Weekly Economic Commentary

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Communication Breakdown?

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Highlights

In our view, Bernanke made a clear case to markets last week that tapering remains data dependent, and he even provided markets with specific metrics the FOMC was watching to gauge progress.

Market participants may need to recalibrate how they listen to the Fed, and the Fed may need to rethink how it communicates with the markets and the public.

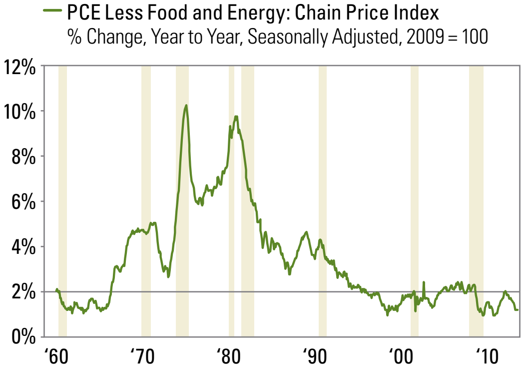
The Fed will need the markets' trust as it begins to prepare for the unwinding of all the monetary stimulus it has put into the system since 2007.

In our recent *Weekly Economic Commentary: Trust* (September 9, 2013), we argued that there was not a clear-cut case for tapering based only on the economic or inflation backdrop. Instead, our view was that concerns expressed by Federal Reserve (Fed) officials over the past six months or so—that additional quantitative easing (QE) could potentially disrupt the smooth functioning of securities markets, cause investors to take on excessive risk and "reach for yield," and add to financial instability in the global economy—would tip the scales in favor of a taper. Perhaps more important, in our view, were shifting market expectations since Fed Chairman Ben Bernanke's testimony before the Joint Economic Committee of Congress in May of this year, when he said:

> *If we see continued improvement, and we have confidence that that is going to be sustained, in the next few meetings we could take a step down in our pace of purchases.*

Financial market participants had since come to expect that the Fed would begin to taper this month, absent a major downshift in the economy. Our view was that if the Fed did not follow through on tapering, it risked losing the market's hard-earned trust, and any trust the markets have in the Fed today will likely come in handy when the Fed has to begin removing stimulus and raising rates in the years ahead.

1 Inflation Remains Well Below the Fed's 2.0% Target, Arguing for a Wait-and-See Approach on Tapering



Source: Bureau of Economic Analysis, Haver Analytics 09/20/13

Shaded areas indicate recession.

"The Song Remains the Same"

Ultimately, however, the trust argument did not win the day. The Fed surprised almost everyone last week (September 16–20) as the Fed's policymaking arm, the Federal Open Market Committee (FOMC), voted to maintain its current pace of combined purchases at $85 billion of Treasuries and agency mortgage-backed securities (MBS) as part of its QE program. In making the decision, the FOMC cited tightening financial conditions (likely largely in the form of higher mortgage rates and the flow of credit to small- and medium-sized businesses), the looming fiscal debates, the still-sluggish economy (real gross domestic product [GDP] growth is tracking below 2.0% in the third quarter of 2013), and the sluggish labor market as the reasons for continuing purchases at the same level. In addition to maintaining the current pace of QE, the FOMC strengthened its commitment to keeping its fed funds rate target—currently near zero—at that level until well after it finally winds down its QE program.

"Ramble On"

The following quotes are from Bernanke's post-FOMC statement and press conference Q&A

"In September 2012, the FOMC initiated a program of purchasing $40 billion per month in agency mortgage-backed securities, in addition to the $45 billion per month in longer-term Treasury securities that we were already acquiring as part of our Maturity Extension Program. We stated that, subject to our ongoing assessment of the efficacy and costs of the program, purchases would continue until we saw a substantial improvement in the outlook for the labor market in a context of price stability…the Committee agreed today to continue asset purchases at that rate, subject to the same conditions that we laid out a year ago."

