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Don't fight the 'Feds'

With the Fed's monetary accommodation set to continue for the foreseeable future (until unemployment falls below 6.5% and/or inflation rises above 2.5%), we think risk assets like stocks and high-yield bonds will continue rallying as it becomes clear that the global economy will avoid recession in 2013.

Furthermore, the world's top-tier central banks all appear determined to pursue reflation and elevate risk assets internationally.

Fed Underwrites Risk Assets By Extending QE3 And Setting High Bar For Removing Exceptionally Low Rates

Don't Fight the Fed: "So what's important is the fact that we're acquiring Treasury securities and MBS, taking those out of the market, you know, forcing investors into other closely related assets. And that's where the stimulus comes from, not so much in the size of the balance sheet, per se." – Ben Bernanke, 12/12/12

Last week the Federal Reserve unequivocally ended 'monetary' policy purgatory, in our view. The Fed explicitly stated that it would keep short-term interest rates exceptionally low "at least as long as the unemployment rate remains above 6.5%, inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee's 2% longer-run goal, and longer-term inflation expectations continue to be well anchored." They explained their reasoning thusly: "The Committee remains concerned that, without sufficient policy accommodation, economic growth might not be strong enough to generate sustained improvement in labor market conditions. Furthermore, strains in global financial markets continue to pose significant downside risks to the economic outlook. The Committee also anticipates that inflation over the medium term likely would run at or below its 2% objective." Setting expectations by issuing forward guidance, in this case by establishing reaction thresholds, increases monetary policy transparency in our view and should reduce market uncertainty surrounding eventual policy changes.

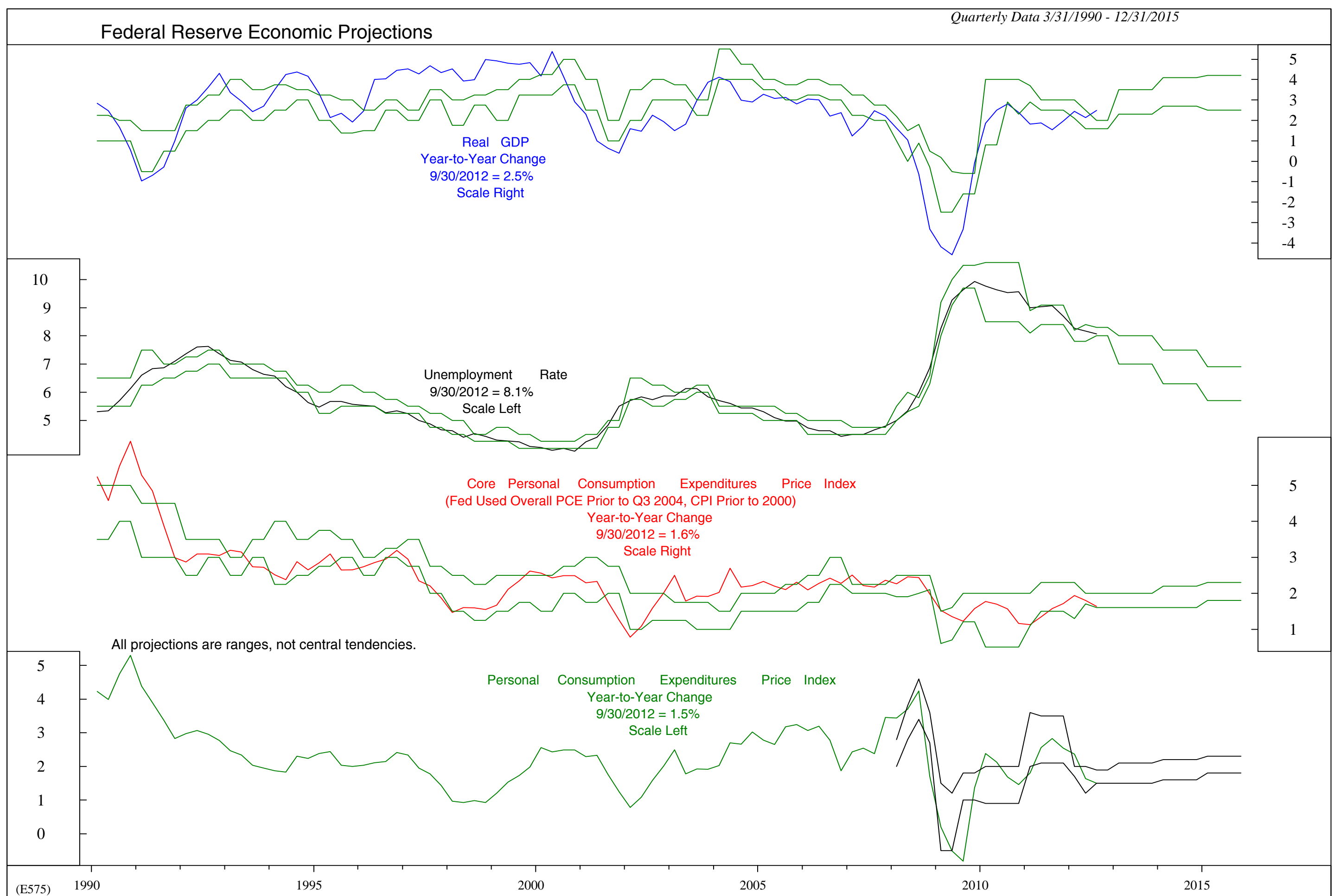
For example, the Fed does not currently project inflation to rise above 2.5% over the next several years, as our Weekly Chart shows, but does anticipate unemployment to fall below 6.5% in 2015, at which point it would begin to contemplate raising the federal funds rate. If inflation (expectations) rise above the 2.5% threshold and/or unemployment were to fall below 6.5% before 2015, then markets should expect an earlier exit from the Fed's zero interest rate policy (ZIRP). Alternatively, if unemployment remains stubbornly above 6.5% (and inflation remains contained below 2.5%) then ZIRP could extend beyond 2015. By making interest rate policy conditional upon economic outcomes, the Fed's communication strategy has now "become a centerpiece of appropriate monetary policy," as the Fed's Vice Chair Janet Yellen (a potential candidate to replace Fed Chair Ben Bernanke) remarked last month.

