First State Investments

US Federal Reserve: Back to the light

Economic research note

October 30, 2014

- The US Federal Reserve ('the Fed') has, as widely expected, removed the final $US15bn/mth of its bond purchase stimulus program. QE3 has now ended.
- The Fed's statement was perhaps a little more upbeat than the market expected. The Fed has expressed more confidence in the labor market outlook and noted that the economy is "expanding at a moderate pace."
- On inflation, the Fed implied that any near-term declines on the back of lower oil prices would be temporary and that the risks of inflation running persistently below the 2% inflation target had in fact diminished.
- We continue to expect the first rate hike from the Fed in June 2015, although the risks around this view have become more balanced and will, of course, be highly data-dependent.
- We expect rate hikes to progress through H2 15 and 2016, with the neutral Fed Funds rate around 3.5% expected to be reached in 2017.
- Markets, however, continue to price in a much more modest tightening cycle.
- This implies an outlook that should see US bond yields move higher, especially at the shorter end of the curve and a stronger USD. Equity markets could be more mixed, worrying about the rise in interest rates, but supported by better economic news. Global financial market volatility should be expected to continue to rise.

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As widely expected, the Chair of the Fed, Janet Yellen, has announced a further and final reduction or 'tapering' in the bond purchasing stimulus program (QE3).

After initially buying $US85bn of bonds per month, since December 2013, the Fed has been steadily reducing the QE3 program by $US10bn per meeting, until a program of just $US15bn/mth remained in September. Now this last $US15bn/mth of bond purchases has been 'tapered".

The QE3 program is, therefore, now at an end.

This is good news as it indicates a degree of confidence in the ongoing US economic recovery from the Fed.

Indeed, the Fed has noted that since the QE3 program started (in September 2012) there has been "substantial improvement in the outlook for the labor market" and that there is "sufficient underlying strength in the broader economy to support ongoing progress toward maximum employment in the context of price stability."

The end of QE3 has necessitated a fairly extensive re-writing of the Fed statement and, contrary to some expectations, the Fed has continued to express some confidence in the economic and inflation outlook.

This confidence would indicate that despite all the volatility in markets over recent weeks and the declines in inflation expectations, **the Fed still remains on course to deliver its first interest rate hike in mid-2015.**

Looking at some of the key changes to the Fed's statement, the Fed now notes that "a range of labor market indicators suggests that underutilization of labor resources is gradually diminishing."

On inflation, the Fed was more balanced (i.e. less dovish) than many expected, stating that "although inflation in the near term will likely be held down by lower energy prices and other factors, the Committee judges that the likelihood of inflation running persistently below 2% has diminished somewhat since early this year."

The Fed has maintained its view, however, that now that the QE3 program has ended "it likely will be appropriate" to hold the Fed Funds rate near zero for a "considerable time following the end of its asset purchase program this month."

The Fed has also affirmed its plan to continue re-investing the coupon payments it receives on its bond holdings back into the market and to roll-over maturities at auction.

Our view remains that an end to coupon reinvestment on the $US4.4tr in securities the Fed has on balance sheet will occur well after rate hikes have begun. And outright sales of some of the $US4.4tr securities on balance sheet are not currently on the agenda.

It is interesting to note that there was only one dissenter on the Federal Open Market Committee (FOMC) today, and that was on the dovish side. The President of the Minneapolis Fed, Narayana Kocherlakota voted to maintain the pace of QE3 at $US15bn/mth and commit to keeping interest rates low for longer. The two 'hawks' who had dissented in September, Dallas Fed's Richard Fisher and Philadelphia Fed's Charles Plosser, both voted in favor of today's more upbeat statement.

The path to monetary policy normalization

We continue to hold to the view that **the Fed will start raising interest rates at the June 16-17 2015 FOMC meeting.** That view has not changed over recent weeks, although the risks around the timing are now more balanced, rather than sooner. Of course, this timing will remain dependent on the data flow.

This policy normalization process is expected to take place with the Fed raising both the interest on excess reserves (IOER) rate, currently at 25bp, and the reverse repo program (RRP) rate, currently at 5bp, in a corridor in which the effective Fed Funds rate will trade.

Once this monetary policy normalization process gets underway **we expect the effective Fed Funds rate to be around 1%-1.25% by the end of 2015**, implying four rate hikes from June 2015 onwards. This view is consistent with the "dot" forecasts published by the Fed in September.

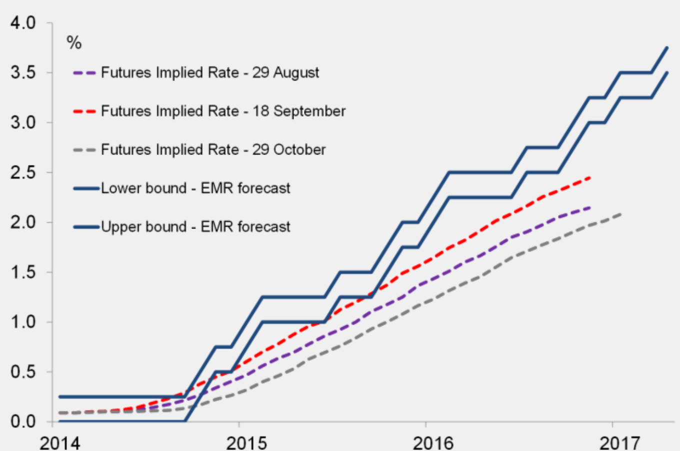
For 2016 we have been expecting the Fed Funds rate to be raised to a 2.5%-2.75% range by year end. Even though this is lower than the Fed's own "dot" forecasts of around 2.75%-3%, the risk now is that the Fed does less in 2016 than we have previously expected.

