

CAPITAL MARKETS ECONOMICS

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Special Report: New Tools And Mitigating Factors Could Accompany Fed Tapering

Attempting to time the potential for tapered asset purchases by the Federal Reserve to the exact policy meeting entirely misses a far more important but absent discussion on how the Fed could use a variety of potential communication tools to assuage investor fears that the Fed will not run and hide in the face of potential concomitant market turmoil. Indeed, tapered asset purchases do not have to be the end of the world for Treasuries and MBS or financial markets in general. We know that the Fed must eventually taper purchases before owning inordinately high shares of the targeted markets. There are, however, ways in which the Fed can use communication tools to address market fears and we make a few such suggestions. This note is therefore intended to be a reminder that an entire FOMC special subcommittee is at work on communications strategies at the Fed, and the work of this committee is at least partly oriented toward ensuring that Fed actions strike a balance between risks to continued stimulus versus greater risk associated with premature policy exits that would short-circuit a still fragile recovery. Differences of opinion on timing the tapering of purchases that deviate only a few months from one another potentially miss the far more important evolution of the next wave of stimulus measures that could be employed by the Federal Reserve. We also provide comments on mitigating influences that may co-exist with tapered asset purchases that are nevertheless not under the Federal Reserve's direct control and influence.

1. Potential Additional Tools

We start by reviewing the Fed's options in terms of potential new policy tools that may be introduced alongside policy tapering.

a. Slower, But Longer — Most Likely

The Fed could hint at program duration and/or magnitude in addition to lowering monthly purchase volumes. A lengthened signal on the period of buying could mitigate risks associated with tapering such that markets could develop more informed opinions on the ultimate size of the QE3 program. The Fed has tended to emphasize that the stock effects associated with purchase activity are more important than the flow effects. It would entail including language to the effect that the Fed sees progress but is not yet satisfied with the pace of improvement in the economy such that it will continue to add reduced stimulus for a significant period of time.

b. Yield Comfort Zone — Also Plausible

Another option that could accompany reduced purchases would entail defining a comfort zone for Treasury yields. This could be done subtly by stating that the Fed will support the Treasury and MBS market as needed in support of a continued economic recovery. Or, the Fed could state that it is mindful of risks facing markets in response to a slower pace of purchases and will monitor financial conditions carefully while acting accordingly to offset or ease potential dislocation in financial markets. There is an army of very bright people involved in communication strategies at the Fed who are far better able to convey such sentiments, but I would not be the least bit surprised to see such a development accompany tapered asset purchases.

c. Yield Caps — Unlikely

A more extreme form of such action would be to instead announce an explicit yield cap. Language could signal an unwillingness to allow US Treasuries to rise above a specific yield threshold, or a specific range.

Options (b) and (c) would both be a Fed twist on ECB President Mario Draghi's conditional bond buying. Just as Draghi's conditional bond buying program eliminated the Eurozone break-up premium in bunds and collapsed spreads across more challenged European sovereigns, the threat of bond buying could work powerfully at the Fed.

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A risk is our view that Draghi has cemented moral hazard into the European market by reducing incentives for politicians to remain committed to structural and fiscal reforms.

This risk may be lower in the US than Europe given the path toward US deficit repair from 10.4% of GDP at the peak to under 5% likely next year and in part due to the checks and balances that exist in the division of powers within the US executive and dual chambers of Congress. This also shows up in our expectations for Treasury issuance that we'll return to in a moment. Whether by accident or design, the US is gradually achieving improved deficits, albeit at a slower pace than may be desired. If Bernanke takes this tack, then it is likely to be accompanied by continued warnings to Congress to put in place a credible path toward deficit repair.

