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Global Central Bank Focus

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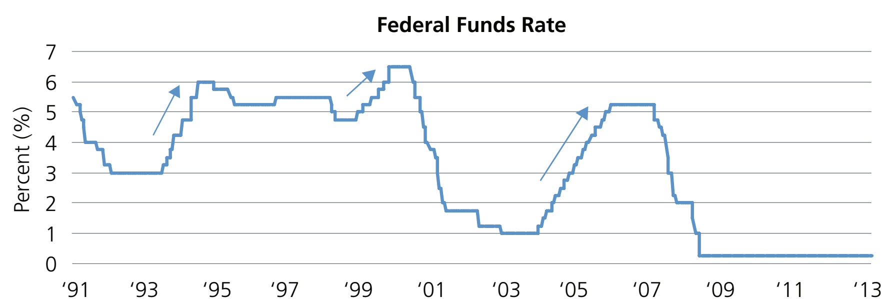
The New Normalization – of Fed Policy

Let's jump to this note's conclusion: Past is not prologue for the projected path of the Fed's policy rate, which we expect will remain low for a very long time. A baby born today will probably be in kindergarten by the time the Fed adopts a neutral stance on monetary policy.

Back in the day, when the Federal Reserve decided it was time to unwind its easy monetary policies, it would raise its policy rate, the federal funds rate, persistently until it reached a point somewhere above 4%, the level the Fed believes is roughly consistent with a neutral stance on monetary policy. The central bank's past three rate hike cycles – 2004 to 2006, 1999 to 2000, and 1994 to 1995 – ended at 5.25%, 6.50% and 6.00%, respectively, as shown in Figure 1.

FIGURE 1: IT'S BEEN A WHILE – REMEMBER WHAT A RATE HIKE CYCLE LOOKS LIKE?



Source: Federal Reserve data through September 2013

Whereas the Fed in the previous three cycles increased the federal funds rate within 18 months of last cutting it, today – nearly five years after the Fed lowered its policy rate to zero – the Fed is *still* easing, providing new monetary accommodation each time it buys bonds through its so-called quantitative easing program. No end to purchases appears likely before at least the middle of next year, if not later, given that the Fed announced in its September 18th policy statement that it had decided against reducing the level of purchases, a surprise to markets.

It's also important to recognize considerable time will likely pass between the end of the Fed's bond buying and its first rate hike. The Fed said as much in its policy statement, which, along with the "no taper" decision, contained the clearest indications yet that the path to a normalization of interest rates will be anything but normal. Call it a new normalization – for rates, that is.

A demonstration of patience

At its September 18th policy meeting, the Fed persuasively demonstrated its patience toward normalizing its accommodative stance, in three ways:

1) Delaying tapering
2) Strengthening its forward guidance
3) Projecting a 2% federal funds rate at the end of 2016

These powerful actions remind us of the adage: Don't fight the Fed! It is sending a crystal-clear message that the unwinding of its extraordinary accommodation will be done with great care and patience, and will take time – a long time.

Although perhaps the least important in terms of longer-term investment implications, the most striking *news* from the Fed's policy announcement was of course its decision to delay the expected taper. The Fed cited three reasons:

1) Insufficient evidence indicating recent progress in the economy will be sustained
2) The recent tightening of financial conditions
3) Uncertainty over the impact of fiscal policy

On the economy, the Fed concludes it sees no credible evidence of the acceleration in economic growth it and others are expecting for 2014. Data continue to suggest 2% growth and that anything faster is more a prospect than a reality at the moment.

The Fed's reference to financial conditions is striking given that the U.S. equity market entered the day a hair from its all-time high! The rise in interest rates obviously jolted the Fed, and it wants to stymie a further rise, lest the nascent housing recovery be put in jeopardy. A key objective of the central bank's activism, after all, is to suppress the term premium, which it aims to influence by suppressing interest rate volatility. Moreover, by showing little tolerance for declines in asset prices, the Fed in essence has underwritten a very large "put" purchase for investors in riskier assets, including equities, albeit one at an unknown strike price.

On fiscal policy, the Fed is concerned that the U.S. economy may continue to feel reverberations from not only the fiscal tightening put in place at the start of 2012, but also from the budget sequestration – automatic spending cuts – enacted in March 2013, because many of the spending cuts have yet to materialize. In addition, American businesses and households are about to witness yet another unsettling battle over the U.S. debt ceiling, Obamacare and funding for the federal government.

