ISSN: 1791-35 35

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GLOBAL ECONOMIC & MARKET OUTLOOK
December 20, 2013
Eurobank
FOCUS NOTES

FOMC starts tapering along with enhanced forward guidance

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- The FOMC decided to reduce its QE asset purchases by $10bn per month beginning in January 2014, equally split between Treasuries and MBS.
- Although there was not a specific reduction in the unemployment rate threshold or an inclusion of a floor to the inflation target, the Committee stated that it is likely to continue its zero policy rate "well past" the time that the unemployment rate declines below 6.5%.
- The economic assessment of the outlook was somewhat more upbeat, acknowledging the cumulative progress in labor market conditions and the diminishing fiscal restraint.
- We expect the Fed to reduce its monthly pace of asset purchases by about $10bn at each subsequent meeting, concluding the asset purchase program in Q4 2014. The reduction in its asset purchases is expected to be evenly applied to Treasuries and MBS. We continue to believe that the first rate hike won't come until mid-2015.

Modest Fed tapering begins in January 2014

In an unexpected move, the FOMC decided at its December 17-18 meeting to start tapering its asset purchases. In particular, the Committee reduced the pace of its agency MBS purchases to $35bn per month from $40 bn per month, and the pace of its Treasury purchases to $40bn per month from $45bn per month starting in January 2014. The Federal Reserve highlighted that future reductions in its asset purchase program would materialize in further measured steps at subsequent meetings provided that the economic outlook is broadly in line with the Fed's economic projections. During his post-FOMC press conference, Chairman Bernanke said that the Committee's baseline scenario expects similar-sized reductions at every future meeting, likely concluding the asset purchase program at the end of 2014. Nevertheless, the Fed wants to keep its flexibility, underpinning that asset purchases are not on a preset course, in the sense that if economic activity proves to be slower than expected, the program could be adjusted accordingly and "skip a meeting or two". In the opposite case, if growth exceeds expectations and picks up more strongly, then we could have a more rapid pace of Fed tapering. According to Fed's consensus, the reductions in the pace of asset purchases will be equally split between Treasuries and MBS. The sole dissent in the December FOMC meeting was Boston Fed President Rosengren who stated that changes to the Fed's asset purchase program are currently premature given the elevated numbers of unemployment rate and the low level of inflation rate which is well below the Fed's target. Fed's concern about the inflation outlook was marginally enhanced, highlighting that "it is monitoring inflation developments carefully for evidence that inflation will move back toward its objective over the medium term".

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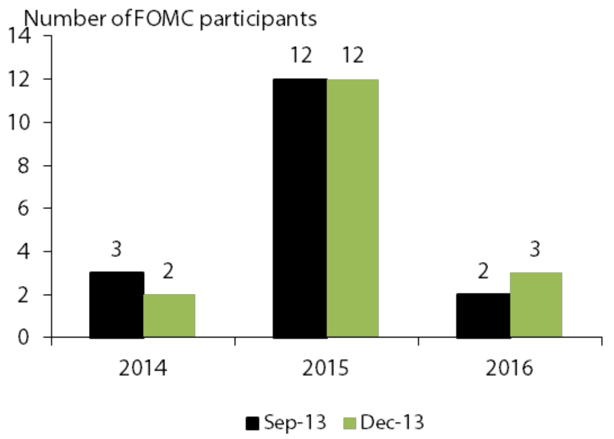
Qualitative change to Fed's forward guidance

As far as forward guidance is concerned, although there was not a reduction in the unemployment rate threshold or an inclusion of a floor to the inflation goal, the Committee stated that it is likely to continue its zero policy rate "well past" the time that the unemployment rate declines below 6.5%, especially if projected inflation continues to hover below the Fed's longer-run goal of 2.0%. Chairman Bernanke saw the December changes as partly enhancing the Fed's forward guidance (i.e. like putting a soft inflation floor in its policy rate guidance) and stated that the Committee could strengthen more its forward guidance in various ways in the upcoming meetings.

The Fed's Summary of Economic Projections (Table 1) revealed that although the unemployment rate is expected to decline to 6.5% by the end of 2014, the majority of FOMC participants expect the first interest rate hike in 2015 of even later (Figure 1). Given that the median participant's forecasts for the fed funds rate fell to 0.75% at end-2015, and the median participant's forecasts for the unemployment rate and core PCE inflation currently stands at 6.0% and 1.8% y-o-y at end-2015, respectively, the Committee implicitly reduced the unemployment rate threshold below 6.5% and gave an inflation floor. Hence, according to the latest Fed's forecasts, the FOMC will keep its zero rate policy until the unemployment rate slows to around 6.0% and PCE inflation is in the range of 1.6-2.0% y-o-y.

