balance sheet) as collateral. The interest rate the banks and other participants in the RRP receive is currently around 5bp, as shown above.

Volume of reverse repo activity, $USbn (RRP)



Source: New York Federal Reserve. Data to 15 July 2014.

According to details provided by the Federal Reserve Bank of New York, an RRP is "an open market operation in which the Desk (of the NY Fed) sells a security to an eligible RRP counterparty with an agreement to repurchase that same security at a specific price at a specific time in the future. Thus, the Desk receives cash from the counterparty and then returns cash at the specific time in the future. The difference between the sale prices and the repurchase price, together with the length of time between the sale and the purchase, implies a rate of interest by the Federal Reserve on the cash invested by the RRP counterparty. When the Desk conducts an overnight RRP, it is selling an asset held in the System Open Market Account (SOMA) with an agreement to buy it back on the next business day. This leaves the SOMA portfolio the same size, but shifts a liability on the Federal Reserve's balance sheet from 'deposits' to a reverse repo while the trade is outstanding."

The key issue here for markets is not just how the Fed plans to raise short-term interest rates, but, as stated above, they must have a clear communications strategy around how rates will be increased.

Fortunately, a good amount of detail around this strategy formed part of the Minutes to the June FOMC meeting. In these Minutes the Fed stated that "most participants agreed **that adjustments in the rate of interest on excess reserves (IOER) should play a central role during the normalisation process.** It was generally agreed that **an RRP facility with an interest rate set below the IOER rate could play a useful supporting role by helping to firm the floor under money market interest rates."**

The Fed then went on to say that "the appropriate size of the spread between the IOER and RRP rates was discussed, with many participants judging that a relatively wide spread – perhaps near or above the current level of 20 basis points – would support trading in the federal funds market and provide adequate control over market interest rates."

Finally, the Fed also reported that "most participants thought that **the federal funds rate should continue to play a role in the Committee's operating framework and communications during normalisation**, with many of them indicating a preference for continuing to announce a target range."

Therefore, it is likely that, when the time comes, **the first attempt by the Fed to raise short-term interest rates will involve an increase in both the IOER and the RRP, with these two rates setting a 'corridor' or band in which the federal funds rate could be allowed to trade.** That is, the RRP will be moved from the current 5bp to a higher rate, while the IOER will be moved from the current 25bp to a higher rate – with the spread between these two rates likely to remain around 20bp.

Nevertheless, despite all the detail in the June FOMC Minutes, **the Fed still has a difficult and complicated communications phase ahead of it.**

This will likely involve further detailed and repeated explanation of the IOER and RRP interest rates and how they will be used to help push short-term interest rates higher.

In the meetings and months ahead the Fed will no-doubt continue with this process. While the bad news is that this is a complicated task, the good news is that in Janet Yellen and Stan Fischer, the Fed has the two best central bankers on the planet to undertake this process – with all due respect to Glenn Stevens and Phil Lowe.

3. What will be the pace of policy tightening?

When the time comes **the Fed is likely to emphasise that the monetary policy tightening cycle will be slow and gradual.**

Indeed, the President of the New York Federal Reserve, William Dudley waded into this territory in a recent keynote speech[2]. He stated that "my current thinking is that the pace of tightening will be relatively slow." He also noted, however, that the pace of rate hikes from the Fed could also be influenced by the behaviour of financial markets. If, for example, the bond market was to sell-off aggressively during the tightening process, the pace of rate hikes could be slowed.

It is worth noting, however, that as at the 17-18 June 2014 FOMC meeting the 16 members of the Board updated their expectations for where the Fed Funds target rate will be at the end of 2014, 2015 and 2016. Even though Fed Chair Yellen as downplayed these forecasts and has stated that they should not be treated literally, they remain instructive.

It is also worth noting that at her Congressional testimony on 15 July, Fed Chair Yellen stated that although the economy was making progress towards the Fed's dual mandate that "a high degree of monetary policy accommodation remains appropriate."

Not surprisingly therefore, as at the June FOMC all but one of the 16 Board members expects the Fed Funds target rate to remain at 0.25% as at the end of 2014.

By the end of 2015, however, the average rate is 1.20%, with three expecting a rate of 1.0% and three a rate of 1.25%. The range of expectations remains a wide 0.25%-3.0%.

Using a rate of 1.25% implies an increase in the Fed Funds target rate from 0%-0.25% currently to 1.0%-1.25% by the end of 2015.

This implies the following timetable for the FOMC in terms of the range that could prevail for the Fed Funds target rate. A more detailed timetable for overall policy is provided in the following pages:

2015	
16-17 June	Fed funds target rate moved from 0%-0.25% to 0.25%-0.50% and other short-rates (IOER and RRP) moved accordingly.
28-29 July	Target rate moved to 0.50%-0.75%.
16-17 September	Target rate moved to 0.75%-1.0%.
27-28 October	Target rate moved to 1.0%-1.25%.
15-16 December	No change in policy rates as Fed pauses to assess impact of policy normalization process.

Footnote:
2. See "The Economic Outlook and Implications for Monetary Policy", William C. Dudley, President and Chief Executive Officer, Federal Reserve Bank of New York, May 20, 2014.

The Fed and Monetary Policy: Approaching the dual mandate
continued

For 2016 the average of the FOMC members expects a Fed Funds target rate around 2.5%, but with a very wide range from 0.5%-4.25%. **By the end of 2016 I have assumed a Fed Funds target rate in a 2.5%-2.75% range,** which would imply a time-table along the following lines:

2016	
Late January	No change in policy rates.
Mid-March	Target rate moved to 1.25%-1.5% (ie. a meeting with a press conference).
Late April	No change in policy rates.
Mid-June	Target rate moved to 1.5%-1.75% (meeting with a press conference).
Late July	Target rate moved to 1.75%-2.0%
Mid-Sept	Target rate moved to 2.0%-2.25% (meeting with a press conference).
Late Oct	Target rate moved to 2.25%-2.5%
Mid-Dec	Target rate moved to 2.5%-2.75% (meeting with a press conference).

2017
Further increases in the target interest rate towards 3.5% would then be expected in 2017.

4. What is the (new) neutral Fed Fund rate the Fed will be aiming for over the coming years?. Is it 4%, or 2%, or something in between?

Perhaps much more important than the pace of change in monetary policy, at least from the point of view of working out fair-value in the bond market, is the question of **what is the (new) neutral official interest rate the Fed is likely to target over the medium-term**.

A significant amount of research by financial markets participants seems to have gone into answering this question and the President of the New York Federal Reserve, William Dudley also discussed this issue in the recent speech noted above.

In that speech William Dudley agreed with the general view that the neutral Fed Funds rate was now likely lower than the previous estimated view due to several factors, such as: more cautious household and business behaviour post the Great Recession, lower potential economic growth rate, including due to changing demographics and the impact of new bank regulation.

The NY Fed President stated that "I expect that the level of the federal funds rate consistent with 2% PCE inflation over the long run is likely to be well below the 4.25% average level that has applied historically when inflation was around 2%. Precisely how much lower is difficult to say at this point in time."

