Payden&Rygel

Economic Update

THOUGHTS FROM OUR ECONOMICS TEAM

JULY 18, 2013

No Preset Course

On June 20th we published a note titled "**Data not Date--One Letter, Key Difference**" arguing that economic data would drive the Fed's decision on tapering QE not the calendar. In his semiannual testimony on Capitol Hill (concluded Thursday), Federal Reserve Chairman Ben Bernanke reaffirmed this view and reminded the market of the differences between its two main monetary policy tools when nominal interest rates reach the zero lower bound: 1) large scale asset purchase ("QE") and 2) forward guidance for the fed funds rate. In particular, Bernanke reiterated the Fed's conviction that a slow-down in the rate of asset purchases (QE) does not mean a move to tighter policy, and that the federal funds rate would remain low for some time even after the end of QE. We think the market is slowly getting the message.

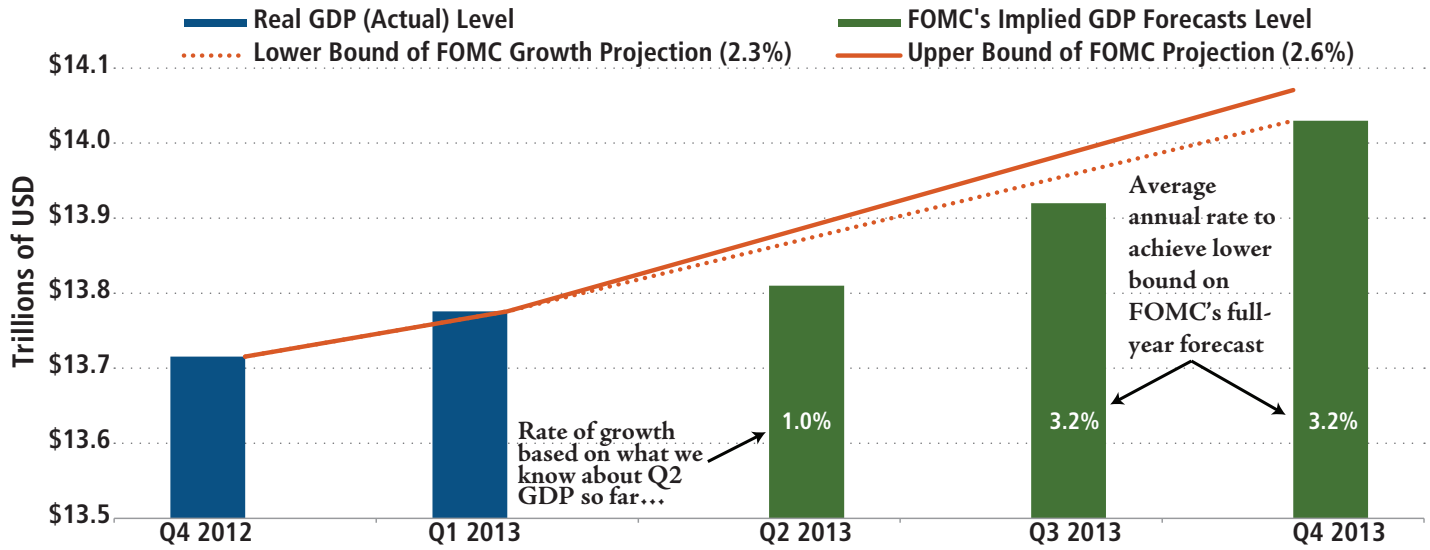
First, with regards to QE, if economic data arrive in accord with the Fed's baseline expectations, expect tapering this fall and an end to asset purchases altogether next summer. In his testimony before the House, Bernanke "emphasize[d] that, because our asset purchases depend on economic and financial developments, they are by no means on a preset course." No preset course means the data horse drives the policy cart. As shown in the Chart below, real GDP growth of 3.2% in Q3 and Q4 are required to achieve the lower bound of the FOMC's 2013 full-year forecast of 2.3-2.6% by year end. Unlikely? The last time we experienced two consecutive quarters of growth above 3%: Q3 and Q4 2004.The tapering of asset purchases may start closer to year-end 2013 and conclude later than the Fed anticipates.

Second, Bernanke worked to move market focus away from the monthly flow of QE purchases toward forward guidance about the future path of the federal funds rate. In December 2012, the FOMC issued thresholds for when a discussion about the first rate hike may occur. Market participants learned that as long as unemployment remained above 6.5%, and as long as forward-looking inflation remained under 2.5%, the target federal funds rate would remain at zero.

In his prepared remarks, Bernanke expanded on the forward rate guidance tool: "If a substantial part of the reductions in measured unemployment were judged to reflect cyclical declines in labor force participation rather than gains in employment, the Committee would be unlikely to view a decline in unemployment to 6-1/2 percent as a sufficient reason to raise its target for the federal funds rate." In addition, Bernanke noted that, "Likewise, the Committee would be unlikely to raise the funds rate if inflation remained persistently below our longer-run objective." So, if low inflation persists and/or workers continue to exit the labor force, the Fed may delay its initial rate hike even with an unemployment rate below 6.5%.

While acknowledging that the QE program (an experimental policy tool) may wind down as economic data improves, Bernanke pushed back against the notion that it would use its other policy tool—an increase in the federal funds rate—to tighten monetary policy. In fact, economic conditions may warrant a longer period of time before that first rate hike occurs. That's the message Bernanke sought to convey and, overall, the two-day semiannual testimony and Q&A sessions established a very dovish tone for the markets.

IS THE FOMC TOO OPTIMISTIC ABOUT THE NEAR TERM HEALTH OF THE US ECONOMY?



Source: Payden Calculations, Federal Reserve