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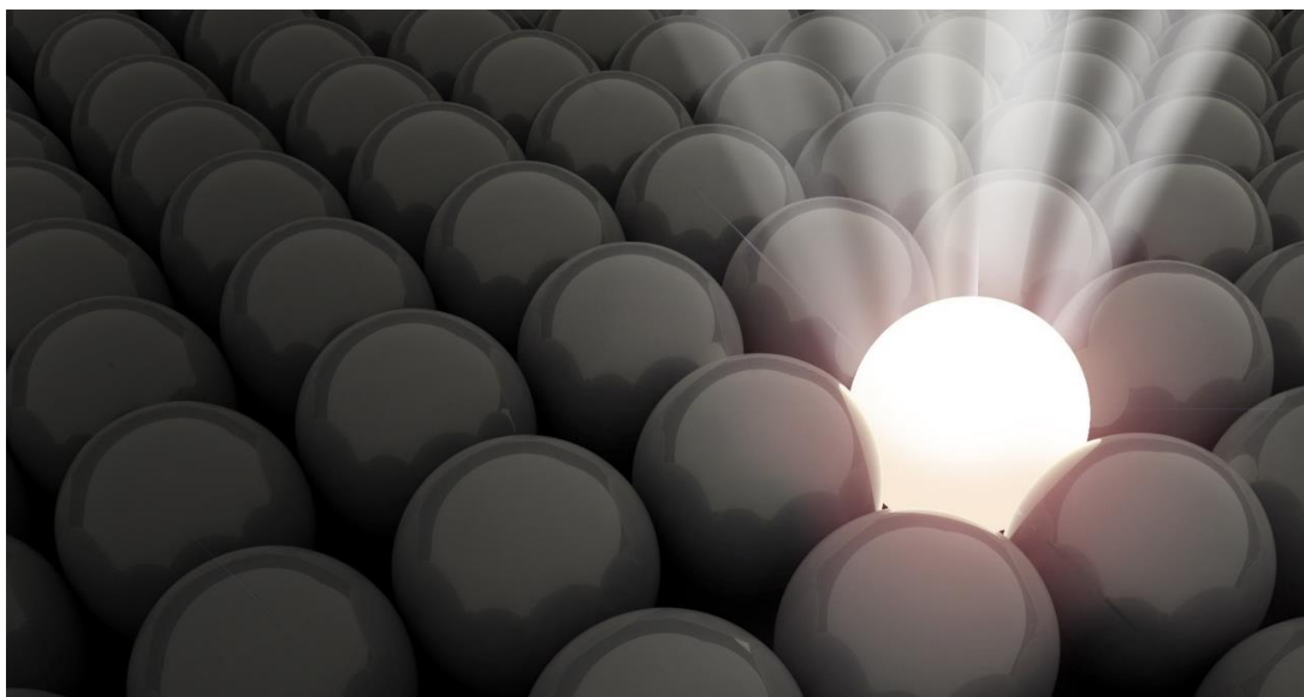
The US Federal Reserve Tapering Update

Tapering begins

December 2013



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Quantitative easing set to wind-back

At 2:00 pm Wednesday 18 December 2013, (6:00 am Thursday morning AEDT), the Federal Open Market Committee (the FOMC – the policy making committee of the US central bank) announced it will begin to scale-back the value of its monthly purchases of Treasury and Mortgage-Backed Securities (MBS).

The statement made by the FOMC is shown below:

"In light of the …improvement in the outlook for labour market conditions, the FOMC decided to modestly reduce the pace of its asset purchases. Beginning in January 2014, the FOMC will add to its holdings of MBS at a pace of $35 billion per month rather than $40 billion per month, and will add to its holdings of longer-term Treasury securities at a pace of $40 billion per month rather than $45 billion per month".

It is important to note this adjustment means a slight reduction in the pace of buying, not a cessation of buying, and certainly not the beginning of sales of securities holdings. Indeed, the FOMC reiterated it will continue to reinvest the proceeds of securities' interest (coupon) payments and the proceeds of maturing securities that it currently holds on its balance sheet.

The policy adjustment is a downward adjustment to the pace of ongoing buying only.

It is also important to note, in attempting to assess the potential impact of tapering on future market performances, that the tapering process has begun for the best of all possible reasons – an improvement in economic (specifically employment) conditions.

The FOMC is of the view their sizable and still-increasing holdings of longer-term securities should maintain a downward influence on longer-term interest rates, support mortgage markets, and help to make broader financial conditions more accommodative, which in turn should promote a stronger economic recovery.

