# Weekly Economic Commentary

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## Taper, No Taper, or Somewhere In Between?

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### Highlights

Our view remains that the Fed is unlikely to announce that it is beginning to taper at this meeting, though it is not totally off the table.

While markets are obsessed with the Fed's decision on tapering, the outcome of this week's meeting may not be as simple as "taper or no taper."

To help make their decision this week, Fed policymakers will likely be examining several metrics on the labor market, inflation, financial conditions, and the broad economy.

We continue to believe that the Fed will begin tapering QE in the first half of 2014 and exit the program altogether by the end of 2014.

The Federal Reserve (Fed) holds its eighth and final Federal Open Market Committee (FOMC) meeting of 2013 this week. The FOMC will release a statement to the public at 2 PM ET, on Wednesday, December 18, along with a new set of economic projections. At 2:30 PM ET Fed Chairman Ben Bernanke will begin what is very likely his final press conference as chairman. Bernanke is likely to read a prepared statement summarizing what actions Fed policymakers have taken (if any), and then take questions from the press.

Our view remains that the Fed is unlikely to announce that it is beginning to scale back, or taper, its bond-purchase program, known as quantitative easing (QE), at this meeting; but a taper is not totally off the table either. We place about a one-in-three chance on a taper announcement at this week's meeting, and if a taper does occur, we expect the reduction in bond purchases would likely be accompanied by strong language on forward rate guidance, the Fed's promise to keep rates lower for longer. As detailed in our *Outlook 2014: The Investor's Almanac*, we expect the Fed to begin tapering QE in the first half of 2014 and to exit the program altogether by the end of 2014.

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### Not Just About the Taper

While markets are obsessed with the Fed's decision on tapering, the outcome of this week's meeting may not be as simple as "taper or no taper." Fed policymakers could also consider:

- **Strengthening its rate guidance.** Currently, the Fed (and the market) expects the Fed's first rate hike in 2015. The Fed could extend that date to 2016 or later.
- **Targeting an end date or end amount of QE.** Currently, the Fed says it will continue to pursue quantitative easing until it sees "a substantial improvement in the outlook for the labor market in a context of price stability." Policymakers could set an end date (mid-2014, year-end 2014) or target amount for QE, in addition to, or in place of, its outcome-based rule.
- **Setting a floor on core inflation.** In recent public announcements, the Fed has noted that "inflation has continued to run below the Committee's 2 percent longer-term objective." The Fed could choose to set a floor on core inflation, and promise to pursue more QE and refrain from raising rates until inflation reaches a minimum level.

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- **Cutting Interest on Overnight Excess Reserves (IOER).** Currently, the Fed pays banks 25 basis points on reserves held in excess of required reserves. Some policymakers have noted that this discourages bank lending. There was some discussion of cutting the IOER at the October 29–30, 2013 FOMC meeting, but we view this as an unlikely outcome
- **Setting a modest pace.** If the Fed does announce a taper, they could "soften the blow" to market psychology (and to the broad economy) by setting out a relatively modest pace of tapering and/or by providing the market (and the public) with more specifics on what it is watching as it gauges the pace of tapering. If the Fed does not taper, our view is that it is likely to start by tapering purchases of Treasuries first, and maintain its current pace of mortgage-backed securities (MBS), at least initially.

Along with the change in message that could come this week, Fed policymakers are likely debating and refining their communications policy for 2014 and beyond as Fed Vice Chairwoman Yellen prepares to take the top spot on the Fed's policymaking committee in early 2014. We expect the Fed to seriously consider—either at this meeting or early in 2014—holding more frequent FOMC meetings (less likely) or holding a press conference after each of the FOMC meetings (more likely). The Fed is one of the few major central banks around the globe that does not hold a press conference after each policy meeting. For example, the European Central Bank (ECB), the Bank of England (BOE), and the Bank of Canada hold 12 meetings a year and hold a press conference after each meeting.