The Fed's projections and new forward guidance: making words more believable

By keeping its bond-buying program intact, the Federal Reserve has demonstrated the credibility of its forward guidance on interest rates, making its projection for a 2% end-of-2016 federal funds rate more believable than it would have been otherwise.

FIGURE 2: FEDERAL RESERVE PROJECTIONS BOLSTER ITS STATED FORWARD GUIDANCE

Summary of Projections of Federal Reserve Board Members and Federal Reserve Bank Presidents, September 2013		
Variable	Central tendency for the end of 2016	Longer run
Unemployment	5.4 to 5.9	5.2 to 5.8
Personal consumption expenditures inflation	1.7 to 2.0	2.0
Federal funds rate[1]	2.0	4.0

[1]This is the average of projections by FOMC participants for the appropriate level of the target federal funds rate at the end of 2016

Source: Federal Reserve, September 2013

After all, how can the Fed reconcile how it expects the federal funds rate more than three years from now to be at just 2% at a time when the economy, again as projected

by the Fed, will be at full employment, with inflation at the Fed's 2% target?

While the central bank could easily have leaned on its explanation that the U.S. economy faces considerable headwinds and downside risks, it is taking no chances. It is acting on its words so that its 2% rate projection is more credible.

Other conclusions from the latest Fed policy meeting are of particular importance to bond investors. In delaying a taper, not only did the Fed show markets it has little tolerance for any tightening of financial conditions, it also strengthened its forward guidance – considerably. These are the two most important statements aimed at that task, both drawn from Chairman Ben Bernanke's September 18th press conference:

> "The Committee would be unlikely to increase rates if inflation were projected to remain below our 2% objective for some time[.]"

> "[T]he first increases in short-term rates might not occur until the unemployment rate is considerably below 6.5%."

The first quote reminds us that slow economic growth means that low inflation, which tends to lag the business cycle by about two years, is likely to stay low for a long time. This is important. Inflation has run well below the Fed's 2% target for three years already, averaging about 1.5%, and it likely will do so over a stretch of five to six years. This threatens the U.S. economy because it limits wage growth just when the U.S. needs wages to grow faster to improve the ability to sustain debt.

In the second quote, the Fed broadened its definition of what constitutes a substantial improvement in the labor market outlook – de-emphasizing the jobless rate while elevating the importance of other indicators on labor market conditions, such as the labor force participation rate, part-time employment, discouraged workers, etc. After all, the jobless rate is an imperfect gauge of labor market slack. An estimate by Jan Hatzius of Goldman Sachs suggests overall employment is 3.5% to 4.0% below its potential.

By focusing on a more comprehensive set of indicators, the Fed can be more patient about reducing and eventually removing its extraordinary monetary accommodation.

Amid the Fed's powerful actions, Ben Bernanke, the departing Fed chairman, is going out with a clear message of support for investors. Detractors will say the Bernanke Fed at the end of the day turned its back on those who worry that the Fed's loose policies will lead to overvalued prices in financial markets and financial instability. Time will tell on this one, but what is needed to prevent these bleak outcomes is real economic growth, of which there has been too little in recent years relative to historical averages.

Investment implications

For bond investors, the Federal Reserve's decision to delay a taper will relieve some of the upward pressure on longer-term interest rates, where the Fed's buying is greatest as a percentage of overall issuance.

Other parts of the yield curve may fare better, however, owing to the Fed's enhanced forward guidance and its 2016 rate projection. We believe intermediate maturities should benefit most, as rate hikes were disproportionately priced into that part of the curve during the summer turbulence.

Elsewhere in markets, prospects should improve for forward rates (as seen in eurodollar futures), where large speculators had done a big "Switcheroo" and moved from long to short to price in rate hikes that PIMCO believes are improbable given our forecast for the first hike to occur in 2016.

Interest rate volatility should remain suppressed, benefiting the rate climate and investments with relatively strong linkages to interest rate volatility, including mortgage-backed securities and options strategies tailored to benefit from relatively narrow trading ranges for bond yields.

Markets hampered by liquidity and technical issues, including emerging markets and inflation-linked securities, are also likely to fare better in the aftermath of the Fed meeting, but a return to full normalcy will take time.

Finally, as we have stressed for some time now, when thinking about the Fed and why the normalization of Fed policy is likely to be anything but normal, keep in mind these three things most of all:

The policy rate,
The policy rate,
and the policy rate!

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