RECENT DEVELOPMENTS IN US MONETARY POLICY AND IMPLICATIONS FOR US TREASURY MARKETS

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Cedric Scholtes
Head of Global Rates

- The Federal Reserve's new 2% PCE objective is above historical assumptions and informal guidance.
- The Federal Open Market Committee (FOMC) is not worried about inflation exceeding target rates over the forecast horizon.
- The FOMC does not put the inflation objective ahead of the full employment objective, but it may seem that way now considering that the employment objective is furthest from its target.
- The FOMC is willing to tolerate modest upside deviation in inflation outcomes to bring about a speedier correction in full employment.
- Expect more aggressive and proactive Federal Reserve accommodation.

RECENT DEVELOPMENTS IN FOMC MONETARY POLICY

Over the last year, the Federal Reserve has made significant alterations to its strategy for communicating monetary policy decisions. Chairman Bernanke has placed emphasis on transparency of communication, asserting that more detailed communication about the Federal Reserve's goals, actions and thinking should improve understanding and reduce uncertainty among households and businesses, thereby improving their ability to plan, save and invest. Given the adoption of unorthodox policy measures in recent years, the challenge of the Federal Open Market Committee (FOMC) communication has certainly become more acute.

Correspondingly, on a quarterly basis, the Federal Reserve now makes public a summary of economic projections (SEP) at the conclusion of the associated FOMC meeting. While the full SEP is released with the minutes after a delay of three weeks, the broad projections are provided in advance immediately following the meeting. The advance release includes charts and tables outlining central tendencies and ranges for real GDP growth, the unemployment rate, and headline and core PCE inflation over the forthcoming three years, as well as over the longer run.[1] In addition, the Chairman now hosts quarterly press conferences.

At the most recent FOMC meeting on January 21-22, 2012, the FOMC also released information (pre-meeting) on FOMC participants' views on the appropriate stance of monetary policy, detailing the distribution of individual assessments of the appropriate level of the Fed Funds rate at various time horizons, and thereby also their views on when rates should begin to rise. It should be noted that these projections are (i) provided by participants prior to the meeting, and (ii) reflect views about the anticipated *appropriate* level of Fed Funds, rather than an expectation about where the Committee will *actually set* the Fed Funds target. In addition, it has been stressed that these individual forecasts are only an input into the final policy decision, which is voted on by a subset of committee members, and communicated in the final policy statement.

[1] http://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20120125.pdf

Thus the committee's joint policy statement, and any guidance on the path of policy rates which it may contain, clearly takes precedence over individual forecasts.

In addition, on January 25th, the FOMC also released a document outlining its longer-run goals and monetary policy strategy.[2] This document, which is subject to annual revision provides further insight on how the FOMC approaches its mandated dual objectives of price stability and full employment. The document is well worth reading in its entirety, but we point out the following highlights:

(i) For the first time, the FOMC had defined its inflation objective: "The Committee judges that inflation at the rate of 2 percent, as measured by the annual change in the price index for personal consumption expenditures (PCE), is most consistent over the longer run with the Federal Reserve's statutory mandate.

Note also that the inflation objective refers to headline PCE rather than core PCE, a change that confirms the FOMC's acknowledgement that fluctuations in energy and food prices matter to consumers, even if their volatility means that core PCE may be a better indicator of underlying inflationary pressures, and thus serves as a better guide for policy. In addition, note that this 2.0% rate for the PCE objective is above the 1.0% - 2.0% range, or "comfort zone" for core PCE that has previously been used as (informal) guidance for the Federal Reserve's definition of price stability, and also above the 1.7% - 2.0% 'longer run' range for PCE contained in November's SEP. This increase from a "comfort zone" mid-point of 1.5% to the new 2.0% objective is important, and perhaps reflects a collective reassessment by the committee of what represents an "optimal" inflation rate – an important issue given several recent brushes with deflationary conditions in recent years. (The new definition of price stability also has clear implications for the evolution of inflation expectations, and the pricing of both conventional and inflation-indexed Treasuries, which we discuss more fully below).