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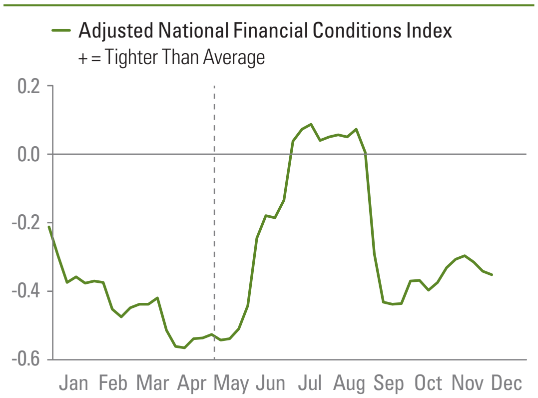
## Data Dependent

To help make their decision this week, Fed policymakers will likely be examining several metrics on the labor market, inflation, financial conditions, and the broad economy. On balance, the hard data under consideration by the Fed is mixed, with slightly more data favoring not tapering at this week's meeting. We believe there is enough evidence from the economic data to suggest that the Fed will refrain from announcing tapering at this week's meeting. The data discussed below have been cited by Fed officials recently as metrics they are monitoring to gauge whether or not to taper.

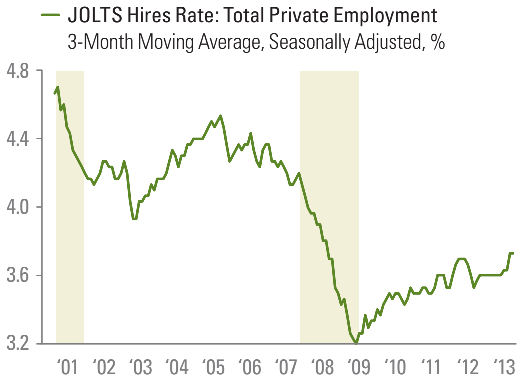
- The FOMC and Bernanke cited tight financial conditions in September and after as a reason why they did not taper. Since then financial conditions, as measured by the Chicago Federal Reserve Adjusted National Financial Conditions Index [Figure 1], have tightened somewhat, and remain tighter than they were in early May 2013, prior to the start of the "taper talk" that drove yields higher in the spring and summer of 2013.
- The FOMC also cited the fiscal uncertainty (shutdown, debt ceiling) and fiscal drag. The budget deal approved by the House last week (and awaiting approval by the Senate this week) reduces the uncertainty, but does not eliminate it, as the U.S. Treasury is likely to bump up against its borrowing authority (debt ceiling) sometime in the first half of 2014.
- Although the labor market is now consistently creating 200,000 jobs per month, several of the labor market metrics cited by Janet Yellen

1 Financial Conditions Have Tightened Modestly Since May 2013 When the "Taper Talk" Began




Source: Federal Reserve Bank of Chicago, Haver Analytics 12/16/13

2 The "Hire Rate" Remains Well Below Pre Great Recession Levels



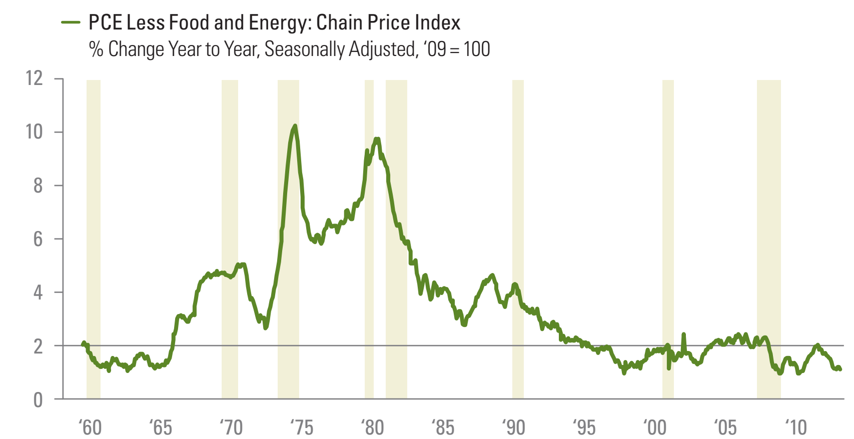

Source: Bureau of Labor Statistics, Haver Analytics, 12/16/13

Job Openings and Labor Turnover Survey (JOLTS) is a survey done by the United States Bureau of Labor Statistics to help measure job vacancies. It collects data from employers including retailers, manufacturers and different offices each month. Respondents to the survey answer quantitative and qualitative questions about their businesses' employment, job openings, recruitment, hires and separations. The JOLTS data is published monthly and by region and industry.

over the past year (the quit rate, the hire rate, and the layoff rate) are still not back to "normal." Although all three have improved, the quit rate (the percentage of job leavers who leave their jobs voluntarily) and in particular, the hire rate [Figure 2], remain well below their pre-Great Recession levels.