In addition to new guidelines for setting monetary policy the Fed also extended its asset purchase program for Treasuries and mortgage backed securities (MBS). They will continue buying longer-term Treasuries at a pace of $45 billion/month and agency MBS at $40 billion/month in order to "maintain downward pressure on longer-term interest rates, support mortgage markets, and help to make broader financial conditions more accommodative," with the goal of fostering labor market improvements in the context of price stability. Moreover, the Fed "expects that a highly accommodative stance of monetary policy will remain appropriate for a considerable time after the asset purchase program ends and the economic recovery strengthens."

In Bernanke's press conference following the Fed's announcement, most of the questions were about how the fiscal cliff would impact the economy and the Fed's response, if any. Bernanke said that he expected congress and the president to find a solution that "does no harm" to the economy while setting the stage to credibly reduce the deficit over the long run. If not, Bernanke reiterated his previous stance that there is no way for the Fed to entirely offset its effects. We remain cautiously optimistic that most of the fiscal cliff will be avoided next year and with monetary accommodation set to continue for the foreseeable future (until unemployment falls below 6.5% and/or inflation rises above 2.5%), we think risk assets like stocks and high-yield bonds will continue rallying as it becomes clear that the global economy will avoid recession in 2013.

The world's top-tier central banks all appear determined to pursue reflation and elevate risk assets internationally. Japan's Liberal Democratic Party won a landslide victory on Sunday, promoting party leader Shinzo Abe to Prime Minister. Abe centered his election campaign on more proactive central banking and will instruct the Bank of Japan to lift its inflation target to 2% from 1% when in office December 26, using "unlimited" means if necessary. Meanwhile, the Bank of England has hired the Bank of Canada's Governor Mark Carney, who in recent speeches has seemed open to pursue more aggressive 'unconventional' monetary policy easing such as nominal GDP targeting. Like Bernanke (and the European Central Bank's Mario Draghi), both Abe and Carney have talked about using their respective central bank balance sheets to follow explicit policy goals and meet forward guidance. We view this as an evolution in global central banking in the fiat currency era (since the gold standard was abandoned in the early 1970s), where exceptionally low rates are the new normal.

THE WEEKLY CHART: FED SEES INFLATION CONTAINED AND UNEMPLOYMENT FALLING



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