(ii) On the other hand, the Committee noted that the "the maximum level of employment is largely determined by non-monetary factors that affect the structure and dynamics of the labor market. These factors may change over time and may not be directly measurable. Consequently, it would not be appropriate to specify a fixed goal for employment; rather, the Committee's policy decisions must be informed by assessments of the maximum level of employment, recognizing that such assessments are necessarily uncertain and subject to revision".

In other words, the FOMC recognizes that full employment, or conversely, the "natural" rate of unemployment, is difficult to measure and impacted by structural factors beyond the control of the central bank. Disagreements about where the economy's prevailing natural rate of unemployment / non-accelerating inflation rate of unemployment (NAIRU) is will therefore continue to complicate policy-setting. But one should consider that some economists and policy makers have indicated NAIRU is path-dependent – the natural rate of unemployment will rise if unemployment rises to elevated levels, driving up rates of long-term unemployment which can depreciate work skills and reduce attachment to the workforce. If this assertion is correct, the implication is that the central bank can influence the natural rate to a degree, and implies that policy should be aggressive in combating increases in unemployment to reduce permanent damage to output and employment. It is worth noting the upward revision in recent years of the Federal Reserve's assessment of the 'normal' rate of unemployment from 4.0% – 5.0% to the current 5.2%-6.0% range.

(iii) It is noted that "in circumstances in which the Committee judges that the objectives are not complementary, it follows a balanced approach in promoting them, taking into account the magnitude of the deviations and the potentially different time horizons over which employment and inflation are projected to return to levels judged consistent with its mandate".

In considering cases where the Federal Reserve's objectives clash, investors have often judged that price stability was the dominant objective, since maintaining a low and stable inflation climate has often been stated as the best way to promote full employment in the long run. However, at the last press briefing, the Chairman clarified that the FOMC placed "equal weight on the price stability and full employment objectives". Intriguingly, Chairman Bernanke also stated that in cases

[2] http://www.federalreserve.gov/newsevents/press/monetary/20120125c.htm

where inflation was modestly above target but employment was significantly below full employment levels, "if there is a need to let inflation return more slowly to target in order to get a better result on full employment then that's what we would do" – confirming that in periods where employment undershot very significantly below the perceived full employment rate, inflation would be allowed to overshoot to a degree. This is an important clarification of the Federal Reserve's monetary policy reaction function, with implications for how investors should think about the probable paths for policy in coming years. The Federal Reserve places equal weight on each objective, but the emphasis will depend on the relative divergence of each variable from its respective target. In the current economic backdrop, investors should recognize that it is the employment objective that is furthest from its target.

Recent policy announcements

Since last August, the FOMC has taken a series of increasingly aggressive steps to provide additional policy accommodation. At the August meeting, the Committee provided forward guidance on the future path of Fed Funds by stating that it did not anticipate economic conditions improving sufficiently to warrant a removal of policy accommodation until "at least mid-2013". While not a commitment *per se*, the message was clear – the pace of recovery was regarded likely to remain unsatisfactory for many quarters, warranting easy policy (as long as inflation and inflation expectations remained anchored). In September, following the US debt ceiling debacle and the intensification of European sovereign debt concerns, the downside risks to growth were deemed troubling enough to warrant further support, in the form of the SOMA maturity extension program. This program, also known as "Operation Twist," involves selling the Federal Reserve's holdings of Treasuries with maturities less than three years to reinvest in bonds with maturities longer than six years, thereby removing duration from the market, and encouraging longer-dated yields to remain low.[3]

In the meantime, of course, US economic growth data has generally exceeded consensus expectations, though initial readings of economic strength in Q3 and Q4 2011 have subsequently been scaled back. For the January meeting, many market participants anticipated acknowledgement from the FOMC of recent improvements in the labor market. Yet the January policy statement language on growth was essentially unchanged, noting that growth would be modest and unemployment would decline only gradually. Indeed, the January central tendency projections for real GDP growth in 2012 and 2013 have been lowered from those issued in November, though the Committee does acknowledge that unemployment has already fallen by more than it had previously anticipated[4]. For 2014, unemployment is still forecast to be between 6.7% - 7.6%, well above the 5.2% - 6.0% assessment of the longer run normal range. Furthermore, despite a moderation in peripheral euro-zone yields, the committee reiterated its concerns over the downside risks posed by "strains in global financial markets", suggesting that the Federal Reserve is not (yet) sufficiently reassured by recent policy developments in the euro-zone.

