FLASH

The Fed blinked

Pictet Asset Management Strategy Unit

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- The US Federal Reserve's decision to delay tapering bond purchases shows it will not take risks with the US economy
- The decision reinforces our view that rates will remain lower for longer; Fed policy will now be far more data-dependent
- Expect riskier asset classes to beneift in the near term and the US dollar to suffer downward pressure

The US Federal Reserve last night surprised markets by choosing to delay tapering its bond purchase programme. The Fed will continue to buy USD85 billion of US Treasuries and mortgage-backed securities (MBS) per month until there is "more evidence" that the economic recovery is sustainable.

The central bank also re-iterated it would not raise interest rates until the unemployment rate falls below 6.5 per cent. To all intents and purposes, the Fed is sticking to the very accommodative policy it has followed since the fourth quarter of 2008 – one which has seen the central bank's balance sheet balloon from USD900 billion to USD 3.7 trillion.

Although the scaling back of bond purchases is still likely to start by year-end or the first quarter of 2014 at the latest, the decision to postpone the withdrawal of monetary stimulus until then has significant implications for investors.

The first is that the Fed will not – as investors had feared since it first announced the plan in May - remove stimulus too soon and too fast and endanger a US economic recovery that has yet to achieve "escape velocity".

The fact is that the central bank was always going to have a difficult time in reversing monetary stimulus – remove monetary accommodation too soon and it would put the economic recovery at risk; keep rates too low for too long and it risked losing its credibility.

Of course, this is a dilemma that central banks face in every economic cycle, but this time round there is arguably much more at stake as the US economy (in common with many others) faces both the threat of deflation (because of deleveraging) and inflation due to the sheer scale of monetary stimulus that has been delivered in the past five years.

The postponement of tapering highlights once more the fact that the Fed is giving the growth target absolute priority. The Fed has cut its growth forecasts to 2.2 per cent for this year and 3 per cent for next – from 2.5 per cent and 3.3 per cent respectively. And it was this downgrade that proved enough to put tapering on hold. In fact, we can say that the Fed's reaction function has changed significantly since 2008 - inflation has been downgraded from a primary target to a "constraint" in the attainment of the growth target.

The second implication for investors is that the Fed's actions will become even more data-dependent in the months ahead– this will generate market volatility and will put the central bank's policy of forward guidance to the test.

Another reason why the Fed has refrained from tapering is the fact that investors had clearly not believed its forward guidance on rates. Indeed, investors had pushed interest rates expectations above the Fed's own published forecasts, and it was this tightening of financial conditions that the central bank cited as a factor behind yesterday's decision.

With tapering now delayed, the interest rate expectations of both the Fed and the market are now broadly aligned, with the Fed funds rate expected to be at about 1 per cent at the end of 2015, 2 per cent at the end of 2016, peaking at approximately 4 per cent.

The Fed's decision can be seen as an attempt to re-establish the credibility of its forward guidance – the problem is that, by choosing to sit on its hands, it has delivered an unexpected twist in communication that raises as many questions as it does answers.

Looking ahead, the Fed's decision confirms our view that interest rates will remain lower for longer and any talk of a rapid normalisation of rates is premature. There are a few reasons for this:

1) Pro-growth bias among central banks

Central banks' reaction function has changed since the Great Recession, and is biased towards easy monetary policy. Deflation is deemed to be a higher risk than inflation so policymakers will continue to focus more on securing growth. For both the Fed and the Bank of England, growth has become the key target while Bank of Japan and the European Central Bank are – respectively – concentrating on reflation and keeping the euro zone intact.

2) Weak recovery

The recovery remains the weakest on record. Real GDP growth in the US is below trend and has averaged at around 2.3 per cent since the trough in the third quarter of 2009, the slowest expansion from recession on record.

What is more, the size of the workforce is the same as it was in 2006. Although the unemployment rate has fallen almost 3 percentage points from its 2009 peak, underemployment remains high, suggesting the level of spare capacity in the economy may be under-stated.

Indeed comparing the current level of US base rates to those implied by the Taylor rule – an analytical framework popular with the Fed that takes into account the deviation of current inflation and unemployment from the Fed's targets - the current policy rates do not look exorbitantly low. (The gap between the interest rates implied by the Taylor rule and the Fed's current rate can be explained by the policymakers' desire to maintain a buffer against the risk of deflation).

3) More fiscal tightening looms

The contractionary effects of fiscal tightening (deleveraging) need to be offset by a very accommodative monetary policy. The International Monetary Fund estimates that developed economies will need to reduce their primary fiscal deficit by some 5 per cent of GDP till 2020 to reduce public debt to sustainable levels.

4) A dovish replacement for Bernanke

While we do not know who will be appointed as the next Fed chairman, the odds are shortening for Janet Yellen, the dovish vice-chairman of the Fed Board. She is very likely to push for a continuation of monetary accommodation. The setting and the communication of a more dovish stance may also become more straightforward once the leadership transition is complete.

5) Inflationary pressures remain moderate

Inflationary pressures remain moderate for the time being. Wage growth and commodity prices are subdued. Output gaps are still wide. What is more, import prices in the US suggest a further decline in inflation. While we expect inflation to accelerate over the next 3 to 5 years, the current inflation readings provide ample room for manoeuvre for central banks.

6) Credit supply contracting

Loan growth is decelerating globally with the exception of Japan. In the US in particular, the rate of growth has halved from 5 per cent to 2 per cent over the past 12 months. In other words, the liquidity available for economic activity is growing at a rate lower than nominal GDP.

Investment implications

We expect the US to keep interest rates lower for longer – we see the Fed's tapering programme beginning either in December this year or the first quarter of 2014. We also envisage only a gradual rise in interest rates – our forecast is for the Fed funds rate to reach 3 per cent in five years' time.

The postponement of tapering adds downside risks to the US dollar, in the short term, and upside risks to emerging market equities, bonds and currencies in particular. In the short-term, government bonds are likely to be supported by yesterday's decision but we still believe that the medium-term trend for bond yields to head higher.

ABOUT THE PSU

The Pictet Asset Management Strategy Unit (PSU) is the investment group responsible for providing asset allocation guidance across stocks, bonds, cash and commodities.

Composed of macroeconomists, quantitative analysts and representatives from PAM's equity and fixed income investment teams, the PSU builds an asset allocation framework through its analysis of economic conditions, market valuations and technical factors such as market liquidity.

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