We note that William Dudley also stated that "if my forecast is correct, as growth strengthens and inflation drifts higher, the focus will turn to monetary policy" – as detailed above, we certainly agree.

My view is aligned with the view of the NY Fed President. **The neutral Fed Fund rate has likely declined from previous levels as the effects of the GFC** (or Great Recession as the US calls it) **and demographic changes have likely lowered the long-term growth potential of the US and the level of interest rates required to affect behaviour.**

The real issue is, therefore, how far has the neutral rate fallen. As the NY Fed President implied this is a difficult question to answer and the range of answers seems very wide, from as low as 2% to around 4%.

In answering this question it is important to break up the neutral Fed Funds rate into two components. The first is the expected rate of inflation over the medium-term and the second is the estimated real neutral Fed Funds rate.

My view is that there is a very strong case to assume a 2% inflation rate, on average, over the medium-to-long term in the US. This is the Fed's stated goal and I have confidence that the Fed will achieve this goal over the long term.

To believe, therefore, that the neutral Fed Funds rate is as low as 2%, you must therefore assume that the real neutral rate is 0%. I find this very hard to believe and cannot accept this view.

The real neutral Fed Funds rate can be described as "the real rate of interest that is consistent with the economy growing steadily at its potential"[3] or "as the interest rate that would maintain output at its potential level in the absence of cyclical disturbances."[4]

Through my meetings in the US and observations over many years, I still am of the view that the US economy is dynamic enough to enjoy a period of solid economic growth into the future – even if this pace of growth may have slowed.

Put another way, the long-run potential economic growth rate for the US economy is probably around 2%. To believe that the neutral real Fed Funds rate is 0% would imply a significantly lower long-rate potential economic growth rate than seems realistic or justified.

The real neutral Fed Funds rate is, therefore, probably in a range around 1%-2%, taking into account the long-run potential growth rate of the US economy and market factors.

Footnotes:
3. Nomura research, 2 June 2014
4. ISI, 27 May 2014

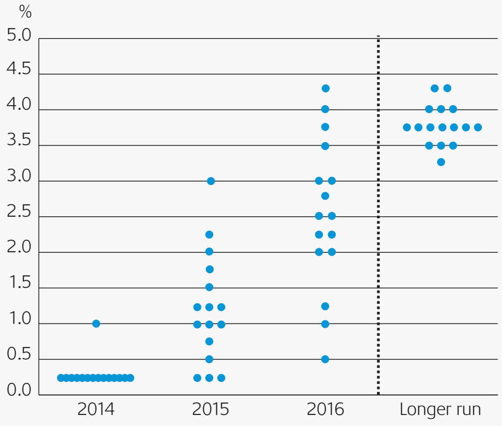
A range of research from economists I respect and who I met with on my research trip to the US (including ISI, JPMorgan, Deutsche Bank and Nomura) place the real neutral Fed Funds rate in a range around 1.25%-1.5%.

This would imply a neutral Fed Funds rate (assuming a 2% inflation rate) of 3.25%-3.5%. This is certainly a lot lower than the 4.25% previous rate nominated by the NY Fed President, but higher than the more-extreme 2% view held by some market participants.

It is also instructive to look at the change in the Fed's thinking on this issue. The FOMC first began publishing their long-run interest rate forecasts in January 2012 and at that time forecast a long-run short-term interest rates at 4.2%, ie. very close to the 4.25% level nominated by the NY Fed President.

By early in 2014 this estimate had drifted down to 3.9% and as at the June 2014 FOMC meeting was down to 3.75%, as shown in the 'dot' chart below. Following the June FOMC meeting, Chair Yellen indicated that this decline was partly due to a downward revision in the FOMC's projections of the potential growth rate for the US economy and partly due to the change of personnel at the FOMC. Specifically this likely includes the views of the new Fed vice-Chair, Stan Fischer.

Expected Fed Funds rate at year end



Source: Federal Reserve June 2014.

The bottom line is, therefore, that **over the medium-to-longer term the Fed is likely to see the (new) neutral Fed Funds target rate as being around 3.25%-3.5%.** This is well below the previous estimates of closer to 4%-4.25%, but significantly above some of the more extreme views currently held by some market participants and academics.

5. What will the Fed do with the $US4.4tr in securities currently on their balance sheet?

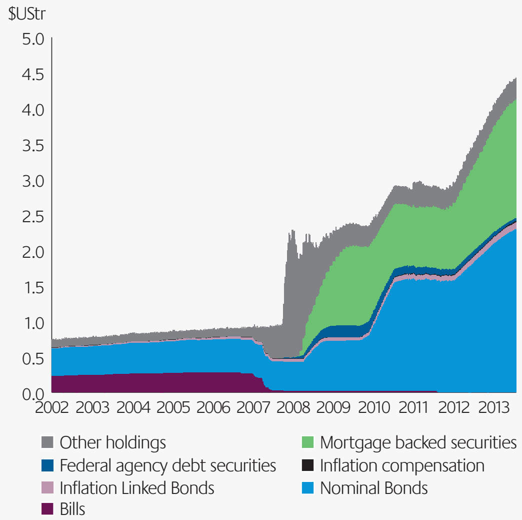
As at late July 2014 the Federal Reserve held balance sheet assets of approx. $US4.4tr, including $US2.4tr in Treasury bonds and $US1.7tr in mortgage-backed bonds.

The question is, therefore, what does the Fed plan to do with these bonds once it starts the monetary policy normalisation process?

The short answer to this question is, I believe, nothing.

I do not expect the Fed to sell any of the bonds it currently holds on balance sheet – either Treasury bonds of Mortgage backed securities – certainly not for the foreseeable future.

Fed's balance sheet holdings (SOMA), $UStr



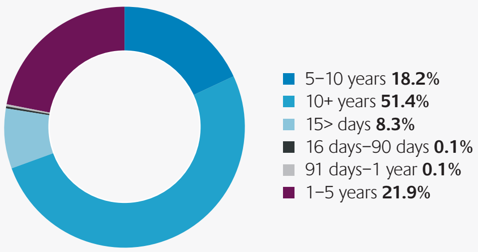
Source: US Federal Reserve. Data as at 11 July 2014.

One of the reasons for this is that the Fed does not want the price (yield) of these securities in the market to be distorted by the Fed adding to supply. **The Fed wants the price (yield) of bonds to be set by the economic and market fundamentals and not by actions of the Fed's balance sheet.**

In addition, the Fed may also be conscience of the 'losses' that could accrue if they sold bonds at a lower price (higher yield) than they were purchased at. The Fed is not a 'hedge fund' and does not need to mark-to-market is bond holdings.

As shown in the pie chart below, more than 50% of the Fed's bond portfolio will not mature for more than 10 years. While around 22% will mature in the next 1-5 years and then 18% on a 5-10 year time frame, **it is clear that it will take many years, ie. more than a decade, for the Fed's balance sheet to return to a more 'normal' size.**

US Fed's bond holdings by remaining maturity – % of total holdings



Source: US Federal Reserve and Strategas. As at 10 July 2014.