Looking at the SEP, a picture emerges of an economy that is projected to grow too slowly to reduce unemployment towards target at an acceptable pace, and which seems set to experience a subdued and modestly below-target rate of inflation. Indeed, the FOMC's projections for core and headline PCE inflation suggest that inflation will remain subdued, and stay at levels at or below the newly-defined 2.0% PCE long-run objective until 2014 and possibly beyond.

The SEP allows us to draw some conclusions:

(i) With a large downside deviation on the employment objective and a modest downside deviation on the inflation objective over the forecast horizon, there is no clash between the Federal Reserve's goals at present;

(ii) The larger miss on the employment objectives suggests that the Federal Reserve should concentrate on this side of its mandate, particularly if the natural employment rate truly is path-dependent;

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[3] Unlike the first and second quantitative easing programs, Operation Twist has certainly helped to lower and flatten the term structure of Treasury yields.

[4] The FOMC's 2012 real GDP projections declined to 2.2 – 2.7% in January from 2.5 – 2.9% in November, and 2013 projections declined to 2.8 – 3.2% in January from 3.0 – 3.5% in November.

(iii) The FOMC's risk management approach to policy also dictates that the Federal Reserve should pay particular heed to the risks posed to global financial conditions by adverse developments in euro-zone sovereign credit risks, as well as the risks posed to growth by fiscal tightening in the US in 2013.

Correspondingly, it is entirely logical that the FOMC chose to change the forward guidance language in the policy statement, stating that it now anticipated that economic conditions "are likely to warrant exceptionally low levels for the Fed Funds rate at least through 2014", instead of through mid-2013, as previously indicated in December.

Fuller details of the SEP will be released with the minutes in mid-February, and there may be further surprises in members' recommendations on the potential timing and method of further non-orthodox policy measures. Certainly, the current SEP suggests further accommodative measures are very possible, though perhaps not until the conclusion of the current maturity extension program in late June.

Implications for Treasury markets

Given generally better economic data in the second half of 2011, many Treasury debt investors were surprised at the lack of upgrades to the FOMC's January growth projections. The language on growth in the statement was essentially unchanged, but the language on inflation was softened. For instance, December's statement that the "committee will continue to pay close attention to the evolution of inflation and inflation expectations" was withdrawn. The 18-month extension of forward guidance for zero interest rates was therefore certainly a surprise to market participants.

The forward guidance is, of course, not a commitment, since the data and SEP can both change. Furthermore, the FOMC's economic forecasting prowess is little better than that of other forecasters, which is to say that it is much less than perfect. There are, though, good reasons to think that the pace of US recovery will indeed be slow over the forecast horizon– namely the prospect of significant fiscal drag in 2013, financial market turbulence emanating from euro-zone sovereign credit risks, and the combination of ongoing household sector deleveraging, a restrictive financial sector regulatory environment and a depressed residential housing market.

Nevertheless, given forecast and the FOMC's interpretation of its dual mandate, the Committee's current policy bias is clear – faced with a significant shortfall in its full employment objective, limited likelihood of inflation rising above target given low rates of capacity utilization, and significant downside risks to growth, the case for continuing to provide accommodative financial conditions is, in the Federal Reserve's eyes, a strong one. Furthermore, the Federal Reserve's risk management approach to policy means that it will, by design, tend to be preemptive in providing further accommodation.

The surprise extension of forward guidance in the January policy statement clearly caught most investors by surprise. As one would expect, Treasuries rallied strongly, with the 5- to 7-year sector performing the best as investors pushed out their expectations for rate hikes. Indeed, in the days following the announcement, the 5-year Treasury yield trading as low as 71 basis points, having been trading at 91 basis points the day prior to the announcement.

It seems probable that the FOMC's "at least late 2014" forward guidance, which many investors (incorrectly) interpret as a commitment, should mean that the 3-year Treasury note will trade in a very tight yield range close to the current Fed Funds rate (between 20 and 30 basis points yield), in the same fashion that the 2-year note has been trading for the last few months. But the trading range for the 5-year yield will, in my opinion, remain less well-defined, given the potential for the economic environment and policy to develop in ways that cannot be fully anticipated over that time frame, and the need for some term premium in Treasury yields. Nevertheless, the FOMC has made clear that real, inflation-adjusted policy rates will likely be negative for several years, and thus negative real yields on 5 and 10-year TIPS should remain the status quo.

