Payden&Rygel

Economic Update

THOUGHTS FROM OUR ECONOMICS TEAM

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Words More Important Than Numbers

This morning's FOMC statement, bearing news of "QE3", initially disappointed the Treasury market, as 10-year note yields reached 1.83% in the aftermath before finishing the day at 1.72%. Where many market participants expected a larger, fixed amount of Treasury (à la QE2) and possibly agency MBS purchases (à la QE1), instead the FOMC initiated a plan to purchase $40 billion of agency MBS per month. With no defined time limit, the new "QE" program comes in addition to the ongoing Operation Twist purchases of $45 billion in longer-term Treasuries per month through year end.

Additionally, today's announcement brought an extension of the "forward rate guidance". The FOMC now "anticipates that exceptionally low levels for the federal funds rate are likely to be warranted at least through mid-2015" (rather than late 2014).

Words More Important Than Numbers

Our key takeaway: the most important element of the statement is not the dollar figure of $40 billion per month but the **explicit tying of asset purchases to improvements in the labor market.** The statement reads: "***if*** the outlook for the labor market **does not improve substantially**, the Committee will continue its purchases of agency mortgage-backed securities, **undertake additional asset purchases**, and employ its other policy tools as appropriate **until such improvement is achieved** in a context of price stability." [Emphasis ours]

We think this is a big deal. The explicit tie to labor market improvement means the Fed's balance sheet could conceivably expand until conditions improve—which even in the Fed's estimation could be a while. In the Q&A Bernanke failed to define "improve substantially," saying that there is "no specific number" for what comprises a "sustained improvement" in the labor market. He did qualify his response, suggesting that the unemployment rate is not necessarily the best--or only--indicator of labor market strength and that the Committee would wait to remove accommodation until the recovery is "well established".

Will It "Help Nudge The Economy in The Right Direction"?

Will the much heralded move have an effect on the real economy? Let's rephrase the question: will buying a steady stream of high-quality assets to keep interest rates lower promote a more vigorous economic recovery? ***We do not think so.*** With interest rates already at 50-year lows, in our view, structural factors (including skills mismatch, dearth of new businesses and investment, technology, a clogged financial/credit system, the fiscal uncertainty, etc) are the real culprits of our unemployment malaise. If we are right, even "open ended" QE will have little effect on growth and employment. Bernanke himself is circumspect on the Fed's ability to boost the economy, admitting during the press conference that the Fed "tools are not so powerful as to solve the entire problem" and can only "help nudge the economy in the right direction".

Yes, the Fed initiated a bold policy step, the central bank's balance sheet will balloon as it removes more bonds from circulation and market interest rates may edge lower, but will QE3 spark the new investment and hiring needed to boost the economy? We may soon find out if the emperor has clothes.