US equity market reaction

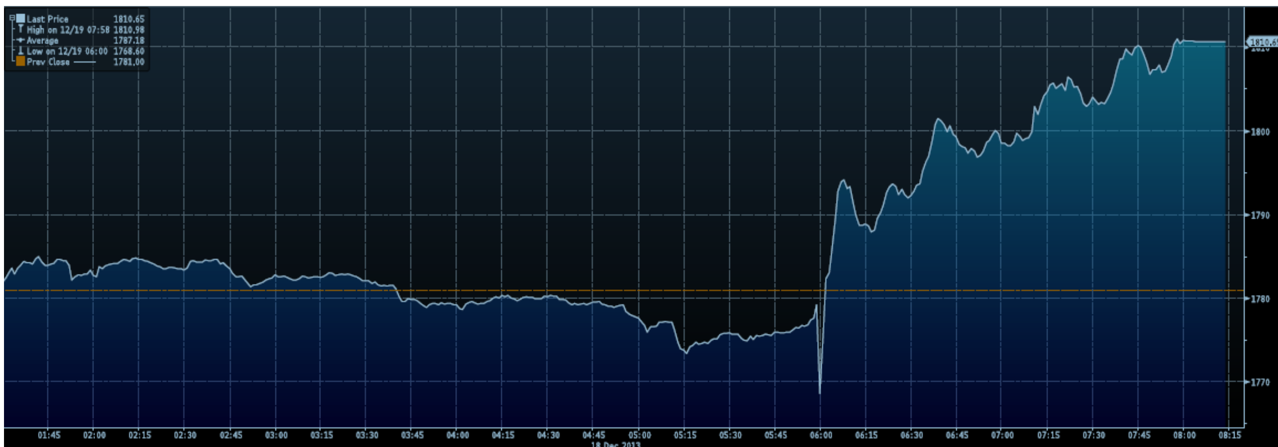
The US equity market reaction to the announcement of tapering was generally positive.

With the FOMC beginning its tapering policy for the best of reasons – because growth conditions have improved somewhat – and not, for example, because inflation fears had begun to rise, the reaction in growth markets (equities) was positive.

The key US S&P 500 index rose by around 1.7% over the day, with more than all of this increase recorded after the FOMC announcement (the market had been lower on the day ahead of the announcement).

Underlying equity sector performances on the day were all positive and broadly indicative of improving growth expectations.

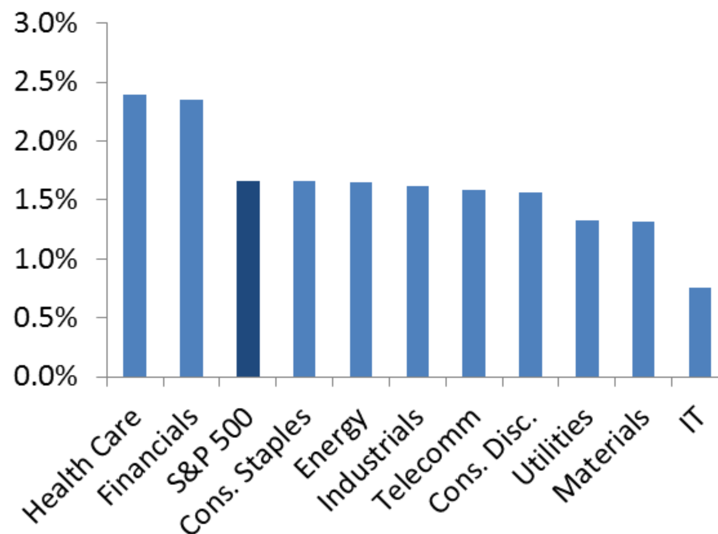
US S&P 500 Index, 9.30 am to 4 pm (New York time), December 18, 2013



(Note the market's change in direction after the 2 pm FOMC announcement)

Source: Bloomberg

US S&P 500 Index Returns, December 18, 2013



Source: Bloomberg

US interest rate market reaction

Interest rates had already risen during the New York morning ahead of the FOMC announcement (owing to very robust housing data released at the start of the trading day).

After the FOMC announcement yields retraced slightly from their pre-FOMC levels, but closed generally higher, overall, on the day, led by more significant increases by longer term securities, while shorter term securities were little changed.