6. What will the Fed do about the reinvestment of coupon income back into the bond market?

As part of the 'exit strategy' detailed by former Fed Chairman Bernanke in June 2011, the idea was that the likely first phase of policy normalisation, after the Quantitative Easing program ended, was to cease reinvestment of coupon income.

However, when I was in the US there was significant debate as to whether stopping the coupon reinvestment program will occur before, concurrently or after the first rate hike.

In the May speech by New York Fed President William Dudley detailed above, he stated clearly that "the language in the June 2011 exit principles with respect to reinvestment needs to be revisited."

NY Fed President Dudley then went on to state that "there are two considerations that suggest to me that ending the reinvestments prior to lift-off may not be the best strategy. First, such a decision might complicate the communications regarding the process of normalisation. Ending reinvestments as an initial step risks inadvertently bringing forward any tightening of financial conditions as this might foreshadow the impending lift-off date for rates in a manner inconsistent with the Committee's intentions."

"Secondly, when conditions permit, it would be desirable to get off the zero lower bound in order to regain some monetary policy flexibility. This goal would argue for lift-off occurring first followed by the end of reinvestment, rather than vice versa. Delaying the end of reinvestment puts the emphasis where it needs to be – getting off the zero lower bound for interest rates. In my opinion, this is far more important than the consequences of the balance sheet being a little larger for a little longer."

This subject was dealt with directly in the Minutes of the June FOMC meeting. The Minutes stated that "many participants agreed that ending reinvestments at or after the time of liftoff would be best, with most of these participants preferring to end them after liftoff."

In addition, the Minutes stated that "participants thought that an early change to the reinvestment policy would involve risks to the economic outlook if it was seen as suggesting that the Committee was likely to tighten policy more rapidly than currently anticipated or if it had unexpectedly large effects in MBS markets: moreover, an early change could add complexity to the Committee's communications at a time when it would be clearer to signal changes in policy through interest rates alone."

Further, the June FOMC Minutes also highlighted the view that any end to the Fed's reinvestment program would likely be gradual. The Minutes stated that "a number of participants thought that it might be best to follow a graduated approach with respect to winding down reinvestments or to manage reinvestments in a manner that would smooth the decline in the balance sheet."

It now seems likely, therefore, that **the Fed will stop reinvesting its coupon income into the bond market after the first rate hike**, ie. likely late in 2015.

As highlighted by the June FOMC Minutes, one of the key issues here is that **the Fed wants to return short-term interest rates to the position as the primary vehicle of monetary policy in the US, and make balance sheet management a secondary matter.**

The Fed's policy timeline – a possible path to policy normalisation

In terms of a detailed pathway towards policy normalisation, I would offer the following as a guide:

2014	
Aug–Sept	Official data continues to show growth of around 3%/yr after the very weak Q1 14 GDP report and the solid rebound in Q2 14 GDP. The unemployment rate continues to drift lower and inflation higher in-line with the Fed's dual mandate.
21–23 Aug	Jackson Hole Central Bank symposium. The focus of this year's conference is "Re-Evaluating Labor Market Dynamics" and could be an opportunity for Janet Yellen to talk about the progress made in the US labour market to date.
16–17 Sep	FOMC meeting. Fed 'tapers' QE3 to $US15bn per month ($US10bn Treasury bonds and $US5bn Mortgage-backed securities). Chair Yellen confirms that QE3 will end in October and that the Fed will increase its communication around the next phase in policy normalisation. The Fed's economic projections are updated.
28–29 Oct	FOMC Meeting. Fed 'tapers' QE3 by a final $US15bn and QE3 ends. Janet Yellen continues the communications process around the 'exit strategy' and the rhetoric begins to change – emphasising the progress being made on the duel-mandate and that highly accommodative monetary policy does not mean zero rates forever. She reinforces the need to restore short-term interest rates to their position as the primary instrument of monetary policy and downplays the balance sheet. She highlights that any tightening of monetary policy will be slow and gradual.
Oct–Dec	Official data continues to show growth of around 3%/yr. The unemployment rate continues to drift lower and inflation higher in-line with the Fed's dual mandate.
16–17 Dec	FOMC Meeting. Janet Yellen reinforces the progress being made on the duel-mandate and that monetary policy will need to be normalised at some stage in the near-future. She will also note, however, that monetary policy will remain highly accommodative even as short rates rise from zero. The Fed's economic projections are updated accordingly. More details around the mechanics behind interest increases are discussed.
2015	
27–28 Jan	FOMC meeting. Fed provides more details around the mechanics behind the eventual need to move short-term interest rates higher. Testing period of RRP, which expires on 30 January, is extended. New counterparties could be added and size of allotments increased.
Feb–Mar	RRP full-allotment size increased and used to further test the system and ensure that the majority of financial market participants in short-term money markets can participate to help force interest rates higher.
17–18 Mar	FOMC meeting. Fed reports on workings of the array of short-term instruments of monetary policy and expresses confidence that when the time comes the Fed has the necessary tools to force short-term interest rates higher. Economic forecasts updated and Chair Yellen holds a press conference.
28–29 Apr	FOMC meeting. Fed continues to report on the workings of the array of short-term instruments of monetary policy and expresses confidence that when the time comes the Fed has the necessary tools to force short-term interest rates higher.
Apr–May–Jun	Economic data continues to improve. Unemployment rate is under 6% and close to the NAIRU. Inflation rate is at or above the Fed's 2% target.
16–17 Jun	FOMC meeting. Fed announces first monetary policy tightening, moving IOER rate to 0.50% and RRP rate and other short-term rates, including the Fed Funds target rate, up to a new 0.25%-0.50% range. Fed announces that the re-investment of coupon income from their bond holdings will cease at some stage in the future. Fed announces that they have no plans to sell any of the bonds held on balance sheet.
28–29 Jul	FOMC meeting. Fed announces increase in IOER to 0.75% and Fed Funds target rate and RRP to 0.50%-0.75%. Other short-term interest rates also forces higher through Fed's liquidity management.
16–17 Sep	FOMC meeting. Fed announces an increase in target rates to a 0.75%-1.0% range and IOER to 1.0%.
27–28 Oct	FOMC meeting. Fed announces as increase in target rates to a 1.0%-1.25% range and IOER to 1.25%.
15–16 Dec	FOMC meeting. No change in monetary policy. Fed announces that they will continue to monitor the economic data and continue the policy normalization process in 2016 as required. Fed likely announces the start of a winding down in the coupon re-investment program.

The Treasury and Fiscal Policy: Better Days

US Department of Treasury building in Washington (right next door to the White House).
Source of image: istock.

The Treasury and Fiscal Policy:

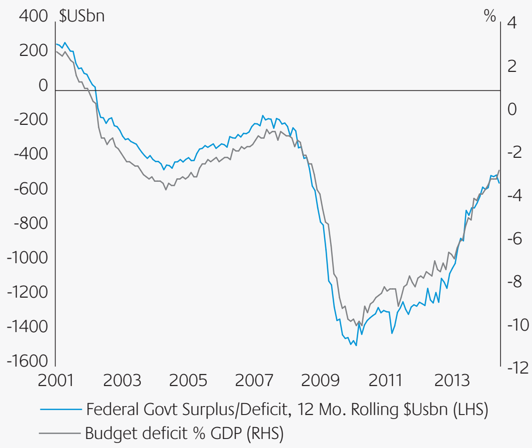
Throughout 2013 and earlier years, financial markets had to deal with a number of key risks. One of these was the fiscal policy 'games' coming out of Washington. With seemingly endless debate over the budget deficit and debt ceiling, this led to the October 2013 government shutdown and a previous credit rating downgrade for the US.

