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GLOBAL ECONOMIC & MARKET OUTLOOK
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FOCUS NOTES

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Fed tapering is the most likely outcome in the upcoming FOMC meeting

- Our baseline scenario is that Fed officials will likely taper the monthly rate of its asset purchases at the upcoming September 17-18 FOMC meeting.
- We believe that the unemployment rate will continue its downward trend, with demographic factors offsetting any cyclical rebound in the participation rate.
- Downside risks to US growth have diminished since the fall, and we expect real GDP growth to start picking up momentum towards the end of the year as the fiscal drag gradually diminishes.
- The Fed will likely embark on a modest taper, whereby Treasury purchases are reduced from $45bn to $35bn per month and MBS purchases are either held steady at $40bn per month, or reduced to $35bn per month.
- Given that the Fed tapering has been priced into investors' expectations, such a move should not spook the market, especially if the slower pace of easing is accompanied by a strengthening of Fed's forward guidance.

The August employment report was on the soft side…

The mixed August employment report has created more uncertainty about the prospects for Fed tapering, with some market participants believing that the Fed will hold back from reducing the pace of monetary accommodation at its September 17-18 FOMC meeting. August nonfarm payrolls increased by a modest 169k, and downward revisions to previous months subtracted 74k from payrolls. The majority of the downward revisions were driven by changes in the government sector, as public sector payrolls were revised down a net 38k in June and July, reflecting partly the sequestration process that took effect in March 2013. The unemployment rate declined one-tenth to 7.3%, but the decline was entirely attributed to the downward trajectory of labor force, as a two-tenths decline in labor force participation more than offset the 115k decline in household employment (Figure 1).

…but not weak enough to prevent tapering

While the August employment report was on the soft side disappointing market expectations, we do not believe that it is weak enough to prevent the FOMC from tapering in September. Employment growth has slowed since the beginning of the year, with the three-month

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moving average declining from its recent peak of 233k in February to roughly 150k in August 2013. However, this slowdown could be attributed to the concurrent seasonal adjustment that the Bureau of Labor Statistics (BLS) implements to its labor market data, as the annual change in nonfarm payrolls has stayed steady over the past two years (Figure 2). Furthermore, other high frequency employment indices do not point to a slowing trend in job growth. Initial jobless claims have recently been on a downward trend, the employment indices of the manufacturing and non-manufacturing ISM surveys are both above the threshold of 50 that indicates expansion (Figure 3) and hiring intentions are increasing, as is evident in the NFIB small business and the Manpower surveys.

Figure 1

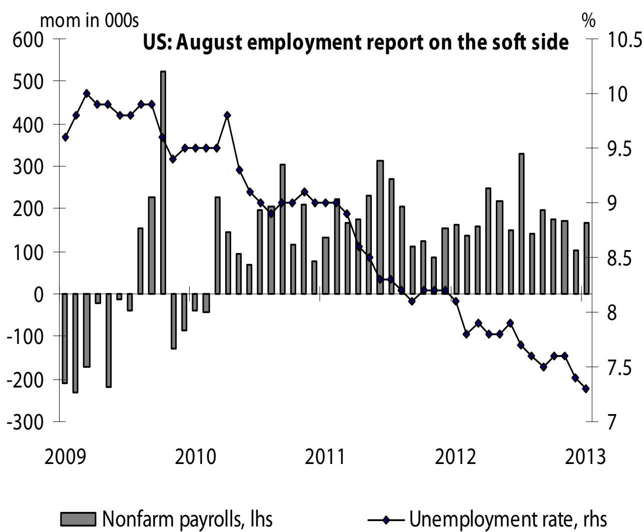
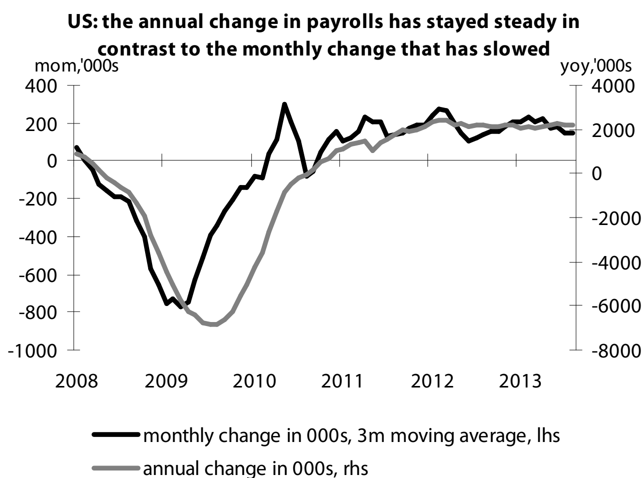
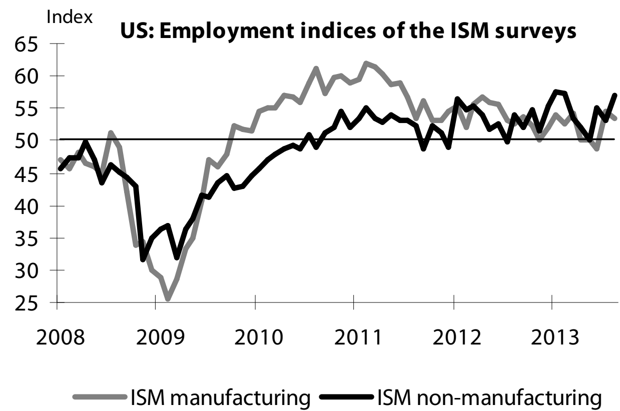


