CAPITAL MARKETS ECONOMICS

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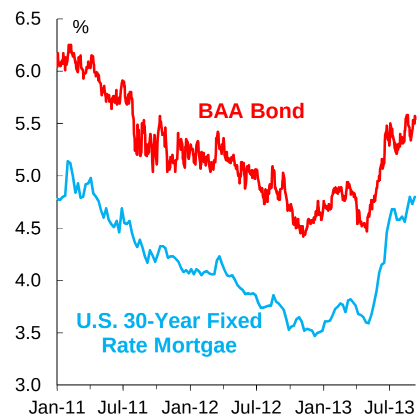
Special Report: Tapernomics: Why Now, And What Else?

- **The Federal Reserve faces many options, but tapering should not be among them — yet.**

The debate over exactly if, when, and by how much the Federal Reserve will reduce asset purchases over-simplifies the richness of policy options facing the Federal Reserve. Understanding the Fed's options and their probabilities of enactment is important to managing the post-statement market trade when the statement lands at 2pmET next Wednesday followed by the press conference at 2:30pmET.

The range of consensus opinions on some of the key tapering variables is captured in the accompanying charts and drawn from the September Reuters survey of primary dealers. This still stands in contrast to far lower expectations for tapering manifest in the survey of National Association of Business Economists. While tapering now and strengthening forward guidance on the length of the pause period for short-term rates could be constructive to Wall Street's net interest income, it is not clear to us that this would benefit the main street economy. Indeed, we think there are six reasons why tapering at this juncture would be a policy misstep that would be reminiscent of Chairman Bernanke's past criticisms of the Bank of Japan.

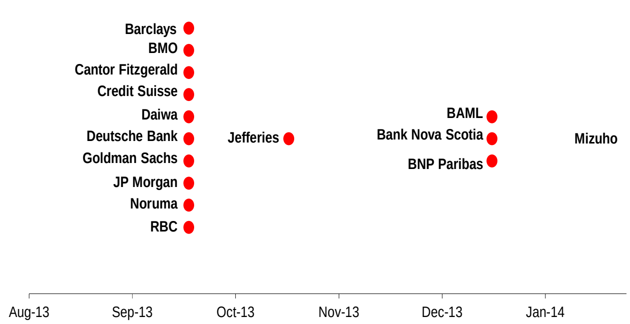
Fewer Reach-For-Yield Worries



Source: MBA, Moody's Investors Service.

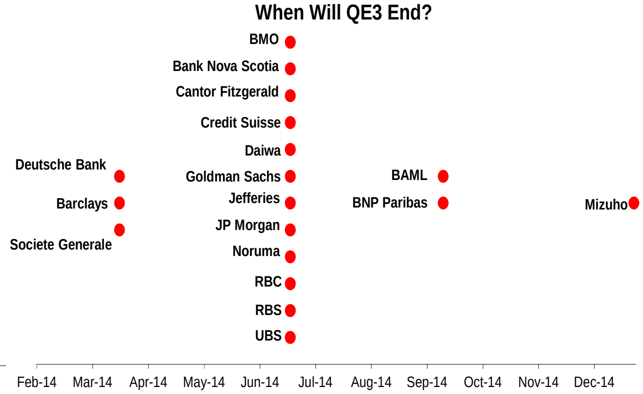
One is that the evidence of frothy behaviour in financial markets has significantly abated since May when Chairman Bernanke first suggested that purchases could be lowered 'later in the year'. The adjacent chart provides two such measures. Tapering now would risk pushing US 10s well above 3% and dragging mortgage and corporate borrowing costs still higher to the detriment of housing markets and capital spending. To avoid lighting up market excesses all over again, however, the Fed would have to retain or expand conditional language behind eventually tapering if it chooses not to do so yet.

When To Taper?



Source: Reuters.

When Will QE3 End?



Source: Reuters.

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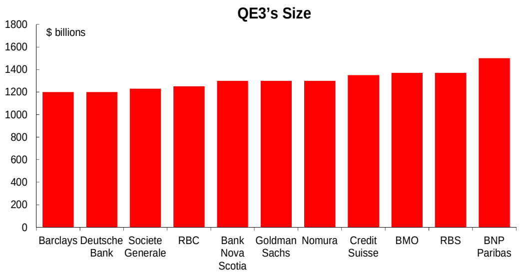

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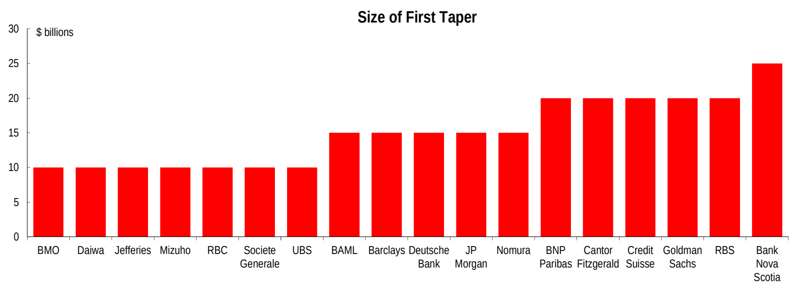

Source: Reuters.

