

Research

US: Fed up with QEII

- **Markets over interpreted the August FOMC statement - QEII is still not a done deal**
- **Whether we will get a new round of easing is a close call, but it will take time for the FOMC to agree.**
- **We think it will take a continued weakening in the labour market, an ISM below 50 or a significant decline in inflation expectations to trigger the Fed**
- **Generally we attach a 40% probability of a new round of treasury purchases**

Quantitative easing II not a done deal

As we have highlighted earlier markets seems to have over-interpreted the dovishness of the latest FOMC statement. Information received since the release has generally painted a less worrying message than the impression obtained from the statement. In particular, the balance sheet status quo reasoning for reinvesting the MBS and agency proceeds has been stressed several times, most recently in the FOMC minutes.

A key takeaway from Bernanke's speech at the Jackson Hole conference was of the three policy options mentioned for further easing, (1) carry out additional purchases of longer-term securities, (2) modify the Committee's communication, and (3) reduce the interest paid on excess reserves, with a cost-benefit analysis favouring the first option. The key question is what could trigger such purchases and when this might that happen.

Agreement will take time

Firstly, it is worth highlighting the internal disagreement within the committee. While Bernanke is on the dovish side of the camp, other members seem more hesitant, as indicated by the following extracts from the FOMC minutes

“A few thought that the economic effects of reinvesting principal from agency debt and MBS likely would be quite small”

Trigger points for Fed to engage in large scale quantitative easing II

| Last datapoint before rate cut | Nov-02 | Jul-95 | Trigger point | Current |
|--|--------|--------|---------------|---------|
| ISM | 49.0 | 45.9 | <50 | 56.3 |
| Unemployment rate, 3M change | +0.2 | -0.2 | >+0.3 | -0.4 |
| Private payrolls, 3M average change | -273K | +120K | <0K | +51K |
| Real personal spending, 3M change AR | -0.4% | 5.3% | <1.5% | 2.0% |
| Michigan 5yr inflation expectations, 6M change | -0.4 | -0.1 | <-0.3 | +0.1 |

Source: Reuters Ecowin and Danske Markets

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“A few members worried that reinvesting principal from agency debt and MBS in Treasury securities could send an inappropriate signal to investors about the Committee's readiness to resume large-scale asset purchases”.

This implies that it will take some time for the FOMC to agree on implementing additional QE. Hence, any major policy actions are not likely before we get closer to year-end, with the December meeting likely the earliest candidate.

What could trigger the Fed

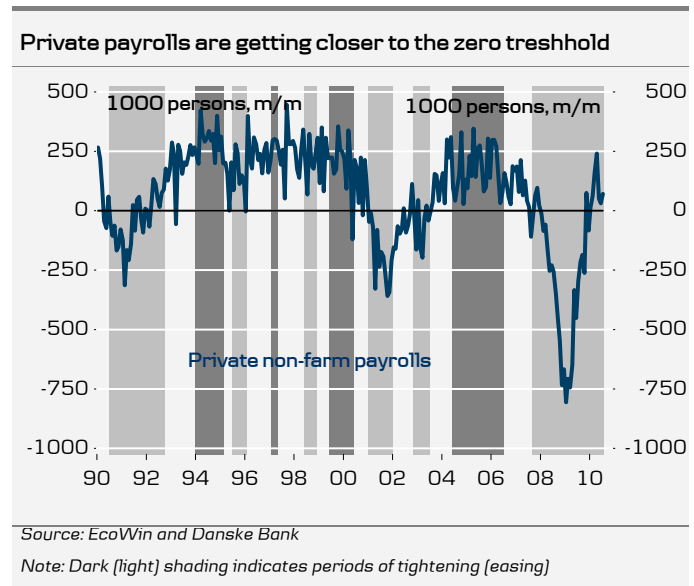
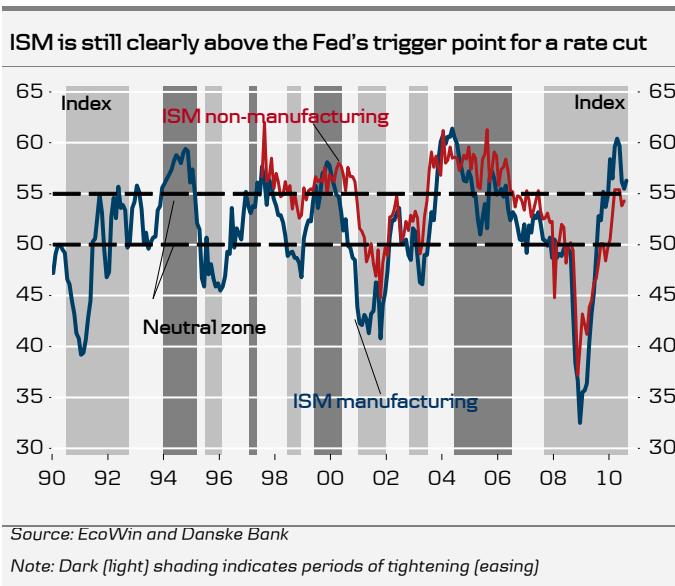
Whether the Fed will eventually introduce further QE is a close call. In order to better judge what the triggers could be, we have taken a look at the “usual” key indicators. As we do not expect the current slowdown to spiral into a recession we think the best benchmark are the slowdowns in 2002 and 1995.