"But in evaluating whether a modest reduction in the pace of asset purchases would be appropriate at this meeting, however, the Committee concluded that the economic data do not yet provide sufficient confirmation of its baseline outlook to warrant such a reduction. Moreover, the Committee has some concern that the rapid tightening of financial conditions in recent months could have the effect of slowing growth…"

The FOMC's actions surprised market participants, who expected the FOMC to begin tapering its purchases to around $70 or $75 billion per month, from the current $85 billion per month, and also to confirm that QE would end by mid-2014. Instead, the FOMC backed away from its earlier guidance about ending QE in mid-2014, suggesting a later start date for tapering and a later end date for QE, likely late 2014. In his prepared remarks prior to his post-FOMC meeting press conference on Wednesday, September 18, 2013, and during the Q&A period of the press conference itself, Bernanke worked hard to convince markets that tapering was not tightening, noting:

> *...even after asset purchases are wound down — which we will do in a manner that is both deliberate and dependent on the incoming economic data — the Federal Reserve's rate guidance and its ongoing holdings of securities will ensure that monetary policy remains highly accommodative.*

"Good Times, Bad Times"

A quick review of the public appearances made by Bernanke and his colleagues on the FOMC since early May 2013, as well as the FOMC statements and minutes from the June and July FOMC meetings, do show that Fed officials essentially repeated that same mantra — predicating a tapering this fall on better data. Markets, especially fixed income and many emerging markets, reacted swiftly to (some of) Bernanke's words during the spring and summer and drove bond yields sharply higher, largely ignoring the data dependent part of the Fed's case.

Looking ahead, market participants may need to recalibrate how they listen to the Fed, and the Fed may need to rethink how it communicates with the markets and the public. In an effort to aid the market, and be more transparent, Bernanke laid out the Fed's action plan for the next several FOMC meetings in several key passages from last week's post-FOMC press conference ["Ramble On"]. In addition, Bernanke specifically mentioned several metrics the FOMC will be watching in the coming months as it decides whether or not to taper. The indicators he mentioned were:

Inflation

- The personal consumption deflator excluding food and energy (also known as the core PCE deflator)

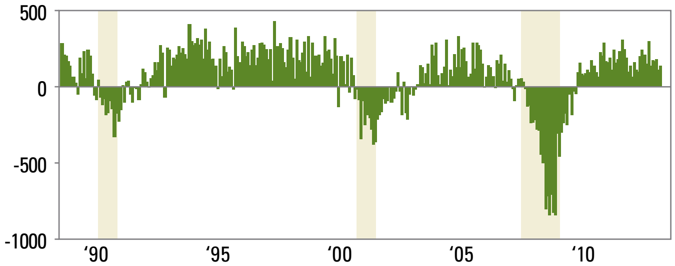
The Labor Market

- Private sector job count
- Unemployment rate
- Initial claims for unemployment insurance
- Aggregate hours worked
- Consumers' assessment of whether jobs were easy or hard to get
- The labor market participation rate

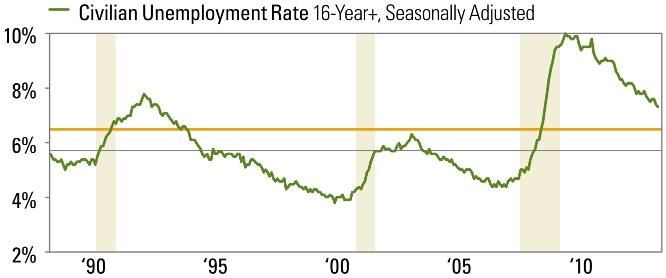
2 While Some Labor Market Indicators Have **Met the Fed's Expectations...**

...Many Other Indicators Remain **Stubbornly Weak** and Argue for a Wait-and-See Approach on Tapering

