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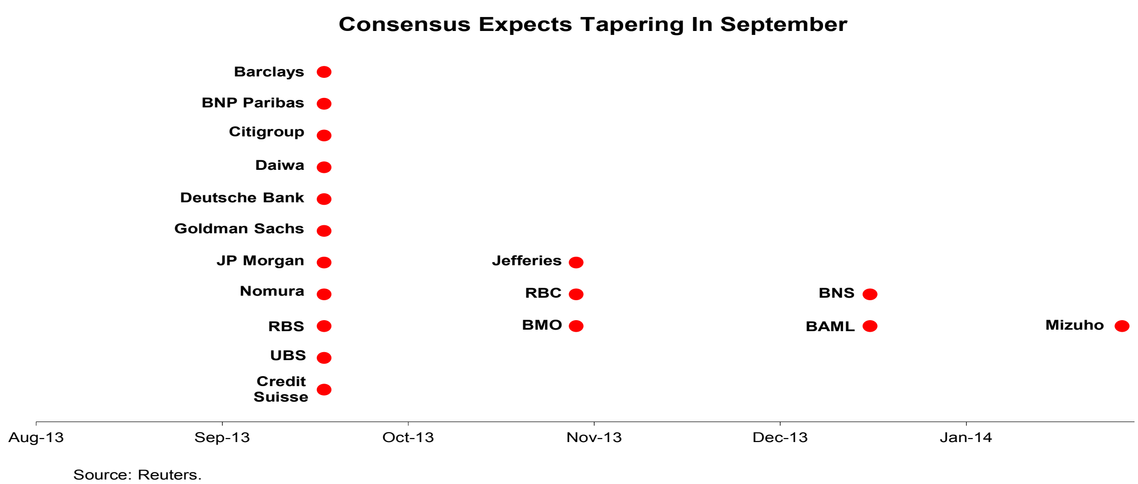
Special Report: How Consensus Lines Up Across The Tapering Variables

Tomorrow could be another big day for Fed watchers. That's because the minutes to the June 18th-19th FOMC meeting will be released at 2pmET and about two hours later Chairman Bernanke will speak at an NBER conference on the first 100 years of the Federal Reserve. It is before similar forums when Chairman Bernanke has often dovishly noted that the Fed will not repeat the mistakes that contributed to the Great Depression via prematurely tightening monetary policy. In advance of these two events, we take the opportunity to graphically portray where we stand on the key variables that matter to Fed watchers using the results of the July post-nonfarm Reuters survey of primary dealers including BNS. We also comment on what may arise from the minutes.

When Will Tapering Happen?

- 17 of 21 primary dealers answered this question (81%). This is the highest response rate among the questions posed by Reuters. Unfortunately not all primary dealers responded to the survey or to each question.
- A modest majority of consensus (11 out of 17 respondents and 21 dealers) now expect a tapering announcement at the September 18th FOMC meeting (**chart 1**). In July, five shops brought forward their expected date for tapering compared to the June survey. We don't know what the other five shops believe.
- Of the remainder who answered, three expect the Fed to taper at the October FOMC meeting, two expect tapering in December (including ourselves, BNS), and one expects this to occur in 2014Q1.
- Note that none of the primary dealers expect tapering to be announced at the July 31st FOMC.
- Our view has always been that US growth would ebb into Q2/Q3 after consumers brought forward consumption growth into Q1 and that the sequester would impose additional downsides while inflation continues to under-shoot the Fed's policy goals. Such factors are in addition to external risks to the US economy, the global impact of early tapering, and the continued uncertainty over the US debt ceiling debate. These views would support later tapering rather than sooner.
- Two things have now changed. One is that the Fed can perhaps now tick the box on moderate sustained employment growth in the wake of upward revisions to US job growth. Note, however, that significant slack in job markets still persists and so does the debate over potentially lowering the unemployment rate threshold.