In late 2002, just before the easing cycle was resumed cut, the labour market was weak with private payrolls printing negative numbers and the unemployment rate rising. At the same time, the manufacturing sector was slowing but not dramatically and the ISM had dipped just below 50. In our view this is probably the period which most resembles the current, suggesting that developments in the labour market will be key.

In mid 1995 just before the first Fed funds rate cut, the manufacturing sector was in a significant slowdown with the ISM at 45.9. Opposite, the labour market and private consumption was holding up.

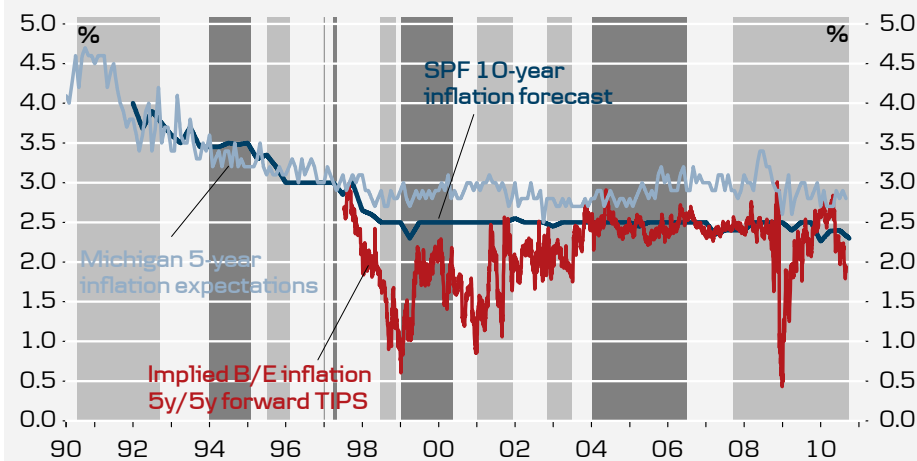
This suggests that a more significant deterioration in the manufacturing sector, with the ISM falling below 50, and/or a continued slowdown in the labour market with average private payrolls growth at zero and rising unemployment are likely triggers. Another potential trigger could be a substantial decline in inflation and inflation expectations.

Further, Bernanke’s speech highlighted that a key element in his expectations of a continued recovery is private consumption growth. Hence a large disappointments in retail sales and personal spending could also tilt the balance towards more easing.



The hurdle might be higher this time around, as there is more disagreement on whether additional easing will have an effect compared with a situation where the Fed could use the standard interest rate instrument. On the other hand, given that employment is high and fiscal policy is close to impotent, the doves in the committee are likely more positive towards using monetary policy to secure a sustained recovery.

So far limited signs of a declining inflation expectations



Source: Ecowin and Danske Markets

Overall, we attach a 40% probability that one of the above triggers will be activated, leading to a new round of treasury purchases. In that event, we expect the intervention to be large-scale, as the Fed would want to secure a positive market reaction.

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