This would give the Federal Reserve some flexibility in light of our second reason which points to considerable uncertainty in the flow of recent data governing how the economy is responding to twin oil and interest rate shocks. This is particularly key for housing as the Fed should be extremely sensitive to the risk of snuffing out an encouraging but still nascent housing recovery. Indicators like mortgage purchase and refinancing applications, new home sales, core durable goods orders, still-soft inflation, perhaps total consumption data that started off weak in July as we await August data with potential revisions, and downward revisions to nonfarm payrolls are all pointing toward uncertainty regarding the sustainability of progress toward the Fed's full employment mandate. Removing stimulus at this juncture could further the damage. In contrast to the view that the Fed should taper now to reinforce expectations, we think it should use its powers to tamp down yields and spend more time evaluating how the economy performs particularly insofar as the key interest-sensitive sectors are concerned. Otherwise, with financial market pressures abating and the Fed likely to revise growth lower, tapering now would require some serious explanations.

Third among our reasons is the high degree of potentially destabilizing event risk including uncertainty regarding Syria, the expiration of the Continuing Resolution and the risk of a temporary government shutdown, and hitting a binding debt ceiling somewhere between about mid-October and early November. Add to this that we do not know who will be the next Chairman of the Federal Reserve, nor how markets will react to his/her nomination. There is also enough global risk lurking in the background to merit treading carefully, ranging from Europe's uncertain recovery to Chancellor Merkel's shaky position in German election polls to potentially destabilizing emerging market influences.

Fourth, and most important, the Federal Reserve remains a long way from achieving its price stability and full employment goals. In the context of all of these arguments, we frankly do not understand what is the rush to reduce asset purchases at this precise juncture. We'll get to that point when net marketable debt issuance by the US Treasury materially tapers later next year, and when the many clustered forms of near-term uncertainty abate, but now is not the time in our opinion without jeopardizing the very essence of a still-fragile recovery.

Finally, we reject the assertion that QE policies are doing nothing to promote the economy. That's far too harsh an assessment. Indeed, we're going through the needed out-of-sample experiment to remind us of this. The Fed's attempt at engaging in an open dialogue with markets about tapering purchases has been met by an abrupt rates sell-off since May and evidence that data covering key portions of the economy is rolling over in response. Further evidence is needed, but that requires more time.

Many of the options for next week that we now list below are not necessarily mutually exclusive.

1. Just Delay Tapering

This option would repeat the July statement and guidance that the Fed is not yet ready to taper, but with a more cautious take on housing instead of repeating that "...the housing sector has been strengthening..." This would acknowledge the steep declines in mortgage purchase and refi activity, a plethora of announcements of layoffs in the mortgage industry, the drop in new home sales, and uncertainty over when resales will react to higher borrowing costs and weaker mortgage activity given that resales lag behind other housing data due to rate holds and closing periods.

2. Spell Out Data-Dependent Guidance On Tapering

In keeping with its new preference for 'state-based' monetary policy, the FOMC could offer data-dependent criteria for tapering but avoid tapering at this juncture. Currently, the guidance on asset purchases calls for bond buying to continue "until the outlook for the labor market has improved substantially in a context of price stability". This could be replaced by more concrete or detailed guidance, signalling eventual tapering without actually undertaking it.

3. Hint More Strongly At Tapering With Calendar Guidance

This option would be stronger than the two previous because the Fed could, for instance, tighten up 'later in the year' language by making it clearer that it intends to reduce purchases in October or December while resisting such a move this month. This would be tantamount to providing calendar-based guidance.

4. Taper, With Further Reductions Being Data Dependent

The Fed could reduce purchases next week, but make it clear to markets that it is not on an unambiguously straight line toward cutting purchases to zero by the middle of next year.

5. Taper, And Hint At A Pause

Central banks have often used the tool of changing their policy rates and then hinting at a pause before contemplating further action. It would therefore not be all that unusual if the Federal Reserve were to do so with unconventional policies by reducing purchases next week but providing calendar guidance that it won't keep reducing purchases at each and every meeting over the duration of the year. This would assist the Fed in taking its time to evaluate the consequences and could be taken constructively by markets.

6. Taper, And Hint At More To Come

This would be the strongest form of tapering whereby the Federal Reserve could cut purchases next week and make it clear that it intends to cut more at future meetings in October and December. It would do so by using language conditioned around the calendar as opposed to economic and financial market variables.