Chart 1



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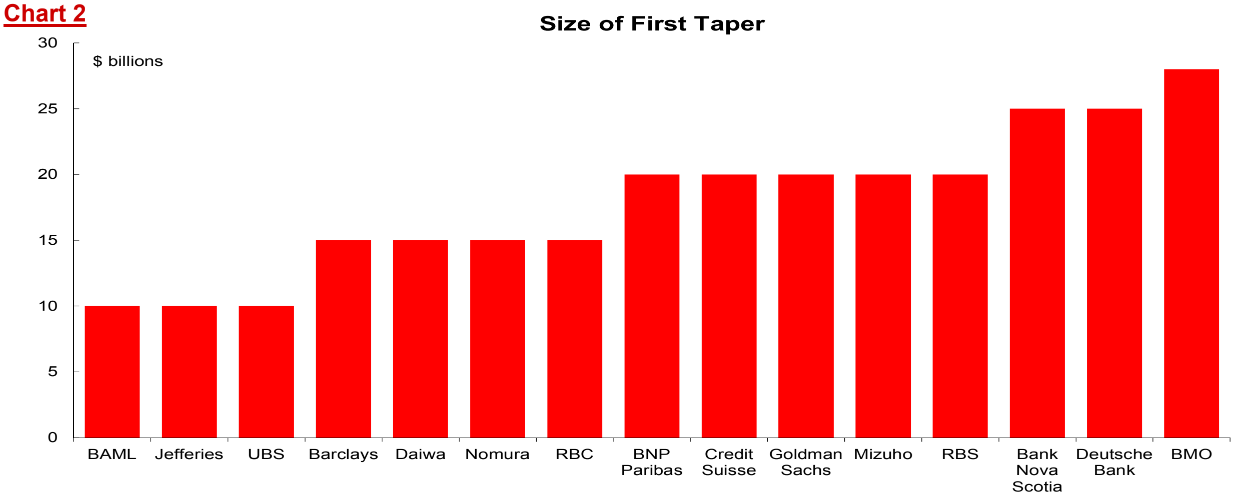
- While job growth has improved, reach-for-yield concerns have gone the other way and toward imposing a broad financial shock on the US economy. Witness the USD's 3-6% appreciation against the yen, Euro, pound sterling, CAD and the A$. Also note that a sharp rate shock has, for instance, returned the 30 year fixed mortgage rate to the highest level since May 2011 and the Moody's BAA corporate benchmark yield to October 2011 levels. Also note that oil prices are at their highest levels since early 2012 in the wake of instability in Egypt.
- On net, less evidence of reach-for-yield pressures may lower the perceived urgency for the Federal Reserve to taper purchases, while growth downsides amid a significant shock across several financial variables counsel caution on timing the tapering decision. This is likely why no one expects tapering on July 31st. Although the tone of data and markets going forward will be instructive and we could well be proven wrong by better data and/or a possible policy misstep, at this juncture we feel that consensus is being overly hasty in bringing forward tapering expectations.

How Big Will Tapering Initially Be?

- 15 primary dealers answered (71%).
- The median estimate expects monthly purchases of MBS and Treasuries to be initially reduced by $20 billion.
- The range of estimates is wide from $10 billion to $28 billion (**chart 2**).
- We expect tapering later (in December) but expect among the largest tapering decisions at $25 billion. Only two other shops are toward the upper bound on the size of the first taper. Our view is that when the Fed decides tapering is necessary, it would be futile to come in low on the adjustment.
- It is important to note that there appears to be no relationship between the timing of the first decision to taper and the amount of this taper. We are among the minority expecting later but bigger tapering.

Chart 2

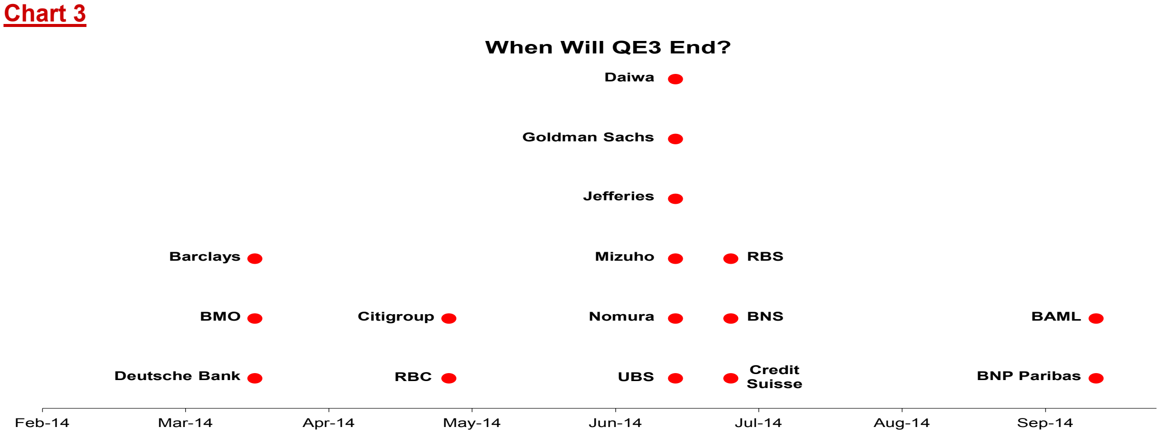


Source: Reuters.