Yield caps are dicey, however, as they connote an artificially precise magic number that is more likely to be tested than a more subtly nuanced range. The Fed has also had an at best mixed experience with yield caps long ago. The effort toward containing yields is better conveyed through more subtle language that connotes greater policy flexibility as circumstances evolve. The Fed could actually have its cake and eat it too in that it could taper, and thereby reduce concern in some corners that heavy buying will box them in by way of inordinately high shares of the stock of debt, but still control yields via the threat of action if vigilantes start smelling blood.

d. Nominal GDP Targeting — Least Likely

I don't expect the Fed to go down this avenue by stating that it will maintain a stimulative stance until the economy is restored to a targeted nominal GDP trend line, but it could be one communications experiment in addressing tapering risks that would be even more extreme.

I believe this to be the worst possible option in that it is fraught with risk. That's because I don't think central banks should signal total indifference over achieving higher nominal output entirely through higher volumes, or entirely through higher inflation, or any combination of the two. Also, setting the starting point for an NGDP trend line, and at what rate to grow it over time are entirely arbitrary exercises. For instance, some speculate that the BoE may come to entertain NGDP targeting under Governor-designate Carney (a view we don't share). If the BoE were to adopt NGDP targeting, then starting the trend line in, say, 2000 would still have the UK economy actually above a reasonable NGDP trend line because policy was arguably too loose for years before the crisis. Being above trend would imply the need for abrupt policy tightening now. Starting such a trend line in 2008, however, would still characterize the economy to be well below such a trend line. There are enough vagaries to the conduct of monetary policy without embracing such an arbitrary experiment.

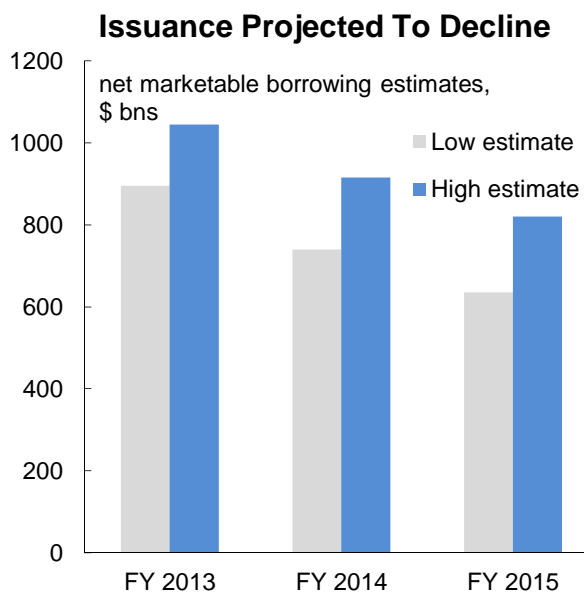
2. Potential Mitigating Factors

There are at least two forces beyond the Fed's influences that may also mitigate the impact of tapered asset purchases. The Fed could, however, draw reference to such influences in its communications.

a. Tapered Supply

One mitigating factor is that as the US government's deficit improves from a peak of 10.4% of GDP to under 5% next year, reduced Treasury issuance will result. As the Fed tapers demand, the supply side could simultaneously move lower. This could be a powerful supply side influence. As the accompanying chart demonstrates, Scotiabank Economics projects that net marketable borrowing by the US government in 2014 could decline by \$130-155 billion from 2013 borrowing estimates and then another roughly \$100 billion by 2015. This translates into an average monthly decline in net marketable borrowing of around \$12 billion in 2014 from 2013 borrowing estimates, and another \$8 billion in 2015. Compared to the current pace of \$45 billion in monthly Treasury purchases by the Federal Reserve, only a portion of the reduced buying could be offset by reduced supply pressure, but it would help. For instance, the Federal Reserve could taper purchases to, say, \$30-35 billion per month into 2014 and this would be significantly offset by reduced supply pressures. The implications for duration vary

Chart 1



Source: Scotiabank Economics.

significantly, however, according to how issuance buckets evolve in relation to the flow of buying across these same maturities.

b. Easier Credit

A second market force that could accompany somewhat higher rate risk concerns credit availability. To an extent, today's mortgage rates represent an untouchable temptation. Credit is simply not available to many American mortgage borrowers. This is, changing, however, and in favour of a slight move toward easing mortgage credit conditions. It is entirely possible that this move continues in favour of further easing and hence improved mortgage credit availability into 2014 and beyond. If so, then somewhat higher mortgage rates that nonetheless remain low could be offset by a higher probability of securing credit. Simply put, a mortgage at, say, 50-100 bps higher rates than today's is better than no mortgage at all. This would hardly be the first time that coming out of a period of economic weakness results in both rising rates and easier credit.