Thankfully, that period is now behind us. **From my meetings in Washington it was clear that the 'adults' are now back in charge of fiscal policy and the threat of destabilising fiscal events have reduced significantly.**

While a formal budget, or a continuing resolution, will need to be passed for the new financial year starting 1 October 2014 (FY15), both the Democrats and the Republicans have agreed to funding levels for the government all the way out to 30 September 2015. There is, therefore, very little risk of a budget related source of instability or 'shut down' until the end of 2015.

Significantly, and this is yet another sign of the economic recovery, the budget deficit is improving very quickly. As shown in the chart below, in the year to June 2014 the rolling 12 month budget deficit was just $US536bn, or around 3% of GDP. This is close to the lowest deficit since just before the start of the GFC and only marginally higher than the average deficit since 1960 of 2.5% of GDP.

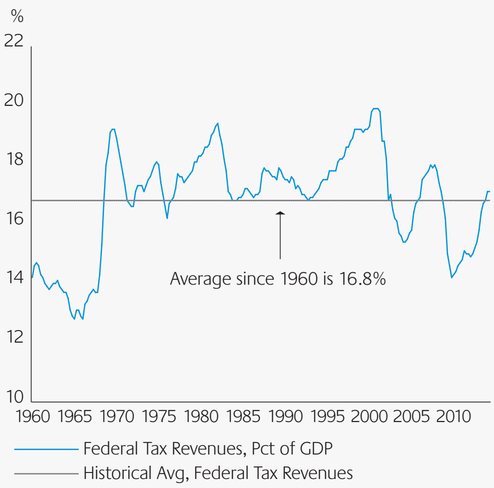
US rolling Budget deficit – $USbn and % of GDP



Source: Congressional Budget Office. Data to 30 June 2014.

It is important to note that this fiscal improvement has come from both sides of the balance sheet. Federal tax revenues are now at 17.1% of GDP, well up from the low around 14% post-GFC and above the average of 16.8% since 1960. This revenue has come from across the board – profits, incomes and capital gains. Indeed, corporate tax receipts are up 28.2%/yr, while miscellaneous tax receipts from various sources are up 13.3%/yr.

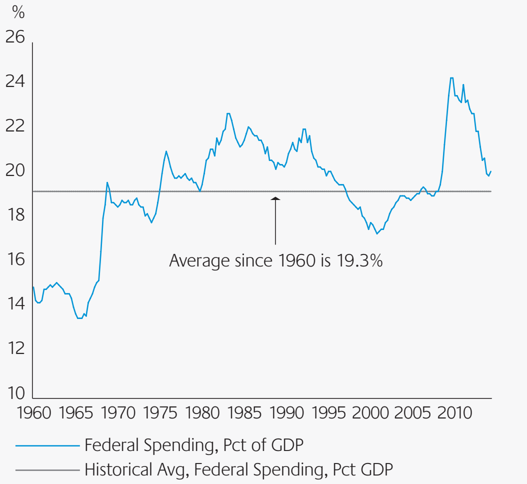
US Revenue as a % of GDP



Source: Congressional Budget Office. Data to 30 June 2014.

Government expenditure is now down to 19.3% of GDP, from a high near 24.5% at the depths of the GFC, and almost down to the post-1960 average of 19.3%. For the largest expense items, the biggest fall in outlays over the past year has been for income security at -6.5%/yr and in defense spending at -10.3%/yr.

US Budget outlays as a % of GDP



Source: Congressional Budget Office. Data to 30 June 2014.

Quite remarkably, however, some of the economists I met in Washington stated that on the current pace of improvement the US could achieve a budget deficit of just 2% of GDP in FY15 and a surplus for FY16.

This could be a major political advantage to the Obama Administration ahead of the November 2016 Presidential election.

However, Congressional Budget Office (CBO) estimates put the Budget deficit at 2.8% of GDP in FY2014, 2.6% of GDP in FY2015 and back to 2.8% of GDP in FY2016.

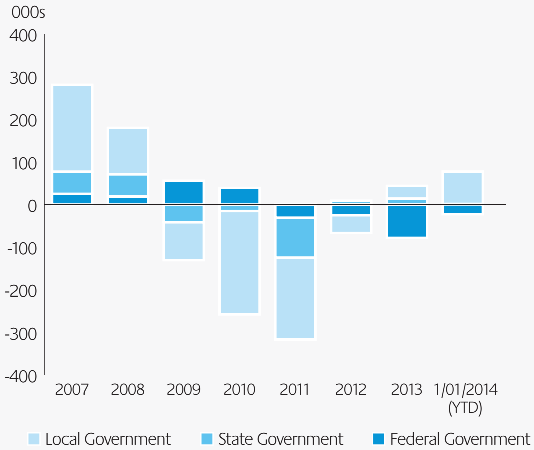
The improvement in the budget is one the factors that will be a key support for the economy this year and in the years ahead. In FY13, Federal fiscal policy subtracted 1.3% points from GDP growth. In FY14 this contraction is expected to shrink to just 0.2% points.

In addition, there is also a substantial improvement in the budgets of the state and local governments. For the financial year just begun on 1 July 2014 (state budgets run on a 1 July-30 June year) a number of states are expected to be in budget surplus.

With 30 state Governors up for re-election in the November mid-terms, there is a growing expectation that a number of state's will be easing fiscal policy in FY15 – likely through a combination of tax cuts and infrastructure spending.

A good way to show this is the fact that state and local government employment has started to rise again – as shown in the chart below. An improvement in state and local budget positions and an upward trend in employment at this level of government will be a very important part of the ongoing US economic recovery.

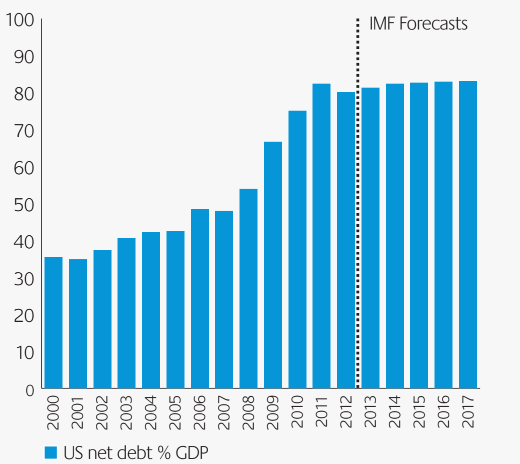
State and Local government employment



Source: Bureau of Labor Statistics. Data to June 2014.

The improvement in the fiscal position is also clearly a positive for US government debt. With the Federal budget deficit for the next few years expected to be below the pace of GDP growth, the government's debt to GDP position is expected to stabilise and then start declining to around 70% of GDP.