Figure 2



Source: US Bureau of Labor Statistics, Eurobank Research

Figure 3



Source: Institute for Supply Management (ISM), Bloomberg, Eurobank Research

The unemployment rate will probably continue its downward trend

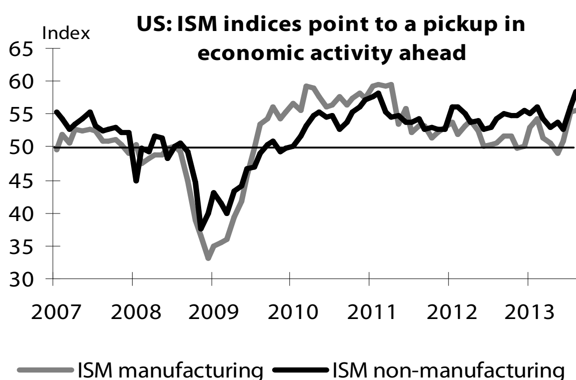
Meanwhile, the unemployment rate has gradually declined to 7.3%, well below the high rates (above 8%) that urged the Fed one year earlier to announce a third round of quantitative easing. Although a large part of this decline is due to a drop in labor force participation, we do believe that the pace of job growth will be large enough to keep the unemployment rate on a downward trajectory ahead. The unemployment rate is computed as the number of unemployed people actively looking for a job as a proportion of the overall labor force and, therefore, is vulnerable to fluctuations of the active labor force. Many investors and economists believe that a number of discouraged workers who exited the labor market during the recession will turn back into the labor force and reverse the ongoing downward trend in the unemployment rate. Although there could be a cyclical rebound in the participation rate as the ongoing recovery might encourage more potential workers to join the labor force, any upward pressure from new entrants will be offset by the downward trend driven by structural demographic factors i.e. the aging of the working population and retirements among the baby boomers (See Eurobank Research, Global Markets Special Focus Reports, “A closer look at the US labor market”, 6 April 2012).

Reduced downside risks should prompt a pickup in economic activity

As Fed officials have clearly stated, downside risks to US growth have diminished since the fall. Peak fiscal drag is probably behind us as the restraint is somewhat front-loaded, suggesting a lessening drag on spending growth throughout the year. Equity price gains and the recovery in the US housing market have undoubtedly added to household wealth, providing a significant stimulus for additional spending. Both the manufacturing and non-manufacturing purchasing manager’s indices have been very

strong, reporting their highest readings in more than two years (Figure 4). The Fed's September Beige Book that includes information collected between early July and late August highlighted that real economic activity expanded at a "modest to moderate" pace. In line with the improvement in investors' confidence and the general expectation that the impulse from changes in financial balances will start to rebuild as the drag from fiscal retrenchment diminishes over time, we expect that real GDP growth will start to pick up momentum towards 2.5% qoq saar in Q4 from an annual rate of about 1.7% in the first three quarters of the year.

Figure 4



Source: Institute for Supply Management (ISM), Bloomberg, Eurobank Research

Modest Fed tapering of about $10-15 bn per month, centered on Treasuries

Altogether, we believe that the Fed is becoming more confident in a sustained recovery of the economy as we move towards the end of the year, and more concerned about the declining benefits of quantitative easing versus rising costs. Our baseline scenario is that Fed officials will likely taper the monthly rate of its asset purchases at the upcoming September 17-18 FOMC meeting, but at a modest amount due to the disappointing August employment report. In line with Krishnamurthy and Vissing-Jorgensen's paper presented at the Jackson Hole conference in late August[1], we believe that the Fed will focus most or all of the slowing of quantitative easing on Treasury purchases rather than Mortgage Backed Securities (MBS) purchases. The empirical findings of the above mentioned study, which are consistent with some Fed officials' thinking on the effectiveness of asset purchases, highlight that MBS purchases have been more effective in lowering mortgages rates and easing financial conditions than Treasury purchases. The reason is that Treasury purchases push down Treasury yields and, therefore, affect government borrowing costs, but leave other private sector yields largely unaffected, while MBS purchases lower private borrowing costs more directly, having a much more direct and effective effect on the economy.

Having said that, the Fed will likely embark on a modest taper, whereby Treasury purchases are reduced from $45bn to $35bn per month and MBS purchases are either held steady at $40bn per month, or reduced to $35bn per month. However, the September tapering is a close call; should the Fed decides to wait for more reassuring signs for a sustained pickup in real economic activity, then the start of asset purchases tapering will be pushed out to the October 29-30 FOMC meeting. Mr. Bernanke has highlighted in his speech at the post-June FOMC press conference that the asset purchase program will be completed when the unemployment rate is around 7%. Based on our forecasts, the quantitative easing program should be concluded by the end of Q1 2014. Given that markets are largely prepared for some degree of tapering at the September meeting, this move seems to have been priced into the market. Hence, we do not believe that the Fed tapering would spook the market, especially if the slower pace of easing is accompanied by a strengthening of Fed's forward guidance, which, in our view, is the most likely scenario.

[1] Krishnamurthy, A. and A. Vissing-Jorgensen, 2013, "The Ins and Outs of LSAPs", Federal Reserve Bank of Kansas City, August 9.

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