The failure of forward guidance

- **The Fed's forward guidance failed its first major test**
- **But the fault was with the guided as well as with the guide**
- **QE will still come to an end in 2014**

In common with most other commentators, I misread the Fed's intentions and was therefore surprised by the no-change to QE decision on 18th September. Following that decision, there are some questions which should be addressed.

First, was this a failure of forward guidance? Second, was the Fed's decision justified? And, third, what happens now?

The general market surprise at the Fed's inaction is proof enough that if forward guidance is an attempt to give markets a clear steer as to where monetary policy is heading, then it failed its first major test. However, that failure was on both sides – the guide as well as the guided.

Taper talk began in earnest last May, when Chairman Bernanke said that the FOMC was likely to begin its taper later this year and that he expected QE to have run its course when the rate of unemployment dropped below 7%. He did stress, as have other FOMC members, that the policy is data-dependent.

This is where forward guidance first failed. The guided – markets and others – listened to what was being said and – not unnaturally – thought that such explicit guidance meant that taper was a done deal. They reacted accordingly, including selling off bonds. Yields on US Treasuries rose by around 100bps. The failure of the guided was to not listen carefully enough to what the various Fed spokesmen were saying in the meantime, when they stressed that there was no firm decision taken at all. Instead, the conviction that QE taper would now begin, in October if not September, grew.

However, there was also failure on behalf of the guide – the Federal Reserve. This is more serious and on multiple levels. One reason that the Fed did nothing was apparently that they were concerned about higher bond yields and did not want to do anything that would push them even further. But, it must have been obvious to the members of the FOMC that any taper talk would lead to a bond sell-off.

More importantly, at no stage over the summer did anyone from the Fed say 'the economy has been much weaker than we expected; we need to postpone the start of the taper.' Yes, it was repeated that policy was data-dependent – but data has not been that bad. Unemployment continued to fall – and note that Chairman Bernanke at his post-FOMC meeting press conference explicitly ruled out the lower participation rate as a main cause of lower unemployment – and Q2 GDP came in stronger than originally estimated. Labour market and housing data weakened slightly – but that was one month's data (two, including the revision of the previous month's non-farm payrolls). If the Fed is going to be spooked by one or two months' worth of data, it will never be able to change any policy.

Stein Brothers (UK) Ltd.
Telephone: +44 (0)7768 094 340
Email: gabriel.stein@steinbrothers.co.uk

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Whether or not the Fed decision was justified, remains to be seen. However, on the basis of data published over the summer, while activity in Q3 is likely to be slower than in Q2, the recovery remains on track. The Fed has revised its economic forecasts; but growth in 2014 is still projected to be above-trend, with unemployment likely to reach the 6½% trigger next year. In fact, the unemployment forecast is revised down, not up, even though output growth is also revised down.

The Fed's concern about rising bond yields is understandable; but the muted reaction to the decision (aside from the immediate market jump), a signal that markets believe the postponement was only a matter of months, means that we are unlikely to see a reversal to bond yields prevalent a year or even six months ago.

A second Fed concern is the fiscal policy debate, including an upcoming need to raise the debt limit. But this debate is likely to remain a part of the political landscape for the foreseeable future. Meanwhile, the impact of the much-feared 'fiscal cliff' has been considerably less than expected; and state and local governments (whose share of GDP exceeds that of the federal government) no longer need to tighten policy.

On these bases, it seems that the justification of the Fed's inaction is doubtful at the very least.

Looking to the future, one common analyst reaction was that if the Fed did not announce a taper in September, why would they do so in October/November (the next meeting is 29-30 October), meaning that we won't see anything until December at least. Changing position within six weeks is perceived to harm the Fed's credibility. But that view risks repeating the errors that caused the September surprise. Chairman Bernanke was clear that tapering could still begin in 2013; and Jim Bullard, President of the St Louis Fed, has said that tapering could well begin in October. It would be wise to pay heed to this. Equally, when the Fed says that even after a taper decision they can vary their purchases up as well as down, we should take that on board as well.

If anything, the art of parsing FOMC statements will now reach new heights. But, worryingly and paradoxically, in its attempts to be ever more clear and transparent, the Fed may actually be the cause of further volatility and confusion. Different Fed Governors and regional Fed Presidents have differing views, frequently expressed. Meanwhile attempts to clarify by adding further conditions – Chairman Bernanke mentioned a possible inflation rate below which interest rates would not rise – also add to the uncertainty.

What seems clear is that some time next year (probably by mid-year) the quantitative easing will come to an end. The 6½% unemployment threshold should be reached in H1 as well. The Fed probably – should also consider one increase in the Fed Funds rate in late 2014, mainly as a signal that interest rates will be normalised. But, on current data, it seems highly unlikely that the Fed Funds rate will rise before 2015.

Gabriel Stein 2013-09-23
gabriel.stein@steinbrothers.co.uk

Stein Brothers (UK) Ltd.
Telephone: +44 (0)7768 094 340
Email: gabriel.stein@steinbrothers.co.uk

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