US net government debt as a % of GDP



Source: IMF. Forecasts from 2013. Data updated in IMF Fiscal Monitor April 2014.

Politics: Mid-terms and the 2016 Presidential Election

The next time the Federal debt ceiling is due to be looked at again is March 2015. However, with the improvement in the budget and debt position the debt ceiling may not need to be raised – or suspended – again until September 2015.

The improvement in the US budget and debt position is important for two reasons. Firstly, they remove a contractionary force on the economy and, secondly they reduce political risks. Both these factors should be supportive for assets markets in the years ahead.

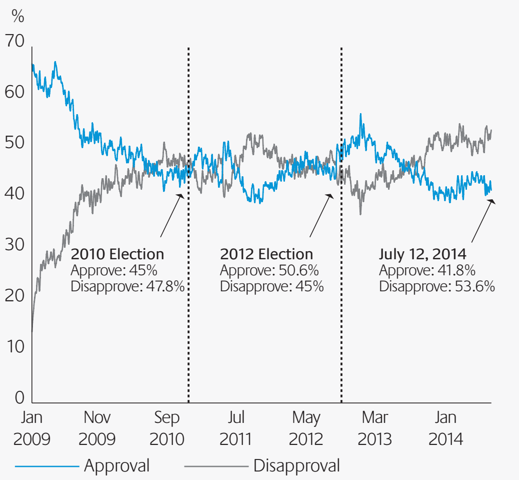
Politics – Mid Term Elections and 2016 Presidential election

While attending meetings and travelling around Washington I found myself thinking about "House of Cards". Many years ago I read the original books by Michael Dobbs and then watched the BBC series – both were excellent. But the current US version is the most incredible window into a world of power, corruption and self-interest – it is addictive viewing.

In Washington I met a number of people that have spent many years observing and participating in the US political process. In these meetings I wanted to better understand if politics in Washington was more like "The West Wing", that is 'a fantasy about what Americans wish their government could be', or "House of Cards" – 'a nightmare of what Americans fear their government has become.'

The key political issue right now in Washington is the November mid-term elections. With President Obama's approval rating stuck in the low-to-mid 40%, there is a growing sense that the Republican Party will gain ground in November.

President Obama 'Approval' and 'Disapproval' rating

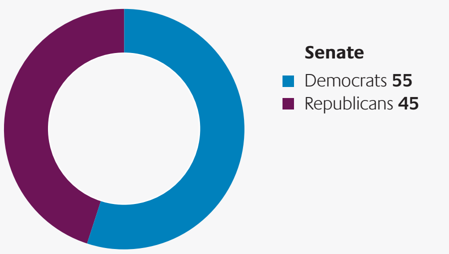


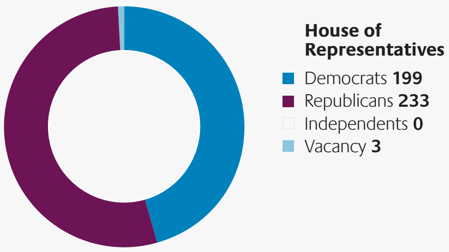
Source: Gallup and Strategas. Data as at 12 July 2014.

Of the 100 seats in the Senate, the Democrats currently hold 55 and the Republicans 45. With the usual one-third rotation of seats, plus a couple of retirements, there are 35 seats up for re-election in November (nominally 21 Democrat and 14 Republican). At this early stage and, importantly, with the primary votes on who will actually be candidates still underway, there appears to be around 12 seats that are 'in play' at the election – that is, in danger of changing hands.

If the current opinion polls are correct, then it looks like the Republicans will be able to win at least the 6 seats they need to gain a majority in the Senate, ie. 51 of the 100. The Republicans will then have a majority in the both the House of Representatives (234 of 435) and the Senate.

The House of Representatives and the Senate





Source: US House of Representatives and Senate.

But it is important to note that, given the US political parties rarely vote as a block, the key number to 'control' the Senate is 60, as that is how many votes are needed to suspend debate on legislation. So while the Republicans are likely to have a majority in both Houses, they will not 'control' both Houses.

Nonetheless, from November 2014 to the Presidential election in November 2016 the US will likely have the Republican Party dominating both the House and Senate and a Democratic President. Under this scenario there are likely a few key areas of policy that will be a priority.

The White House on a lovely spring day.

The first is health policy, ie. Obamacare. Even the President would likely admit that the implementation of his signature policy has not gone as smoothly as he would have liked. While the President is not likely to agree to any substantial changes on health care, he could be persuaded to make some changes at the margin.

Second is fiscal policy, or more specifically entitlement and tax reform. As discussed above, fiscal policy has largely been agreed until 1 October 2015, but there could well be a push for further reforms in the year ahead of the 2016 election, especially a move to lower tax rates, both for income and company tax.

Thirdly the focus will be on energy policy. The Republicans are likely to push hard to allow further exploitation of the US new found energy sources and the technology (ie. fracking) needed to access this energy.

There is also likely to be a bigger push to allow the export of energy, both gas and oil, that would bring substantial income into the US.

In addition, the minimum wage and immigration policy are also likely to remain key political issues.

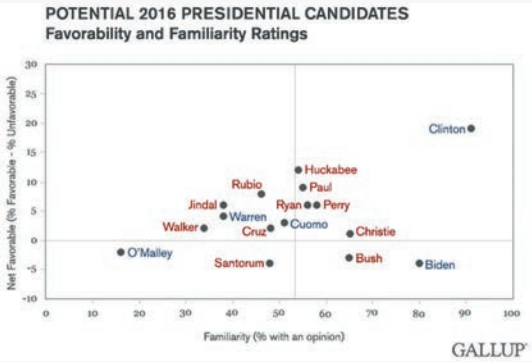
The other focus on the political field is the 2016 Presidential election. With the very large caveat that there is still over 2 years to go, it seems that the Presidential election can be summarised in one short sentence – Hillary Clinton v everybody else.

Hillary Clinton has not yet declared that she is running and if she does she will be the second oldest (she turns 69 in 2016) first-term President – after Reagan – and she has had some health issues.

But, as my contacts confirmed, she is showing all the signs of wanting to run (ie. she has just released a book). **The bottom line is that if Hillary Clinton does decide to run, she will likely be very difficult to beat and will become the first female President of the United States.**

Lincoln Memorial at night – Very impressive. Source of image: istock.

Recent opinion polls (Gallop, 17 July 2014) have Hillary Clinton at a net ‘favourable’ rating of +19pts (55% favourable and 36% unfavourable) and a 91% recognition rate. The chart below shows further details.



Source: www.gallup.com. Data as at July 2014.

If Hillary Clinton does not run the rest of the Democratic Party is likely to be very unhappy, as this will leave the other potential candidates with a late run. In the event Hillary does not run other potential names mentioned to me include Elizabeth Warren (Senator Massachusetts), Andrew Cuomo (Governor New York), Joe Biden (Vice-President), Martin O’Malley (Governor Maryland) and Deval Patrick (Governor Massachusetts).