The Fed's "dots" also imply a move to the new neutral Fed Funds rate of 3.75% in 2017 – but we see the rate lower at closer to 3.5%.

This projected path for the Fed Funds rate is shown on the next chart. As can be seen, our expected path differs from the market expectations, with the market expecting a much slower pace of tightening in the years ahead.

Current market expectations are for the Fed Funds rate to be around 0.5% at the end of 2015 and around 1.5% at the end of 2016. **To our mind, this remains well below the likely actual outcomes.**

Projected path of US short rates and market expectations



Source: Bloomberg. Data to October 29, 2014. Lower and upper bound is the Economic and Market Research team forecast.

In our view, the Fed's monetary policy timetable will look something like this:

FOMC meeting	Fed action
2014	
October 28-29 (actual)	QE3 completed. Fed expresses confidence in the labor market outlook and that inflation will be lower on a temporary basis.
December 16-17	Fed's economic projections expected to be updated to show achievement of employment goal in 2015, but inflation remains below target.
2015	
January 27-28	Fed expected to continue to indicate that the policy normalization process will get underway when appropriate.
March 17-18	Economic projections updated – markets will be looking for more detail around the timing of the first rate hike.
April 28-29	Fed expected to express confidence on the economic outlook and confidence that they have the necessary tool to push rates higher.
June 16-17	**First rate hike**. Fed Funds target range lifted from 0%-0.25% to 0.25%-0.50%. IOER from 0.25% to 0.5% and RRP from 0.05% to 0.25%. Economic forecasts updated.
July 28-29	Fed Funds target moved to 0.5%-0.75% and other short rates moved higher.
September 16-17	Fed Funds target moved to 0.75%-1.0% and other short rates moved higher. Economic forecasts updated.
October 27-28	Fed Funds target moved to 1.0%-1.25% and other short rates moved higher.
December 15-16	No change in policy. Economic projections updated – with further rate hikes indicated for 2016.

Source: FSI

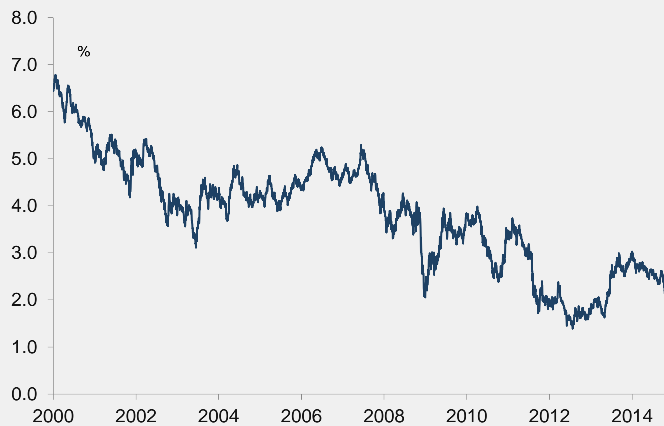
Financial markets

As noted, the Fed's statement today was a little more 'hawkish' than seems to have been expected by markets and the Fed clearly remains on a path towards the first tightening in monetary policy in mid-2015.

Longer-dated Treasury bonds have generally moved higher on the day, although most of this increase occurred prior to the Fed statement. 10yr yields up 3bp at 2.32%, whilst 2yr yields are up 9bp at 0.49%. The yield curve has, therefore, flattened.

We continue to expect to see bond yields move higher in the months ahead. 10yr yields could be expected to trade towards 3% into 2015, while the yield curve is expected to continue to flatten.

US 10 year bond yields



Source: Bloomberg. Data to October 29, 2014

The US equity market has ended the day a little weaker, with the Dow down 0.18% and the S&P500 down 0.14%. The equity market will now have to get used to life without the liquidity injection of QE3, but should be well supported by the confidence shown in the US economic outlook.

The US dollar (USD) has strengthened on the day, buoyed by the slightly more hawkish stance of the Fed and confirmation of the end to QE3.

The US dollar index (DXY) has rallied to 86.03 from 84.41 previously, while Euro (EUR)/USD is down at 1.2630 from 1.2735 and Australian dollar (AUD)/USD is lower at 0.8795 from 0.8855.

We continue to expect further gains in the USD in the months ahead, especially against both the EUR and the Japanese yen (JPY) as the European Central Bank and Bank of Japan embark on more aggressive QE programs.

USD Index

Source: Bloomberg. Data to October 29, 2014

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