- The national unemployment rate is at 7.0%, a substantial improvement from the 8.1% unemployment rate that prevailed when the Fed began this latest round of QE in September 2012. However, the composition of the drop in the unemployment rate remains suspect (a significant portion of the drop can be attributed to the big drop in the labor force participation rate). In addition, Bernanke has noted that the drop in the unemployment rate may overstate the improvement in the labor market, and that the unemployment rate by itself may not be the best measure of the health of the labor market.
- Gross domestic product (GDP) growth has picked up since the September 2013 FOMC meeting, but mostly due to inventory accumulation. Outside of inventories, real economic growth is still at around 2.0% versus the 2002–2007 average of 2.7%. In addition, the impact of the government shutdown has made some of the recent economic data more difficult than usual to interpret.
- Core inflation (the core personal consumption expenditure (PCE) deflator) at the start of 2013 was running at +1.5% year over year. The latest data point (October 2013) for core inflation is running at just 1.1% year over year [Figure 3].

3 Inflation Has Decelerated in 2013 and Is Below the Fed's Comfort Zone




Source: Bureau of Economic Analysis, Haver Analytics, 12/16/13

Personal Consumption Expenditures (PCE) is a measure of price changes in consumer goods and services, targeted towards goods and services consumed by individuals. PCE is released monthly by the Bureau of Economic Analysis (BEA).

## Does the Fed Tighten in December

Another aspect of this week's FOMC decision is the meeting's proximity to year-end. While keeping in mind that tapering is not tightening—markets don't expect the Fed to begin raising rates until 2015—it may be instructive to review whether or not the Fed has ever tightened policy at its final meeting of the year. Our research found that the while the Fed has raised rates at its final (late November or December) FOMC meeting of the year on many occasions (2005, 2004, 1988, 1978), the last time it initiated a series of rate hikes or policy tightening at its final meeting of the year was in 1986.

We also found that in 1999, during a series of rate hikes that began in June of that year, the Fed chose not to hike rates in December, citing the "Y2K" issue. The Fed also took a break from tightening at its December 1994 meeting after initiating a series of rate hikes in February 1994. The rate hikes resumed in early 1995. In December 1993—with inflation heating up—the Fed could have begun a series of rate hikes, but chose to wait instead until the February 1994 meeting to raise rates for the first time in more than five years. Thus the timing suggests that the Fed may wait until early next year to signal a change in policy.

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The metrics the Fed is watching to determine whether it does or does not taper at this week's meeting may not provide a clear signal. However, Fed policymakers have made it clear they remain wary of continuing QE too much longer as they frequently cite concern over its impact on the proper functioning of the Treasury and MBS markets and its waning efficacy as a boost to economic growth. We continue to believe that the Fed will begin tapering QE in the first half of 2014 and exit the program altogether by the end of 2014. ■

## IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values and yields will decline as interest rates rise and bonds are subject to availability and change in price.

Government bonds and Treasury bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of fund shares is not guaranteed and will fluctuate.

Mortgage-backed securities are subject to credit, default risk, prepayment risk that acts much like call risk when you get your principal back sooner than the stated maturity, extension risk, the opposite of prepayment risk, and interest rate risk.

Stock investing involves risk including loss of principal.

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory.

The Federal Open Market Committee (FOMC), a committee within the Federal Reserve System, is charged under the United States law with overseeing the nation's open market operations (i.e., the Fed's buying and selling of U.S. Treasury securities).

Quantitative easing is a government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.

## INDEX DESCRIPTIONS

The Chicago Fed's National Financial Conditions Index (NFCI) provides a comprehensive weekly update on U.S. financial conditions in money markets, debt and equity markets, and the traditional and "shadow" banking systems. Because U.S. economic and financial conditions tend to be highly correlated, the adjusted NFCI (ANFCI) isolates a component of financial conditions uncorrelated with economic conditions to provide an update on financial conditions relative to current economic conditions.



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