Figure 1
Appropriate Timing of Policy Firming in the US

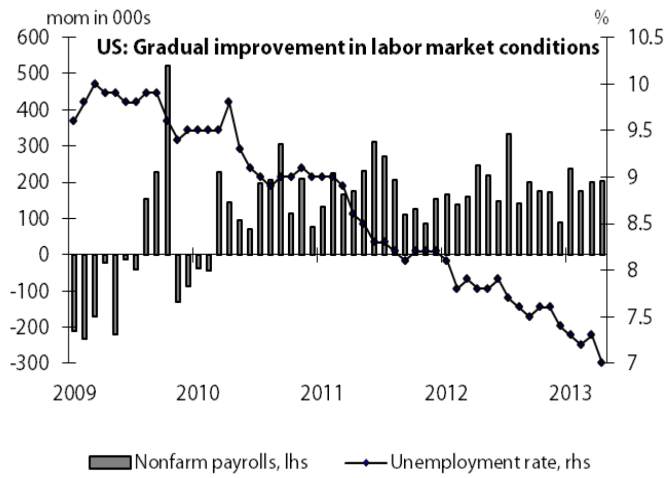


Source: Federal Reserve

Improved economic conditions and balanced risks underpin Fed's decision to taper

The economic assessment of the outlook was somewhat more upbeat than the previous meeting. Justifying its decision to start tapering its asset purchases, the Committee acknowledged the cumulative progress in labor market conditions. Indeed, the November employment report was fairly stronger than expected. Nonfarm payrolls increased by a healthy 203k, with upward revisions to the prior two months that set the three-month moving average to around 200k. In the household survey, the unemployment rate declined more than expected, declining to 7.0% from 7.3% in the previous month (Figure 2). Meanwhile, strong November retail sales points to stronger consumption growth ahead, supported by improved household finances and the housing market recovery. Risks to the economic outlook and the labor market have been characterized as having become more nearly balanced, as the negative effect from fiscal policy is probably diminishing and the uncertainty from the political side has significantly declined. The recent fiscal deal[1], which reverses some of the spending cuts under sequestration over the next two years, reduces the likelihood of another government shutdown on January 15 that the spending authority is set to expire. Furthermore, it actually reduces the expected fiscal drag by about 0.2pp in 2014.

Figure 2



Modest bond selloff, equity market rally

Although the majority of analysts were actually expecting the Fed to postpone tapering until January or even March 2014, the relatively proactive move by the Fed did not provoke a strong correction in financial markets. US 10-y Treasury yields increased by roughly 10bp while Eurodollar contracts were essentially unchanged, suggesting that the slow pace of tapering and the strengthening of forward guidance prevented a bigger increase in longer-term rates. Meanwhile, stock markets more than

[1] The fiscal agreement that both the House of Representatives and the Senate passed the previous days is headed for the President's approval. In particular, the agreement sets non-emergency discretionary spending authority at $1.012trn and $1.014 trn in FY2014 and FY2015, respectively, with an increase of $45bn in 2014 and $20bn in 2015 compared to the levels projected under current law.

welcomed the Fed's announcement, as all three US equity indices (S&P 500, Dow Jones Industrial and Nasdaq) surged more than 1.0% past the taper. Equity markets have probably focused on the strength of the economy and the improvement in labor market conditions that urged the FOMC to start tapering its bond-buying program.

What to expect from the Fed

Revising our forecasts for the US monetary policy, we expect the Fed to reduce its monthly pace of asset purchases by about $10bn at each subsequent meeting and to further strengthen its forward guidance, concluding the asset purchase program at its October or December 2014 meeting. The reduction in its asset purchases is expected to be evenly applied to Treasuries and MBS, in line with the consensus of the FOMC participants. Should we prove to be right, the total amount of asset purchases would reach roughly $1.600trn with the Fed's balance sheet surging at about 4.300trn in Q4 2014. We continue to believe that the first rate hike won't come until mid-2015, when the unemployment rate should hopefully have reached 6.0% (from 7.0% currently) and core PCE inflation 1.6% y-o-y (from 1.1% currently).

Table 1
Economic Projections of Federal Reserve Board Members and Federal Reserve Bank Presidents, December 2013

	Central Tendency*				
USA	**2013**	**2014**	**2015**	**2016**	**Longer run**
Change in real GDP	**2.2 – 2.3**	**2.8 - 3.2**	**3.0 – 3.4**	**2.5 – 3.2**	**2.2 - 2.4**
September forecast	(2.0-2.3)	(2.9-3.1)	(3.0-3.5)	(2.5-3.3)	(2.2-2.5)
Unemployment rate	**7.0 - 7.1**	**6.3 - 6.6**	**5.8 - 6.1**	**5.3 – 5.8**	**5.2 – 5.8**
September forecast	(7.1-7.3)	(6.4-6.8)	(5.9-6.2)	(5.4-5.9)	(5.2-5.8)
PCE inflation	**0.9 - 1.0**	**1.4 - 1.6**	**1.5 - 2.0**	**1.7 - 2.0**	**2.0**
September forecast	(1.1-1.2)	(1.3-1.8)	(1.6-2.0)	(1.7-2.0)	(2.0)
Core PCE inflation	**1.1 - 1.2**	**1.4 – 1.6**	**1.6- 2.0**	**1.8- 2.0**	
September forecast	(1.2-1.3)	(1.5-1.7)	(1.7-2.0)	(1.9-2.0)	
Fed Funds Rate	**0.00 - 0.25**	**0.00 – 0.25**	**0.50- 1.50**	**1.50- 3.00**	**3.50 - 4.00**
September forecast	(0.00 - 0.25)	(0.00 – 0.25)	(0.75- 1.50)	(1.75- 2.75)	(3.75 – 4.00)

*The central tendency excludes the three highest and three lower projections for each variable in each year.

Source: Federal Reserve, Eurobank Research

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ISSN: 1791-3535