When Will QE3 End?

- 16 primary dealers answered (76%).
- The median answer expects QE3 to end in mid-2014. All expect QE3 to end between March and September (**chart 3**).

Chart 3

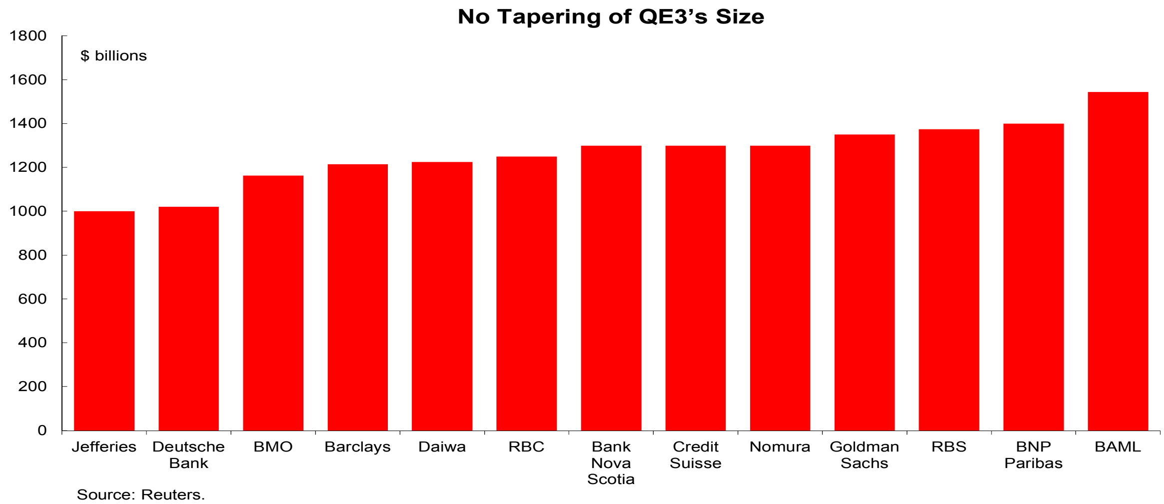


Source: Reuters.

How Big Will QE3 Ultimately Be?

- Only 13 primary dealers answered (62%).
- Few changed their assessment of the cumulative size of the QE3 program with the consensus sitting at a median estimate of $1.3 trillion which is the same as our estimate and actually up but only marginally so from US$1.255 trillion in the prior survey.
- The range of views is materially wide, from as low as US$1 trillion to as high as US$1.4 trillion for a $400 billion difference (**chart 4**). By reference, the Fed has purchased $670 billion in combined MBS and Treasuries under the QE3 program up to the end of June. QE2 equaled $600 billion.
- The most dovish shop expects small tapering in December, is also at the upper bound within consensus on the size of QE3 and expects the program to end only by next September.
- The most hawkish shop expects a large September taper and sees the program ending next March at US$1.02 trillion which lies toward the lower end of consensus.

Chart 4



Implications For The FOMC

Tomorrow's FOMC minutes will add further interpretative colour to the issue of whether the Fed intended to spark a significant rates sell-off or whether this was unintended. Since the most recent FOMC meeting, speakers have tended to rationalize the market's response by increasing the emphasis upon the Fed's bullish central tendency growth projections into next year and flagging excessive risk-taking in the lead-up to the statement and press conference. We did not think it obvious from watching the press conference that Chairman Bernanke anticipated the extent of the now sizeable rates sell-off. A hint to the effect that the backing up in base Treasury yields and corresponding shifts across high-yield, investment grade and mortgage products would be undesired may undermine the Fed's market stewardship. This could come through either the absence of any discussion in the minutes on how markets would react, or a discussion that was dismissive in tone toward significant negative market risks following possible near-term Fed communications and weighted more toward the benefits to markets of greater Fed clarity on QE3 steps.

At least in terms of forecasters within the primary dealer community, we also note that the Fed's problem does not lie in terms of convincing markets that the Fed funds target will be on hold well into 2015. All but one shop expects the first rate hike to occur only by 2015 and the one remaining shop retains a 2016 call.

Further, a key takeaway from our round-up of consensus expectations is that the Federal Reserve appears to have generally succeeded in ensuring stability in the primary dealer community's expectations regarding the stock and duration of asset purchases. Interestingly, despite this success, the issue confronting the Fed is how to manage uncertainty governing the flow of purchases, and indeed this failure has resulted in the volatility in bond prices witnessed since May when the tapering debate intensified.