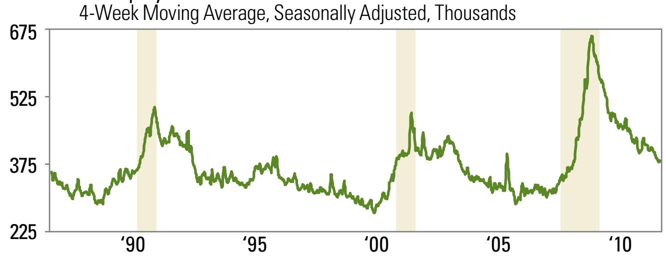
Change in Total Private Employment Seasonally Adjusted, Thousands



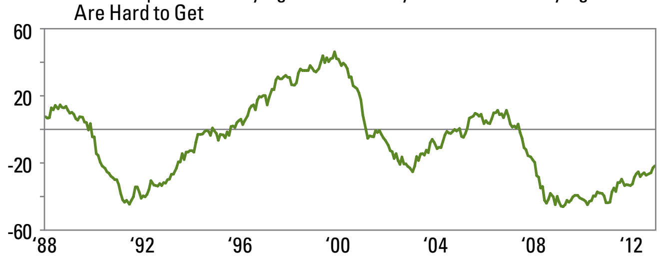
Civilian Unemployment Rate 16-Year+, Seasonally Adjusted



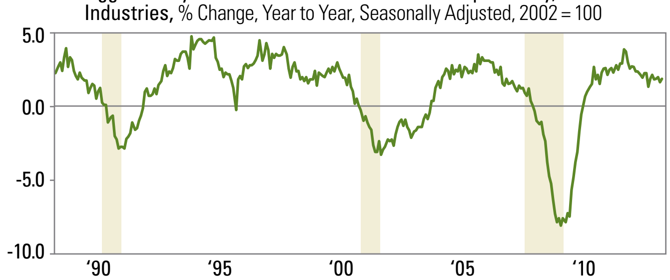
Unemployment Insurance: Initial Claims
4-Week Moving Average, Seasonally Adjusted, Thousands



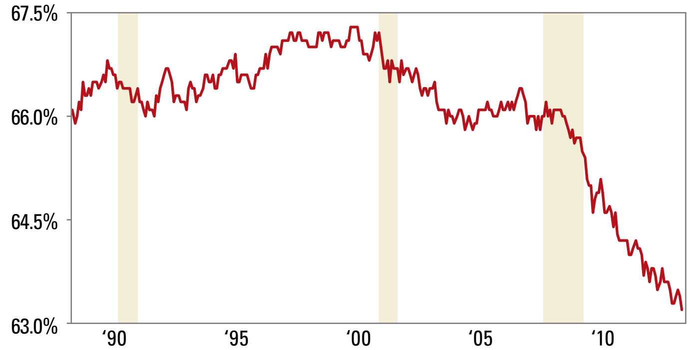
% of Respondants Saying Jobs Are Easy to Get Less % Saying Jobs Are Hard to Get



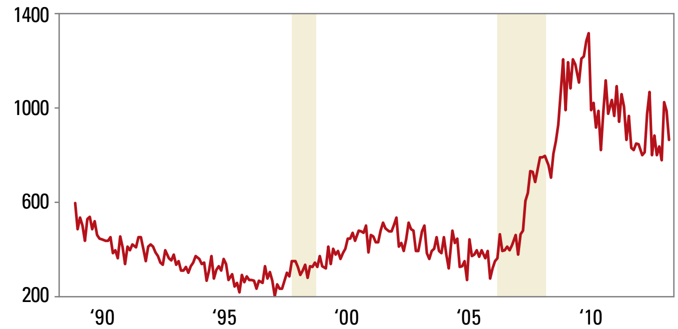
Agg. Weekly Hours Index: Production & Nonsupervisory, Total Private Industries, % Change, Year to Year, Seasonally Adjusted, 2002 = 100