7. Size of First Taper

How big might the first taper be? The range of expectations among primary dealers starts at a miniscule US$10bn and gets as big as US$20bn (for the record, we're at US$20bn, but not until December by our current guesstimate). It's interesting that consensus has backed away from expecting a large first taper now (say, US$40bn) due to the massive sell-off in rates. Thus, while consensus has tightened the timing of its call, it shows less conviction that it is the right thing to do by way of reducing expectations regarding the size.

8. Reduce MBS More Than Treasuries, Or Vice Versa

The Fed not only has options with respect to <u>when</u> it tapers and <u>how much</u> it tapers, but also <u>what</u> it tapers — after all, it is currently buying US$45bn/month of Treasuries and US$40bn/month of MBS. The rapid increase in mortgage rates and MBS yields since May has us anticipating that the Fed will undertake a fairly balanced reduction in purchases, reducing MBS and Treasury buying by an even US$10bn each (but not until December) so as not to rock the mortgage boat even more than it already has.

9. Revise Growth Projections Lower

In its central tendency projections last released with the June statement, FOMC participants expected growth of 2.3-2.6% this year compared to the current Bloomberg consensus call for 1.6% growth. The Fed will therefore have to repeat its multi-year tendency to revise growth numbers significantly lower. It may well have to do so for next year as well. The June central tendency growth projection for 2014 had FOMC participants expecting 3-3.5% versus the current Bloomberg consensus call for 2.7% real GDP growth next year. We realize we are in the minority, but we cannot fathom how the Fed will square the circle in revising all of its growth projections lower at the same time as it reduces the flow of incremental stimulus to the US economy.

10. Lengthen QE Program Reference Period

One option is to signal that the Fed is prepared to purchase Treasuries and MBS for a period longer than until the middle of next year. A revised potential longevity of the program could offset reduced near-term purchases by way of market effects.

11. Strengthen Forward Rate Guidance: Lower The Unemployment Rate Threshold

The FOMC has been justifiably concerned regarding the uptick in shorter-term interest rates during the taper period — after all, the Fed hasn't implied that it will increase short-term rates, merely that it will reduce the downward pressure that it is placing on long-term yields. Currently, the Fed guides that the current "exceptionally low range for the federal funds rate will be appropriate at least as long as the unemployment rate remains above 6-1/2 percent." As the unemployment rate has fallen to 7.3% (80bps in the past year), and we think the Fed seems as though it would like to imply that rates will remain low through mid-2015 (its former target date), the Fed might elect to publish a lower unemployment rate 'threshold'. Other options include adding caveats that further clarify the Fed's view that the unemployment guidance is "a threshold and not a target". Or, emphasize the importance of how a lower unemployment rate is reached, whether through job growth and/or labour force participation in light of the lowest participation rate since 1978.

12. Other Forward Guidance Measures?

Tying the forward interest rate guidance to the unemployment rate (which can improve even as the labour market doesn't — e.g. if the participation rate continues to fall) is somewhat problematic. Perhaps the Fed will instead lower future growth forecasts and hence signal the expectation that it will take longer to achieve full employment and price stability. This could be the backdrop for pushing out the central tendency forecast for when to hike the Fed Funds target rate. This option poses a challenge on efficacy in our opinion, since delayed front-end moves and reduced buying up the curve implies a potentially steeper curve. Given that the US housing market is significantly dependent upon what happens to 30-year fixed mortgage rates that are priced off US 10s and swapped out, it's not clear to us that a steeper curve would fit a goal of feeding a continued housing rebound. A further challenge concerns whether markets would believe such guidance in the first place, particularly given a) the Bank of England's challenges thus far, and b) uncertainty over the future leadership regime at the Fed that relates to appointing a new Fed chairman, as well as replacing two retiring Governors and filling a pending vacancy at the Federal Reserve Bank of Cleveland which gets a vote in the rotation next year.

13. Signal A Comfort Zone For Rates

Cognizant of the rates selloff since May, the FOMC statement and/or the press conference could reveal that the Fed is mindful of the risks to the economy of an abrupt rise in borrowing costs. It could do so by signaling a rough comfort zone on yields. This isn't talk of yield caps that are too extreme for consideration at this juncture and that pose numerous problems such that we don't support explicit caps, but it could alternatively take the form of language that the Fed stands willing to act should it believe that financial market pressures jeopardize the recovery more significantly than at present.

14. Taper, Meet The Flare

Instead of lowering purchases, the Federal Reserve could increase asset purchases. We think this is a very remote prospect, but it is an option that the Federal Reserve retained in its July statement when it said it could "increase or reduce" the flow of purchases. Of course, the exact opposite is also true — the Fed could remove reference to increasing purchases entirely especially if it tapers by a significant amount.