On the Republican side, there is a long list of potential Presidential candidates – some of which are already familiar and some relative unknowns.

Top of the list is Jeb (John Ellis) Bush (ex-Governor Florida), the younger (and generally considered smarter!) brother of President George W. and second son of President George Bush. Although he seems to be the favoured candidate among Republicans, Jeb is reportedly undecided as he has some family issues that could take priority.

Alternatives to Jeb Bush include Chris Christie (Governor New Jersey), but he has had some recent controversy, and Mike Huckabee, former Governor of Arkansas and a Presidential candidate in 2008. Other names mentioned were Rick Santorum (ex-Senator Pennsylvania and 2012 candidate) – who I heard say in a TV interview that ‘a well armed family is a safe family’ – Mitch Daniels (ex-Governor Indiana), Rick Perry (Governor Texas), Rand Paul (Senator Kentucky), Paul Ryan (Wisconsin and 2012 vice-President candidate), Marco Rubio (Senator Florida), Ted Cruz (Senator Texas), Piyush ‘Bobby’ Jindal (Governor of Louisiana), John Kasich (Governor Ohio) and Scott Walker (Governor Wisconsin).

However, rather than select yet another rich, middle-aged white male, there is a school of thought that the Republicans will need to choose a candidate that could counter some of the more significant characteristics that Hillary Clinton would bring.

That is likely mean that the Republicans could also select a female Presidential candidate. The two women most mentioned on my trip and in my discussions were Susana Martinez (Governor New Mexico) and **Condoleezza Rice** (former Secretary of State and now at Stanford University as the director of the Global Centre for Business and Economics).

There is no doubt that whoever makes a run, that the nomination process and the 2016 US Presidential election will be fascinating to watch unfold.

Financial market implications:

One of the key aims from my research trip to the US was to consider the financial market implications of the economic and policy outlook. For the key markets, my expectations are as follows:

The US equity market:

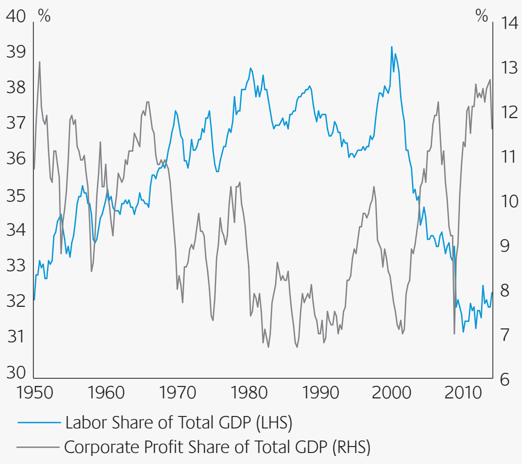
For the equity market, the general view is that the next few months could look a lot like the last few months – a solid market in a tight range. This is based on the idea that the equity market has already priced in the expected improvement in the US economy through 2014 – although as stated above, there were a number of risks that could unsettle things.

One of the key risks was considered to be the geopolitical situation in many places around the world, such as the Ukraine, Israel-Gaza and Iraq. But for most economists, including myself, this is a factor where we have little expertise to add.

Another key risk for the equity market was, however, the outlook for wages and, more broadly, total labour costs. After a number of years of softness, not a surprise given the weakness in the labour market, wages growth has started to pick up.

This is expected to see the wages share of the economy rise consistently from its current very low level, at the cost of the profit share of the economy. This could be a potential negative for the equity market.

Wages share of economy and profits share



Source: Bureau of Labor Statistics. Data to 31 March 2014.

Another potential negative for the equity market could be an inflation scare and the implications for the bond market – discussed below.

In addition, the expected pick-up in capital spending, while vital for the economy, could see dividend payments and share buy-backs reduced, putting some short-term downward pressure on equities.

My view is that the equity market could face a number of potential hurdles in the months ahead, as the Fed begins to change its rhetoric and bond yields head higher.

A realisation by the equity market that the period of Fed liquidity injection and zero interest rates is coming to an end could see volatility return to the equity market, from its current very low levels – see below. In addition, the wages and capex developments that I have described above could also weigh on the equity market over the second half of 2014 and into 2015.

The risk is, therefore, that the US equity market declines from its recent record high levels over coming months, as the 'priced for perfection' period comes to end.

However, as the time for the first rate hike from the Fed draws near, the markets may well re-focus on the fact that the start of the Fed's tightening cycle is based on a much more positive outlook for the economy. And **this should prove supportive for the equity market through much of 2015 and beyond.**

The bottom-line is that corporate balance sheets are in good shape and the economy is expected to continue to recover – with growth broadening and deepening.

The S&P 500 Index and P/E ratio

Source: Bloomberg. Data to 31 July 2014.

Financial Market Implications: Bonds, equities, US dollar

continued

US Bond market:

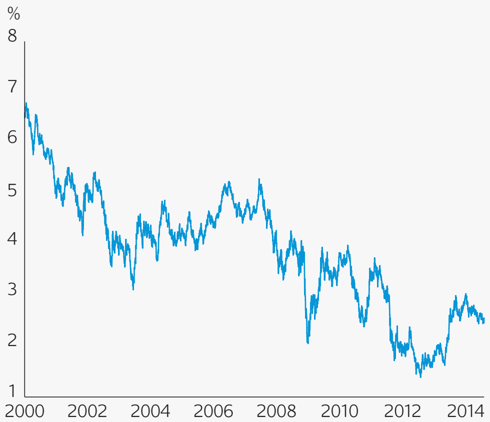
For the bond market, the good news is that consensus agrees with my view. The economic outlook implies a cyclical increase in bond yields, with, for example, 10 year Treasury yields expected to trade up to around 3.0% through to the end of 2014 and higher to 3.25%-3.5% in 2015. The bad news is that consensus agrees with my view – and this trade has, at times, been very crowded.

There are lots of theories as to why bond yields have remained relatively low this year (mainly based on geopolitical events and related 'safe haven' buying, low bond yields in Europe and Japan drawing investors to the US market, the weather affected data and the view that the 'neutral' Fed Funds rate had declined from 4% to closer to 2%), but there were more people than I thought likely on my US trip that highlighted an upside risk to inflation. This could see US bond yields push sharply higher at some stage in the future. Indeed, a rise in inflation was seen as the most 'under-priced' risk for markets.

This upside risk to inflation was expected to come from some technical factors, as well as the expected rise in labour costs and the wages share of the economy. Not only could this see inflation itself move higher, unsettling the bond market, but it could also bring the Fed to start raising interest rates earlier than generally expected. This is not the base case, but certainly a risk.

The bottom-line on the bond market is that there looks to be more risks that could push bond yields higher, rather than risks that could see a substantial rally from current levels. Under this scenario 10 Treasury year yields could be trading around 3.0% into the end of 2014 and around 3.25%-3.5% through 2015.