Furthermore, it is clear that the combination of FOMC policy guidance, clarification of the Federal Reserve strategic objectives, and the impact of Operation Twist, should help contain Treasury market volatility across the term structure. Front-dated nominal yield volatility in particular should continue to fall. At longer maturities, though, the potential for further

surprises on the unconventional policy front, and the FOMC's dual mandate and willingness to tolerate periods of above-target inflation should prevent a collapse of the implied volatility term structure.

We can state with some conviction, however, that recent FOMC actions and communication have probably strengthened the effective 'floor' on breakeven inflation rates. In the January policy statement and strategic principles documents, we learnt that:

- (i) For the Federal Reserve, price stability means PCE inflation at 2.0%, and not 1.5% (the mid-point of the previous "comfort zone") – essentially, the Federal Reserve has increased the inflation objective;
- (ii) The FOMC is not worried about PCE inflation exceeding the target rate over the forecast horizon;
- (iii) That the FOMC does not put the inflation objective ahead of the full employment objective;
- (iv) That it is willing to tolerate modest upside deviation in inflation outcomes to bring about a speedier correction in full employment; and
- (v) That the FOMC will be aggressive and proactive in providing accommodation.

The observations above, and the fact that CPI historically usually exceeds PCE inflation by around 0.50% per annum, current 10-year and 30-year breakeven inflation rates on TIPS at 2.20% and 2.35%, respectively, appear to offer significant value. While TIPS should trade with a discount to conventional Treasuries given their inferior liquidity characteristics, one would nevertheless anticipate some positive inflation risk premium to provide an offset. To my mind, TIPS breakevens should be trading much closer to 2.50% (the approximate CPI target), if not higher. We think the market has been slow to fully grasp the implications of recent developments of the asset class and anticipate breakevens to widen from current levels in coming weeks, particularly at longer maturities. An overweight allocation to TIPS is a key strategic implication.

Likelihood of QE3

If we have not witnessed an improvement in economic prospects by the completion of the Federal Reserve's maturity extension program at the end of June, the arguments above suggest that the FOMC will proceed with another round of quantitative easing.

Consider two of the FOMC's options for providing more accommodation: policy communication and maturity extension of the Federal Reserve's portfolio. In my opinion, additional policy guidance begins to stretch credulity – would anyone believe a 5- or 10-year guidance on zero policy rates? How much faith could one have in economic forecast over those horizons? If the FOMC went down this route, I believe it would instead have to specify the conditions that would need to be met for rates to rise. Since the FOMC feels unable to specify an explicit numerical target for full employment, it is naturally reluctant to go down this route. On the other hand, additional maturity extension will become difficult once the Federal Reserve exhausts its holdings of short-dated Treasuries. There is some flexibility in the balance sheet to provide more 'Twist', but not much, unless the Federal Reserve is willing to now sell all Treasuries with maturities up to four or five years.

More likely, in my opinion, is additional unsterilized quantitative easing, or QE3. Recall that QE1 and QE2 were initiated when inflation was not perceived to be a threat. The current inflation projections mean that additional QE would meet that requirement today. The current consensus is that QE3, if it happens, would come in the form of additional MBS purchases, given recent focus on the role of the housing market as an obstacle to economic recovery. Should the Federal Reserve initiate an additional MBS purchase program, one would anticipate the 10-year Treasury sector to benefit the most as sellers of mortgages look to replace MBS duration sold to the Federal Reserve. A potential replacement of the maturity extension program with a renewed MBS program could thus reduce the heavy demand for 30-year Treasury paper, and benefit the 10-year sector, permitting a steepening of the 10s / 30s curve.

At the same time, of course, we should note that QE1 and QE2 programs did eventually permit Treasury yields to rise, as the liquidity provided arguably worked through both the portfolio balance and inflation expectations channels to reduce investor demand for Treasuries in favor of other asset classes. Should the same dynamic occur, one would expect high quality credit sectors to also benefit on a relative basis.

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