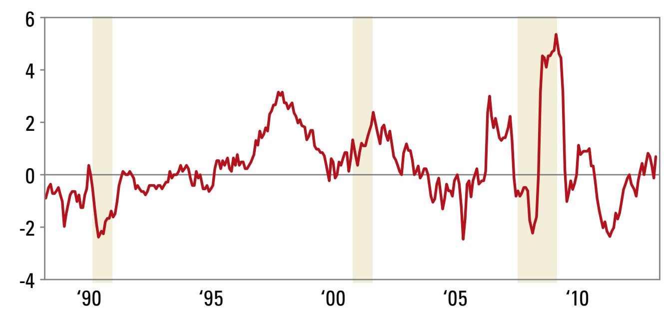
Civilian Participation Rate 16-Year+, Seasonally Adjusted



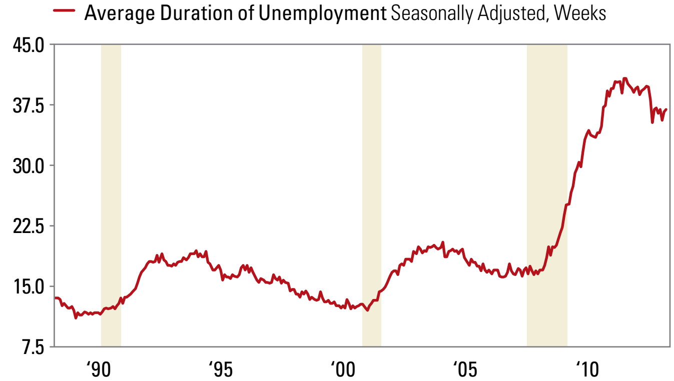
Discouraged Workers Not Seasonally Adjusted, Thousands



Real Average Hourly Earnings: Production & Nonsupervisory,
% Change, Year to Year, Seasonally Adjusted, '82–'84 $/Hour



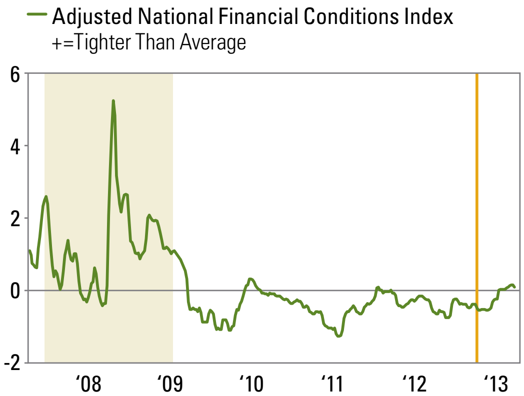
Average Duration of Unemployment Seasonally Adjusted, Weeks



Sources: Bureau of Labor Statistics, Department of Labor, Haver 09/20/13

Shaded areas indicate recession.

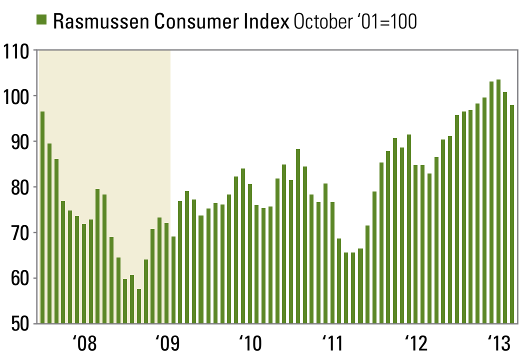
3 Financial Conditions Have Tightened Modestly Since May 2013, a Largely Unwelcome Outcome for Fed Policymakers



Source: Federal Reserve Bank of Chicago, Haver Analytics 09/20/13

Shaded areas indicate recession.

4 Concerns About the Looming Fiscal Battles in Congress Have Contributed to a Weakening of Consumer Sentiment in Recent Months



Source: Rasmussen Reports, Inc., Haver Analytics 09/20/13

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"...Finally, the extent of the effects of restrictive fiscal policies remains unclear, and upcoming fiscal debates may involve additional risks to financial markets and to the broader economy. In light of these uncertainties, the Committee decided to await more evidence that the recovery's progress will be sustained before adjusting the pace of asset purchases."