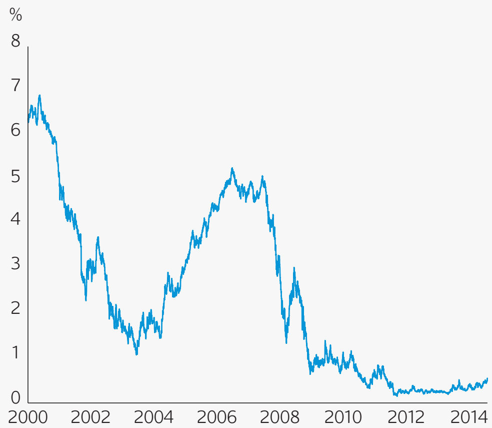
US 10 year Bond yields



Source: Bloomberg. Data to 31 July 2014.

The other likely trend is for a flattening of the US yield curve, with shorter-dated yields selling off further than longer dated. As can be seen in the chart below, 2 year bond yields have only just begun to move higher again over recent times. As the market continues to move towards the view that the Fed Funds rate is likely to be around 1.5% in 2 years' time, current US 2yr bond yields at near 0.55% will look increasingly expensive.

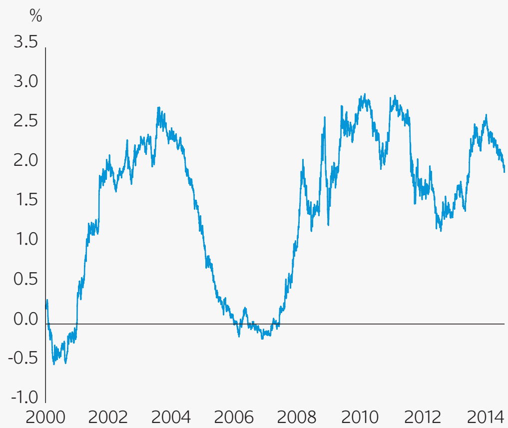
US 2 year Bond yields



Source: Bloomberg. Data to 31 July 2014.

This trend, of rising 2 year bond yields and a move higher in 10 year yields, is expected to see the US yield curve continue on its 'bear-flattening' trade – as shown below.

US 10yr – 2yr yield curve

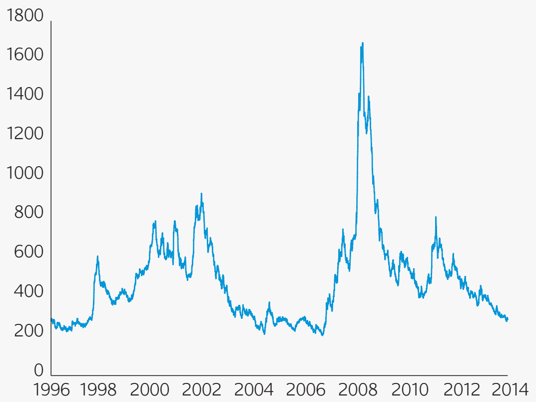


Source: Bloomberg. Data to 31 July 2014.

I also met with an economist who warned of **potential dangers in the corporate or high-yield (HY) bond markets**, with the very low level of HY yields and their tight spreads to Treasury bonds likely unsustainable.

The price-makers of these securities are running very low inventories and have a very low desire to hold stock on their balance sheet. Any desire by the holders of HY bonds to sell some of their holdings is likely, therefore, to be met with sharp moves in prices as price-makers may not want to add to their inventories. **There is, I was told, the 'veneer of liquidity' in the corporate bond market.**

US High-Yield spread to Treasury index

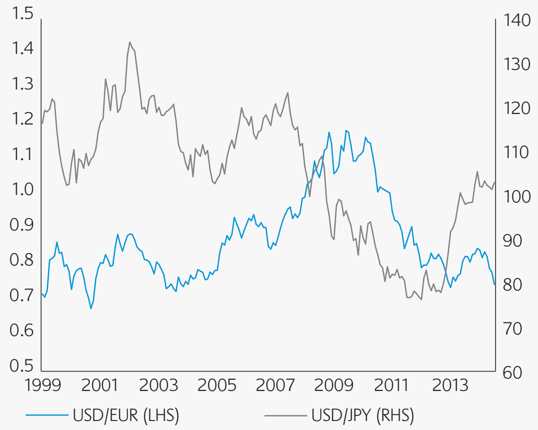


Source: Merrill Lynch. Data to 17 July 2014.

On the USD the consensus, once again, agrees with my base case that **the economic and policy outlook in the US favours a stronger USD**. This is likely to especially be the case against the EUR and the Yen, where both the European Central Bank (ECB) and Bank of Japan (BoJ) are still easing monetary policy.

Of course, this has been the situation for some time and the USD has failed to appreciate much. But is where the fundamentals lie, and I am going to stick to that view.

USD v EUR and Yen



Source: Bloomberg. Data to 31 July 2014.

Financial Market Implications: Bonds, equities, US dollar
continued

Volatility:

One of the key characteristics of financial markets over the past year or so has been the big decline in market volatility. As shown in the chart below, as measured by the VIX index, market volatility is current at the lowest level experienced at any time since the start of the GFC.

This very low market volatility seems to be based on the view that the major central banks will continue to add to liquidity in markets and that, with inflation low and well behaved, any tightening of monetary policy remains a long time off and that official interest rates will be low for a long time to come.

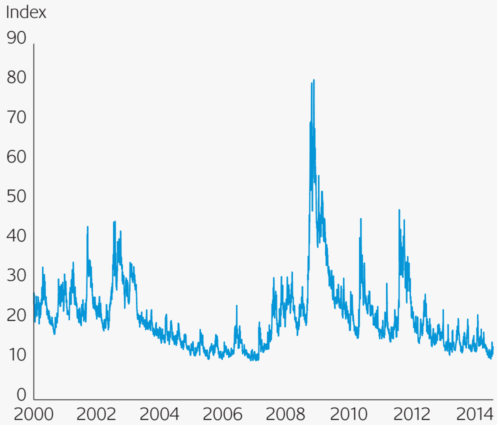
As discussed above, **I am of the view that the time for the start of the monetary policy normalisation process in the US is drawing near and that markets are underpriced for this risk.** While the European Central Bank and the Bank of Japan are likely to retain highly accommodative monetary policy well into 2015 (and beyond) it is my view that a number of central banks will be raising official interest rates over the next year or so.

Apart from the US Federal Reserve, this will also include further rate hikes from the Reserve Bank of New Zealand (where rates are already up from a low of 2.5% to 3.5%), the Bank of England (where rates are expected to rise late this year), the Reserve Bank of Australia (with an interest rate hike expected in the first half of 2015) and the Bank of Canada (with the first rate hike expected in H2 2015).

Put another way, over the year ahead I believe there will be a generalised trend to higher official interest rates across the $ Bloc nations, while both Japan and Europe will be retaining highly accommodative monetary policy.

Under these circumstances it seems highly likely that an increase, and perhaps a significant one, in market volatility could be expected to occur.