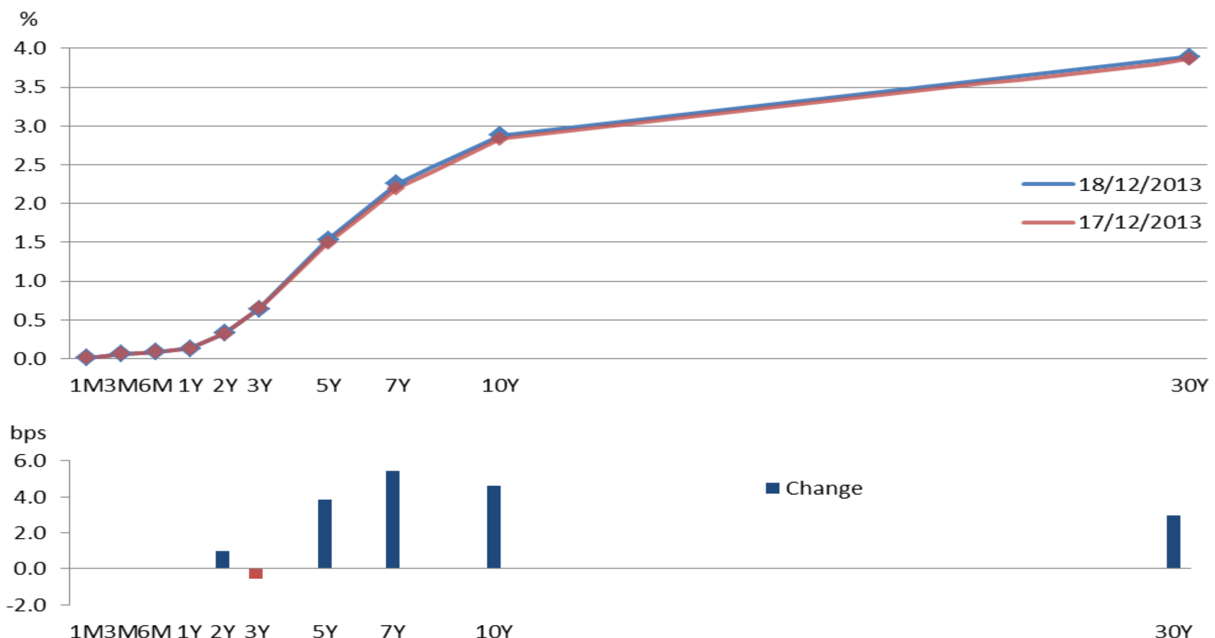
This reaction across the yield curve (higher longer term yields and little change in shorter term yields) suggests that while longer term interest rate securities recorded increases in their yields (mainly because the "real" or "growth sensitive component of the overall yield rose) the FOMC's first attempts at "forward guidance" were successful.

The FOMC has now begun to employ what it describes as 'forward guidance" to describe its expected outlook for official interest rates – the federal funds rate.

Last night the FOMC's guidance consisted of a statement that said the FOMC *"now anticipates…that it likely will be appropriate to maintain the current target range for the federal funds rate well past the time that the unemployment rate declines below 6-1/2 percent, especially if projected inflation continues to run below the FOMC's 2% longer-run goal".*

This "guidance" seems likely to have played a key role in preventing shorter term yields from increasing.

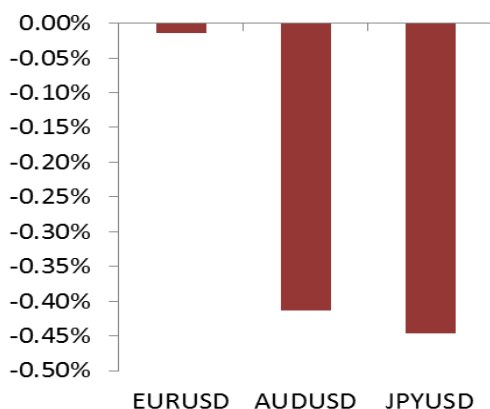
US Yield Curve Changes, December 18, 2013



Source: Bloomberg

Currency market reaction

Compared with levels recorded yesterday morning, the US dollar is trading higher against the Australian dollar, the Japanese Yen and the Euro this morning



Conclusions

Our “base case” remains an expectation the US economy’s recovery will continue to be slower than usual (sub-par) while inflation pressure remains muted.

This environment would be expected to enable the US Fed to slowly taper its purchase of securities, withdrawing its level of accommodation at a pace slightly behind the pace of improvement in growth expectations.

It is likely the US Fed will want to err on the side of maintaining its stimulus for longer than required rather than winding down its QE policy earlier than required.

Our reason for this conclusion is that it would likely be less difficult for monetary policy makers to solve the problems caused by slow tapering (potentially higher inflation, but stronger growth) than the problems likely to be caused by premature tapering (loss of growth momentum and rising deflation risk).

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