- The median duration of unemployment
- Real wages
- Discouraged workers

Financial Conditions

- The Federal Reserve Bank of Chicago's Financial Conditions Index

Fiscal Policy

- Rasmussen Consumer Sentiment Index, as a proxy for the public's concern over the looming debates in Congress over the government shutdown (September 30, 2013) and the debt ceiling (mid- to late-October)

In Figures 1–4, we show the recent performance of these important metrics. Inflation remains well below the Fed's 2% target. Our view is that there are still plenty more factors pushing down on inflation than pushing it up. The next core personal consumption expenditure (PCE) reading (for August 2013) is due out this Friday, September 27, 2013. In Figure 2, we've grouped the labor market metrics mentioned by Bernanke into two categories. On the left side of the page are the indicators that Bernanke mentioned as showing some improvement in recent months. The indicators on the right side of the page detail the labor market metrics that have underperformed the Fed's expectations. While the claims data are released weekly, and the jobs easy-to-get/hard-to-get metric is released along with the consumer confidence data (due out Tuesday, September 24), the market will have to wait until October 4 for the September employment report. With just one more report on the labor market prior to the October 30, 2013 FOMC meeting, it is unlikely that the FOMC would have enough additional evidence that the labor market was improving to take any action on tapering.

Figure 3 does show that financial conditions have tightened since May, and Bernanke's comments last week suggest that most of this tightening was unwelcome by Fed policymakers. We chose this particular metric (from the Chicago Fed National Financial Conditions Index) to highlight because Bernanke has mentioned it recently, but there are many other measures of financial conditions (St. Louis Fed Financial Stress Index, Senior Loan Officers Survey, and Bloomberg Financial Conditions Index, to name a few) that we and the market will be tracking closely in the weeks ahead. If financial conditions are tighter in late October than they are today, it is unlikely that the Fed would opt to taper at the October 30 FOMC meeting.

"When the Levee Breaks"

Also arguing against an October taper is the fiscal situation. We chose to use the Rasmussen Consumer Sentiment chart to illustrate consumers' concerns with the fiscal debate in Congress [Figure 4]. Although this data point is available daily, we chose to present the monthly chart. The chart clearly shows that consumer sentiment has turned lower in recent months, posting back-to-back monthly declines for the first time since mid-2011, the last time the debt ceiling debate dominated the headlines.

"We have a three-part baseline projection which involves increasing growth that's picking up over time as fiscal drag is reduced, continuing gains in the labor market, and inflation moving back towards objective."

"We're looking to see in the coming meetings, we'll be looking to see if the data confirm that basic outlook. If it does, we'll take the first step at some point possibly later this year and then continue so long as the data are consistent with that continuing progress. And so that basic structure is still in place…"

On balance, the FOMC decided at its September 2013 meeting that the weaker-than-expected readings on the economy and inflation, tightening financial conditions (partially as a result of its own communication breakdown with markets since May), and the looming fiscal debate in Congress trumped the trust argument, and chose to maintain the current pace of QE. In our view, Bernanke made a clear case to markets last week that tapering remains data dependent, and he even provided markets with specific metrics the FOMC was watching to gauge progress. One of the key takeaways from last week for markets was Bernanke's assertion during the Q&A portion of his press conference:

> *...we can't let market expectations dictate our policy actions. Our policy actions have to be determined by our best assessment of what's needed for the economy.*

Our view remains that while the Fed may not need the markets' trust right now, it will down the road as it eventually begins to unwind all the monetary stimulus it has put into the system since 2007. ■

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

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Government bonds and Treasury bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of fund shares is not guaranteed and will fluctuate.

Mortgage-backed securities are subject to credit, default risk, prepayment risk that acts much like call risk when you get your principal back sooner than the stated maturity, extension risk, the opposite of prepayment risk, and interest rate risk.

Stock investing involves risk including loss of principal.

Quantitative easing (QE) is a government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.

The Federal Open Market Committee (FOMC), a committee within the Federal Reserve System, is charged under the United States law with overseeing the nation's open market operations (i.e., the Fed's buying and selling of United States Treasure securities).

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory.

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