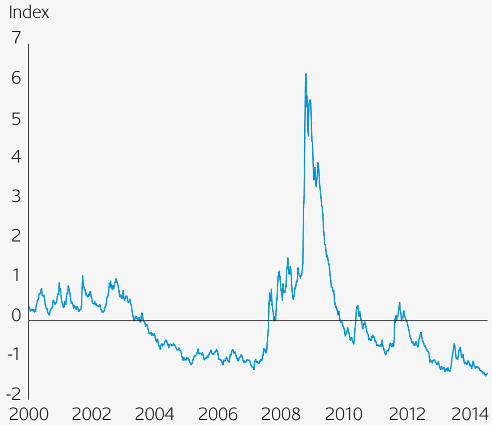
Market volatility is extraordinarily low – as measured by the VIX



Source: Chicago Board Options Exchange SPX Volatility Index. Data to 31 July 2014.

This very low level of volatility can also be seen in the St Louis Fed's Financial Stress Index, which is shown below.

St Louis Fed Financial Stress Index



Source: Bloomberg. Data to 18 July 2014.

Wall St. Source of image: istock.

Conclusion: As is

For almost two weeks I travelled in the US getting a better understanding of where the economy and policy are headed and, most importantly, what the implications are for financial markets. I held a series of meetings with economists from a number of independent research providers, banks, hedge funds and Fannie Mae, as well as key policy makers from the Federal Reserve and the Treasury.

I started my trip with a relatively positive view on the US economic outlook and this remains the case. There are, however, **clearly more risks than I had appreciated.** And, if the still very low bond yields in the Treasury bond market are any guide, **investors remain very skeptical about the outlook for both the economy and policy.**

Despite the very poor Q1 14 GDP report, which was significantly affected by the brutal winter weather and the measurement of health spending, **I believe the US economy is firmly in recovery mode.** This was well demonstrated by the strong bounce in the Q2 14 GDP report.

Fiscal policy will go from being a big negative on growth to a neutral and the housing market is now a neutral. But the labour market is strengthening, wages are beginning to rise, the consumer is improving and the forward indicators on capital spending are all turning positive. I expect GDP growth to accelerate to around 3% in H2 2014 and maintain this pace into 2015.

Inflation is likely to remain moderate, but move a little higher through 2014 and into 2015 to closer to 2%, rather than the previous levels around 1.5%-1.75% (as measured by core PCE). But, **the risk on inflation is to the upside**.

The firming in the labour market and gains in wages could see the trend in inflation continue to turn up, and there are some technical factors around the measurement of the CPI and medical costs that could see measured inflation trend higher. **Sharply higher inflation is not the base case, but it is probably the risk the market is least prepared for.**

The fiscal situation is improving rapidly, both as a result of the better economy (revenue as a share of GDP is rising) and as a result of the sequester and budget deal done last year. The deficit could shrink to around 2.5% of GDP in FY15, from around 10% of GDP a few years ago. This should stabilise total government debt/GDP at around 70%.

The rapid development of the energy sector is the real deal. This could significantly lower the cost of energy in the US and make the US a major energy exporter.

For the bond market I am left with the strong view that the macro-economic fundamentals point to higher yields. Growth is accelerating, as will inflation. Expected nominal GDP growth of 4%-5% means bond yields at current levels look very expensive.

I expect 10yr yields to trade 3.0% through to the end of 2014 and higher towards 3.25%-3.5% in 2015. The problem with this view is that it is also consensus and has, to date, been a difficult view to hold as 10 year bond yields remain range-bound at very low levels around 2.4%-2.6%.

There are a number of reasons why the bond market has defied expectations of higher yields.

The expected growth acceleration is not yet 'in the bag'; the housing activity data has disappointed to the downside and housing is seen as critical to the recovery; inflation remains lower than most expected at this point in the cycle; there has been safe-haven buying on events in the Ukraine and northern Iraq; the long-term terminal Fed Funds rate has likely declined from 4% to 3.0%-3.5% (some think even lower) and this is pulling down nominal yields; and the portfolio rebalancing out of bonds and into equities has largely run its course.

To me this is not a reason to get bullish on the bond market – it has just delayed the inevitable increase in bond yields as both growth and inflation head higher in the months and quarters ahead.

For the equity market – the outlook is mixed. The positive for equities is that corporate balance sheets are in great shape, management is moving from 'survival' strategies to 'growth' strategies and the economic recovery is broadening and deepening. The negative is that the wages increase that is now underway is likely to see the wages share of GDP rise, from current very low levels, meaning that the profit share of the economy will decline.

In addition, companies are moving into a stronger capex phase and are likely to need to reduce their dividend payouts, stock buy-back and M&A activity.

The result is likely to be increased volatility in equity markets and a choppy trading range. Into 2015, however, I suspect that the better economic fundamentals will prevail and the equity market will head higher.

The big question is what does the Fed do? A further 'taper' of the bond purchase stimulus program (QE3) at coming FOMC meetings is seen as a given. As we now know, the Fed has acknowledged that **QE3 will end at the October FOMC meeting with a final 'taper' of $US15bn**.

The next phase for the Fed is, however, the most dangerous. For the remainder of this year and continuing through early 2015 the Fed (mainly Chair Janet Yellen and vice-Chair Stan Fischer) **will need to continue to communicate the strategy for not just the timing on rate hikes, but the technical aspects on exactly how they plan to sequence their policy moves.**

The Fed will need to continue to explain how they propose to force the Fed Funds target rate higher, which is likely to be via draining reserves from the system via the IOER (interest on excess reserves) and the reverse repo program (RRP).

The Fed will also need to confirm at what point they will no longer be re-investing coupon payments back into the market, but state clearly that they will NOT be selling any of their bond holdings.

The Fed is expected, in June 2015, to start raising the target rate by 25bp at almost every meeting. This will take interest rates from 0%-0.25% currently to a 1%-1.25% by the end of 2015, 2.5%-2.75% by the end of 2016 and to 3.5% sometime in 2017.

The sequencing of these policies will be critical, as will be the communications strategy. As shown in the 'taper tantrum' of 2013, the risks from miscommunication are high.

On the political front, President Obama's approval rating is stuck at low levels around the mid-40% range. **There is a general expectation that the Republicans could win the required six seats at the upcoming Mid-Term elections to gain a majority in the Senate** (ie. they currently hold 45 of the 100 seats).

So we will have a Republican majority in both Houses and a Democratic President from end 2014 to the general elections in November 2016. A situation that is not usually a recipe for significant policy action.

For the 2016 Presidential race there is Hillary Clinton vs everybody else. If she decides to run, Hillary will be the second oldest first-term President (69) – after Reagan – and she has had some health issues. But she is showing all the signs of wanting to run and will be very difficult to beat (at this very early stage).

On the Republican side the favoured candidate is Jeb Bush. There is a long list of other potential candidates, including Condoleezza Rice (ex-Secretary of State and now at Stanford University). This is going to be fascinating to watch....more like "House of Cards" than "The West Wing"!

I trust that you have enjoyed this research report, as well as my blogs and video from my US *Travelling Economist* trip. I hope that you have found the information useful in helping to guide your investment decisions.

All comments and questions are welcome and I look forward to discussing my findings with our clients and investors.

The real Washington? Source: First State Investments

Acknowledgments

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- Deutsche Bank
- Fannie Mae
- ISI Research
- JP Morgan
- Nomura
- Observatory
- Strategas
- US Department of Treasury
- US Federal Reserve

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