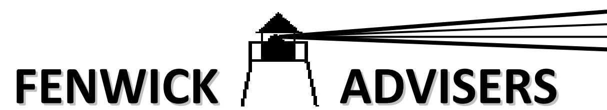
No Tapering (yet), the Neutral Funds Rate and Other Fed Nuances

In answer to media questions about why the FOMC decided to forestall tapering of its asset purchases, Chairman Bernanke offered three considerations that weighed on members during the discussions. First and most straightforward, the economy and labor market conditions simply were not where members had wanted before they eased off the monetary throttle. On this, there is little debate: unemployment still is high and growth in both output and employment has not lived up to the Fed's own forecasts. By this metric alone, members seem justified in waiting a bit longer. Second, there was concern that monetary conditions actually had tightened with the backup in Treasury bond yields and mortgage rates. Bernanke said some members wanted to wait and see whether those higher market rates would adversely affect interest-sensitive sectors that were leading the recovery. That argument is less compelling and somewhat circular. There are no guarantees that the economy will strengthen and asset purchases at the current pace are intrinsically unsustainable since the Fed someday would end up owning all the outstanding Treasuries. At some point, the Fed must call it quits and it is better to do so while the economy is stable. The third, and in my opinion a telltale comment, was Mr. Bernanke's admission that the Committee had discussed the risks associated with the congressional deadline next month on the debt ceiling. Later, he also admitted that the Fed had an obligation to deal with any backlash from congressional deadlock on the debt ceiling and in fact that is exactly what had happened in 2011 when Congress also threatened to suspend payments on its obligations. To me, Bernanke's strong words and repeated warnings on this subject over the past few days indicate that Congressional intransigence weighs heavily in FOMC members risk assessment and may have been the last straw in deciding to postpone any tapering for another month.

On the Fed's other monetary tool, forward guidance, Mr. Bernanke emphasized that the Committee would redouble its efforts to communicate its view on the future course of the fed funds rate. The majority of members still do not expect the first rate hike until 2015 and some expect it to be delayed until 2016. Most significantly, the consensus of FOMC members expects the funds rate to be 2% when the economy is forecast to reach full employment sometime in 2016. Under normal circumstances, the expected funds rate at full employment would be considered the so-called 'neutral' funds rate. So Bernanke had to avoid this terminology because Committee members are no yet willing to abandon the historic norm of 4% to which the Fed might someday have to revert. To reconcile that inconsistency, Bernanke had to claim that the nature of deleveraging and legacy banking issues including unfinished regulatory safeguards would preclude a return to a 4% funds rate for many years after 2016. He quipped that pontificating about interest rates that far in the future stretched credulity - similar to Keynes's quip that in the long run we are all dead.

In short, the Fed's message is much the same as we have expected - policy rates will stay low for a long time and duration suddenly is back in fashion because pension funds and



other institutional investors need duration to match their liabilities. Moreover it appears that the market has come around to our view that fair value on the UST 10-yr bond currently is somewhere in the range of 2-1/2% to 3%. The big winner today, though, were Eurodollar futures, which clearly were grotesquely mispriced when they called for a first rate hike in 2014.

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