3. Conclusion — The Fed Is Still Filling In Behind Broad Money Destruction

In summation, if the Fed reduces purchases and leaves everything else intact, then markets will be in a state of upheaval. This, in my opinion, would be a policy error and it would repeat the Fed's tendency to follow an erratic commitment to stimulus that risks Chairman Bernanke's past criticisms of the Bank of Japan reverting back upon the Fed itself.

The Fed could alternatively taper and accompany this with soothing guidance to markets by essentially employing new stimulus tools but doing so within reason (i.e., not NGDP). Such a framework would be tested by markets, and so there are no guarantees of success, but this also emphasizes the importance of improved clarity of communication by all FOMC officials during the exit phase. I expect tapering to be accompanied by other tools and mitigating factors that we have attempted to describe, but not yet. Summertime tapering remains unlikely in my opinion, versus more toward the end of the year after summertime uncertainty regarding 1. the manufacturing outlook, 2. the sustainability of the way in which US consumers funded Q1 consumption growth, and 3. the sequester's effects have all been evaluated in the context of ongoing uncertainty over the impact of US budget and debt ceiling negotiations. I also expect no asset sales for years, such that a reduction in the Fed's balance sheet will only occur through run-off of maturing securities that will carry duration implications going forward.

At issue remains the need to fill in behind the broad money destruction that the crisis brought on. The fact that very broad money remains flat five years into the crisis in contrast to the explosive growth in the Fed's balance sheet over this same period is why inflation fears are overblown in my opinion, and why talk of asset bubbles is exaggerated. Chart 3 makes this point by showing the Fed's balance sheet on the right hand axis, versus a largely flat but much broader definition of money on the left hand axis. For more on the definition of this broad money aggregate that attempts to track the Federal Reserve's former broad money aggregate named 'L' [go here](#).

Nevertheless, economics is hardly such a precise field that economists can justify expending much effort toward nailing the precise meeting at which such tapering decisions are taken. Deep conviction over the timing issue is amusing, not substantive. What is of far bigger consequence to markets is not this precise timing, but how it is communicated to markets. On that, a fair assumption may well be that the Fed will not do anything so foolish as to reduce purchases without spending a great deal of effort upon improved communication and other tools to accompany such an eventual decision.

Chart 2 Mortgage Availability Slowly Improving

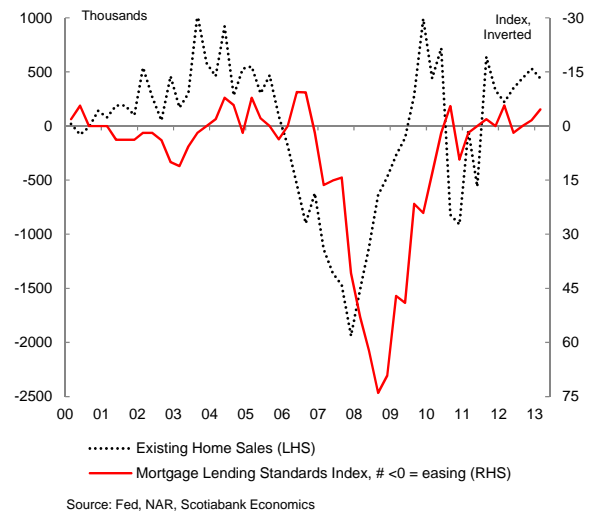


Chart 3

Fed's Balance Sheet Only Filling In Behind Broad Money Destruction

